# Introducing a Transformational Process for Optimizing Private Company Value

A White Paper for Lower Middle Market Business Owners, Managers, and Investors on a Process for Optimizing a Private Company's Value

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## Introduction

The Private Company market place has grown significantly over the last few decades. While there are likely others, reasons include:

1) The increasing cost of compliance for publicly traded companies has led numerous companies to de-list. The regulations and scrutiny placed on public companies is often prohibitively expensive.
2) Not too long ago, companies needed to trade on public markets to raise growth capital, but today an abundance of capital available in private capital markets make this less necessary. Only the very largest and fastest growing firms need the liquidity provided by public markets. The majority can thrive without an IPO.

While excessive regulation is often counterproductive, there is an upside to constantly being under a microscope. Publicly traded companies are required to report their financial performance appropriately and to use professional managers to ensure they are creating value. Private companies, however, don't have the same stringent reporting requirements. And they often don't have incentive at all to articulate the value they are creating in the market unless a sale or large capital raise is imminent. Even with audited financials many of them come far short of understanding the value they might be creating (or destroying) and road-mapping a path to their optimal value. While many private company owners look only to profit margin to understand their value creation, many of them may be destroying value. By "destroying value" we mean that a company is earning less of a return on its assets then it could with those assets deployed elsewhere. If this is the case, the world and the company's owners are worse off because the company keeps its doors open.

We believe that thousands of private companies across the world are operating far below their optimal value. Developing a roadmap to optimize that value will not only increase the wealth of the company's owners but also of the surrounding community - which will benefit from higher quality and/or better-priced products and services. We see massive opportunities for business owners, managers and investors to reap the benefits of increased wealth and also to build private markets that enhance the lives of customers, employees, vendors, and communities. The massive wealth transfer that is only beginning as a large baby boomer generation seeks to retire and exit their businesses only amplifies these opportunities.

Emerge Dynamics brings to the market a unique approach for evaluating and managing the performance of private companies that roadmaps the path to optimizing value. We believe this process can better inform:

1) investment decisions for those seeking to purchase companies (our process works equally well for private equity investors or strategic buyers looking to expand their footprint); and
2) management team actions as they increasing build their business intelligence and situational awareness so they can optimize their organization's value.

Or process involves three deeply interdependent focus areas. We believe these areas together bring a process to the private company value creation space that is usually absent from investment, valuation, and management decisions.

## The Valuation of Private Companies

The valuation profession falls far short of providing the insight needed to either bring a private company transaction to a close or to guide managers on paths to optimize their value.

From a transaction standpoint, typical valuation reports fail to consider whether a transaction would happen as an asset sale or stock sale and the numerous repercussions of each. They also fail to consider how or if a transaction could be financed. For example, three buyers may each offer $50,000,000 for a company. Buyer one might offer the entire purchase price up front, the second may offer half of the purchase price up front and then the remainder over time, and the third may offer only 40% of the purchase price up front, the remainder over time, and the ability to earn even more after the transaction should the company later hit certain milestones. While it may seem that the first buyer is clearly offering the best deal, there are many other variables that may make the second or third options more valuable for the seller. The typical valuation report is completely silent on this issue.

And from a path-to-optimize-value standpoint there is almost a complete void in the marketplace of trusted voices. While one likely wouldn't expect a valuation report or a valuation practitioner to be the architect of a company's strategic plans, the diagnosis of the maturity of a company's operations is so pivotal to the price and multiple that ends up getting paid in a transaction, that it is amazing the valuation profession has gone this long without a formal framework. The maturity of a company's operations (also called "Company Specific Risk") is a factor that is so sensitive that it often trumps all other adjustments in a typical valuation report combined. Business owners often become so focused on achieving the same transaction multiple their peers have achieved, but often have no idea why a buyer might pay one multiple versus another. Transaction multiples used by valuation practitioners are often the mean of a peer set and no consideration is given for standard deviation around that mean. A mean of 6X EBITDA may be the advertised multiple, but actual transactions may have occurred between 4.5X and 7.5X. A serious valuation study should dig into what drove the difference between the transactions at either end of the range and where along the spectrum a particular company might fall if it were to sell.

Even companies with identical cash flows can have drastically different values. While there are numerous examples of this, a couple of examples will suffice here. Imagine we have:

<u>Scenario 1</u>

Consider Company A and Company B which are both in the exact same industry.

Company A has $10,000,000 in sales, $1,000,000 in operating cash flow, and the founder is an industry all-star with talent not seen before in the industry. He doesn't need strong managers to run the company.

Company B has $10,000,000 in sales, $1,000,000 in operating cash flow, and the founder is talented, but assisted by two general managers who were trained by the founder and follow a process of systematically finding and closing on new business.

Which one would you pay more to buy? A or B?

Scenario 2

Consider Company A and Company B which are both in the exact same industry.

Company A has $10,000,000 in sales and $1,000,000 in operating cash flow.  The founder of the company is proud of his new client which has a nationally recognized brand and makes up $4,000,000 of the $10,000,000 in sales.

Company B has $10,000,000 in sales and $1,000,000 in operating cash flow. The company has numerous clients, none of which are larger than $1,000,000.

Which one would you pay more to buy? A or B?

Emerge's exhaustive process take all of this into account. Those buying businesses will better understand what to pay and how to pay it. Those running businesses will better understand why a buyer might pay what they would and how to increase that number well in advance of a transaction that they can transact at the upper end of the multiple range when the time does become right for a transaction.

## Measuring the Value Created by Private Companies

When we review financial performance with managers of middle-market private companies we find, with few exceptions, that their focus is almost exclusively on their income statements. "It's all about profit," they say. "It's all about the bottom line." In practice many chase revenue, even unprofitable revenue, but most understand that profit is necessary and that increasing it is a good thing.
We believe, however, that even if we are only talking about financial performance and not societal value, it isn't all about profit. Profit is very important, but there's more to it than that. And some of the pieces of the puzzle can be found on the balance sheet.

Here's one example we often run through with businesses we work with:

Suppose we have Company A and Company B, both in the same industry and making similar products. They each have $10 million in revenue and $1 million in profit. Company A creates its profit with $10 million in assets (machinery, accounts receivable, inventory, etc), while company B creates the same profit with only $5 million in assets. Which one is creating more value?

Hopefully it's clear to see that Company B is creating more with less and would have a higher market valuation. Its owners only needed to invest $5 million to create their profit, while the owners of Company A needed to part with twice as much to get that same profit.

An exhaustive assessment of the value a private company is creating involves some more involved calculations that are best explained in their own paper. However, if consideration is not given to the capital required to create the profit, the analysis falls far short.

Emerge Dynamics employs numerous tests, including evaluating appropriate levels of ROA, ROA, EVA, EBITDA Margin, and Cash Cycles, and Solvency Ratios, to build the picture of the where the company is and where it could go.

## A Purpose-Driven Path

While a quick Google search will reveal that even among business gurus there is still confusion about whether a company's purpose statement, mission statement, or vision statement define its "why", there is general agreement that people want an inspiring "why" to go with their "what" they do at work each day.

Simon Sinek, author of Start With Why, lays it out well:

"Studies show that over 80 percent of Americans do not have their dream job. If more knew how to build organizations that inspire, we could live in a world in which that statistic was the reverse—a world in which over 80 percent of people loved their jobs. People who love going to work are more productive and more creative. They go home happier and have happier families. They treat their colleagues and clients and customers better. Inspired employees make for stronger companies and stronger economies."

A recent Harvard Business Review Article confirms this:

"Lots of Companies give lip services to having a mission – a goal beyond bottom-line results…Researchers analyzed 450,000 survey responses collected by the Great Places to Work Institute at 429 U.S. companies, probing whether people feel their work has meaning. 'The actual purpose of the company can differ wildly', the researchers write. 'All that matters [for our study] is that it focuses employees on a goal beyond profit-maximization"

When an organization aligns around a purpose-driven mission, communication works better, team members make smarter autonomous decisions, and customers start to understand why they should keep coming back. Recruiting talent even becomes easier as a company that is living a vision founded on a purpose-driven mission will almost automatically filter out those not in alignment.

It may seem ironic to recommend to companies struggling with profitability that they stop chasing profit. Once we understand that the purpose for our organizations is something much deeper that fills the needs and wants of those in our communities, things start to fall into place - and so does the profit.

All of Emerge's processes and engagements engage around the "why". We identify the current "why" throughout our valuation and assessment process. Often there is a "why" that the current management isn't even aware of. Then, through a purpose-driven strategic planning process we map out the places the company can and should go to increase its profitability and its impact on those it does business with. We constantly iterate, inform and measure the company's progress as it moves toward its maximum value.