VALUATION

The Valuation Business: A Strategic Road Map for Success

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The next time you bring your car to the dealer for an oil change, you may notice that the dealer has provided a "complimentary" multi-point inspection of everything from the car's belts, fluids, and tires, to brakes, shocks, ball joints, exhaust system, and so on. It used to be that you had to pay a hefty tune-up fee for that type of diagnostic service, but the dealers realized that a slightly different process could generate new opportunities without requiring any significant extra time on the lift.

Now, it's time for the business valuation industry to make its own evolutionary step in the services it provides. As is the case with other professional service industries, the valuation industry is beginning to shift toward commoditization. As owners are shopping for valuations on price and turnaround time, valuators should become more conscious of the need and opportunity to provide value-added services, which could generate significant follow-on consulting work.

As valuators, we are in the best position to provide business owners with valuable insights as to how to increase their business value in a methodical, measurable manner. We have the "car on the lift," and we are merely changing the oil and sending them home.

There is a way, however, for us to be a more time efficient, more impactful, and more profitable valuation process: one that also creates significant follow-on opportunities to help the business owner implement value-building initiatives.

For most of us, valuation prospects generally fit into the categories of privately owned businesses with revenues from $5 million, up to about $100 million, often referred to as the lower middle market. Of course there are exceptions at the high and low limits, but our discussion will focus on the market segment described.

Let's first consider the magnitude of the opportunity at hand. As indicated in Exhibit 1, the lower middle market is comprised of approximately 350,000 companies, which collectively generate nearly $6 trillion in annual sales and employ nearly 30 million people, or 25 percent of the entire U.S. employed workforce (Exhibit 1). With that particular segment of companies in mind, overlay the following market dynamics:

- Experts in the exit planning industry estimate that more than 70 percent of all private company business owners will attempt to exit their businesses by about 2030, creating an oversupply of companies for sale, depressing valuations, and resulting in many companies ending up in liquidation.
- Empirical research conducted by the Pepperdine Private Capital Markets Project indicates that approximately 40 percent of all companies that are brought to market do not result in a transaction, with the largest reason for failure being a value gap in the expectations between buyer and seller. Additionally, the majority of companies that do transact include some type of seller concession in the transaction, such as contingent earn outs, reduced valuations, seller financing, or owner retention of some equity.
- Recent reports indicate that approximately $328 billion of private equity capital is currently idle in the U.S. because there are not enough attractive companies in which to invest. As recently as January 2013, that total was estimated at $400 billion, and reports are beginning to appear that private equity firms are being asked by their limited partners to return non-invested capital.

EXHIBIT 1: TOTAL U.S. MARKET

	Sales Range	# of Cos (thousands)	%	Sales $ (trillions)	%	# of EEs (thousands)	%
Micro Market	< $5M	5,678	93.9%	3.57	12%	34,764	29%
Lower Middle Market	$5M - $100M	351	5.8%	5.84	20%	29,712	25%
Upper mid mkt and above	> $100M	21	0.3%	20.33	68%	56,128	47%
Total employer firms		6,050	100%	29.74	100%	120,604	100%
Non-employer firms		21,708		0.99			
Total all firms		27,758		30.73			

Source = United States Census Bureau – Statistics of U.S. Businesses, 2007, last revised August 22, 2012.

No matter how you slice it, there is a large, and likely growing, disconnect between business owners wanting to sell and investors wanting to buy. Therein, exists a large opportunity to facilitate the marketplace and generate significant new revenue streams in the process. So, how can we, as valuators, take advantage of the opportunity?

The key is to start recognizing, and monetizing, the strategic value inherent in our expertise as business valuators. Rather than viewing our practices through the retrospective lens of compliance and past value, begin to view them through the prospective lens of helping business owners to build future value. As valuators, we are in the prime position to help business owners to understand both their current values and their potential values, and to provide them with road maps to move toward their potential.

We can be the catalysts for changing business owners' behavior, by mentoring them up the value scale to become more attractive to private equity, or other acquirers, in the future. We can facilitate the marketplace by driving a higher rate of successful exits, and at higher valuations. In the process, we have an opportunity to significantly expand our service offerings, creating new revenue streams for our firms, and establishing collaborative relationships with other functional experts that could lead to even more referrals.

Even if our clients are not interested in preparing for an eventual exit but, rather, just want to operate their businesses in the most productive, sustainable, value-creating manner, a new approach by us can be invaluable to them. Operating in a manner that would optimize a company's exit value means that the company is always ready to be opportunistic.

The process shouldn't be difficult for us, as it can flow from methods that we already employ in nearly every engagement. Specifically, by enhancing the process we follow for the income method of calculating value, we can convert our efforts to focus on building future value. We already exert significant effort in assessing a wide range of attributes of our valuation clients, for purposes of developing costs of capital to use in our discounted cash flow analyses. Most often, however, our documentation lacks

a clear and transparent link between our assessments of individual attributes and their impact on our value calculations. Make the link and you open a whole new world of strategic valuations.

Most private companies have an opportunity to increase their value by 70 percent–100 percent within three to five years, with our help, if we start using our valuation expertise in a strategic manner. How, you ask? Think unsystematic risk: company-specific risk, industry-specific risk, and even, to a large degree, size risk, sometimes collectively referred to as "company-specific risk" in various combinations depending on the expert with whom you are speaking.

Identify the factors that drive unsystematic risk premiums in your clients, develop initiatives for your clients to undertake to mitigate such risks, and indicate to them the incremental value that they could achieve if they successfully complete the recommended initiatives. In my work, I refer to the process as "strategic valuation" and the product report as a "value road map." Although it might require some up front effort to develop your own process, once you have a repeatable process mastered, it could make your valuations more time efficient, more defensible, more impactful, and more profitable.

A major byproduct of educating your clients about how to increase their value is that many will turn to you for help implementing your recommendations. Your valuation clients could become value growth clients, generating new revenue streams for you during the subsequent three to five years, with engagements for annual valuation updates to measure and monitor progress. The value growth revenue stream could far outweigh the initial valuation fees, and elevate your reputation as an elite practitioner.

GROWING YOUR OWN STANDARDIZED PROCESS

Various valuation experts have developed new approaches to calculating cost of capital, including several who have focused specifically on approaches to assessing company specific-risk. Among them are Gary Trugman of Trugman Valuation Associates and Warren Miller of Beckmill Research. Each proposes a different set of factors to be assessed, and a different method of building the assessment results into the determination of company-specific risk.

While many firms have valuable approaches and methods, the variation I am suggesting establishes a dynamic and transparent link between the factors that are being assessed, and the calculation of company-specific risk.

Below is the formula my company used to develop our own strategic valuation process; a road map for road mapping, so to speak. It provides a good framework for customizing your own standardized process and, although it might seem a little daunting at first, the long-term benefits can be compelling. In our practice, it has reduced our time to conduct a full certified valuation by more than half, while providing added value to clients and generating significant follow-on consulting engagements.

Strategic Valuations: A Three Step Process for Success

STEP ONE: THE ASSESSMENT

Think of your client as a series of interdependent modules that can be separately assessed and strengthened. Although you can segment the company any way you wish, we use eight specific major modules, which we believe best represent the primary areas of any company, each area being equally important to the overall sustainability of the company. Our eight major modules are as follows:

Planning	:	Leadership
Sales	:	Marketing
People	:	Operations
Finance	:	Legal

Each of the eight major modules can then be subdivided for easier assessment and management. As an example, we use the following sub-modules for our finance module:

Finance
Finance Team
Finance Strategy
Planning, Analysis, Reporting
Financial Stability
Balance Sheet
Internal Controls
Information Systems
Risk Management

You can use any sub-modules that make sense for your client base, and there is no magic to the number of sub-modules used for any major module. It will likely vary slightly by industry. Once the company is appropriately sub-divided, develop a set of questions to assess the client's position within each module, the answers to which will form the basis of your value road map.

Developing the question set the first time can be a significant effort but, once developed, it can become your standard assessment questionnaire that only needs to be revised for different industry nuances. The key is to consider categories

of potential risk that cover all areas of the company in a balanced manner, and then to tailor your question sets to assess such categories. Use whatever categories you believe are appropriate, but be careful to make sure they cover the company with enough breadth and depth.

The questions can be developed or adapted from a variety of sources, beginning with your own expertise as a valuator, asking the many questions that you already ask. Published best practices from business magazines and trade journals also make great sources. Textbooks on managing any of the major module categories are generally readily available and can offer much content. Due diligence questionnaires can be obtained from M&A advisors or accounting firms. Books published by industry experts can also be good resources, and trade associations often have resources for their members on how to improve specific aspects of business operations.

STEP TWO: THE LINK

Once the questions are developed, create a standardized answer system that will provide a method of objectively scoring the answers. Just as your questions were developed in a balanced manner, the scoring of each category should also reflect balance. Some might assert that certain categories are more important than others, but be careful not to impose your own subjectivities on the process of determining relative category weights. There will always be some degree of subjectivity in the process, but a standardized, balanced, transparent approach will certainly go a long way to establishing credible results.

Your scoring system will then inform your determination of cost of capital and your calculations of value. Convert your scoring process to a company-specific risk factor, and you have the missing piece to your build-up of cost of capital.

STEP THREE: THE ROAD MAP

Once the weaknesses are all identified through your scoring system, it's time to create the road map and link it to yourvaluation outcome, so that you can conduct "what-if" analysis and communicate the impact of individual recommendations on overall value before they are ever undertaken by your client.

In order to make such an approach both credible and actionable, it should satisfy several conditions:

1. The questions and answers should be standardized, and should be broad enough to cover all categories of sources of potential company-specific risk, and deep enough to get a valid assessment of each particular category.
2. There must be enough questions (we use 400) to demonstrate that the impact of any one answer will not materially alter the overall result, so the valuator has some room for assessment error without rendering the result unreliable.
3. The link should be at the sub-module level, rather than at the major module level, creating transparency as to how each sub-module affects overall value.
4. The links should be dynamic, so that the sensitivity of every sub-module can be immediately understood, and so a plan of action to maximize business value over some time period can be developed in a measurable manner.
5. The process must be simple, easy to execute, and easy to understand, for the valuator, the client, and any other interested reader.

To build the road map, first rank the weaknesses in order of priority to be addressed. We recommend a three-level priority process.

Level One would be the highest priority, reserved for initiatives that are most critical to *protect* the viability of your client, no matter what its growth objectives. Level 1would include issues such as lack of adequate insurance, poor legal structure of the entity, lack of safety procedures, and the like.

Level Two would be second priority, and would include issues that, although not threatening to your client's viability, would *enhance* its quality, efficiency, and overall value, even if no growth plans are contemplated. Level Two would include initiatives such as improving the company's organizational structure, product marketing and branding, incentive programs, and systems of internal controls, among others.

Level Three would represent initiatives that might only be addressed if your client was contemplating significant growth within the next couple years, and needed to position itself to be able to support such growth. Level Three would include such initiatives as making sure the organization can scale to effectively accommodate growth, establishing an outside board of directors, and ensuring that the appropriate financing is available to support the growth within the company's targeted capital structure.

CONVERT YOUR CLIENT TO THE IMPLEMENTATION PHASE

At this point in the process, you've

finished the valuation engagement, developed a more substantive and credible process for calculating cost of capital and overall value, and provided added value to your client through your value road map. Now, it's time to convert your client to an implementation engagement, and help them maximize their value over the next 2 to 5 years.

Based on the priorities established through the above process, work with your client to develop initiatives (the value road map) to address the identified weaknesses, and offer your services to help manage the implementation. Once your clients begin to understand the value they can create, and begin to see the impact of the first one or two initiatives on their businesses, you should become their trusted resource for business improvement and value growth. Some initiatives (Level One) will be a priority to complete within 6 to 12 months. Others (Level Three) may have a timeline of 3 to 5 years.

A recent client underwent our road mapping process twelve months ago, after many years of languishing at the $10M annual sales and $500K EBITDA levels. Our process resulted in them innovating their customer interaction procedures, their market positioning, their mission statement, their employee development program, and other intangibles that have collectively had a giant favorable impact on their growth opportunities, on their customer and employee relationships, and on the overall value of their enterprise. Energy and morale in the company have never been higher, customer relationships have never been stronger and, in 2013, the company has generated a sustainable 20 percent growth in revenue and 60 percent growth in profitability. As their advisors, we generated nearly $50K of new consulting fees relating to the initial process and its implementation, with more opportunity to follow next year.

INTRODUCE THE VALUE ROAD MAPPING PROCESS

If your clients have never undergone a value road mapping process, they should do so as soon as possible. If you have already developed a value road map for them at some recent point, then you should update your assessment and revise your road map on an annual basis, to measure their progress and recalibrate their map.

Value road mapping can become a standard part of your valuation process, as is has with ours, serving as the support for the income method and much of the client survey. It is also a critical part of any effective management transition planning, or long-term exit planning. If the company is underperforming, a road mapping process will generally identify all the weaknesses that are causing the underperformance, and will give you a great framework within which to fix the problems and elevate company performance.

Additionally, if your client contemplates making acquisitions, raising new capital (debt or equity), or selling a product line, or a division, or exiting the company, having a value road map will make them much more attractive to the party on the opposite side of the contemplated transaction.

Lastly, if your client is contemplating rapid growth, a value road mapping process can be critical to their success in managing the growth challenges. There have been countless companies that have crumbled under the pressures of rapid growth because they didn't have the proper infrastructure to support the growth initiatives.

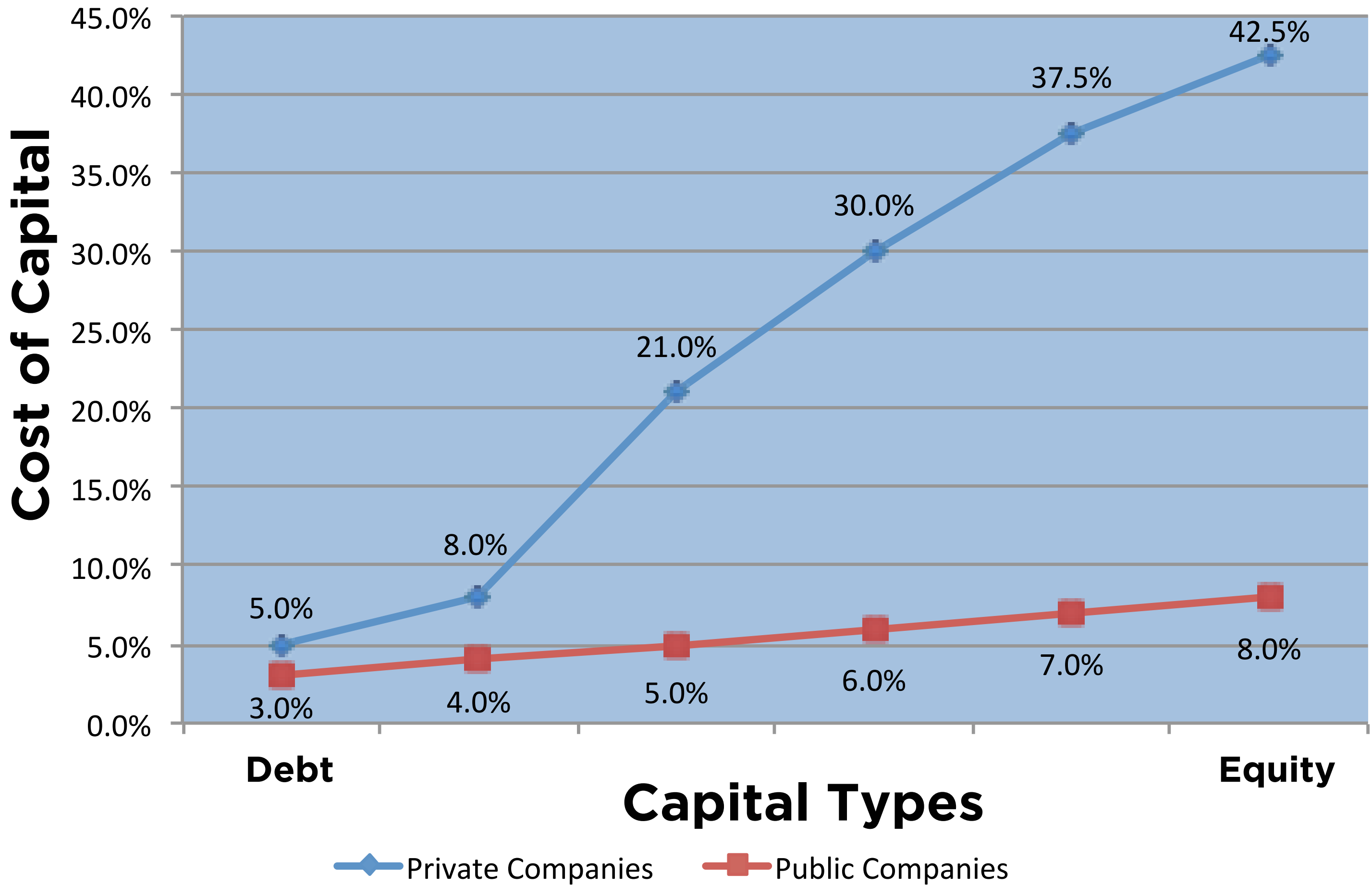
TECHNICAL RATIONALE

There has been much debate about unsystematic risk, and to what extent it should impact the valuation outcome. There are lots of different opinions, explanations, court rulings, etc., covering its appropriate range, how much should be considered unavoidable, how much might already be covered in other measures such as projected cash flows, how to assess it, how to measure it, and how to defend our determination of it. Each specific topic could be the subject of a separate thesis, and I will not attempt to tackle every debate in one article. So, let's step back and think about unsystematic risk from a slightly different, simpler, perspective.

In any company, there are only two general categories of risk that impact value through the calculation of cost of capital: systematic and unsystematic. If systematic risks are, by definition, outside of the control of the business owner, because they are driven by the broad public market, then unsystematic risks must, by definition, be within the control of the business owner, because they are not driven by broad public market factors.

Some risks, such as the basic equity market risk, are only systematic in nature, while others, such as customer concentration, for example, are only unsystematic in nature. Some risks, however, such as those relating to industry, size, and even liquidity, might have both systematic and unsystematic characteristics. By recognizing such mixed risks, we can more accurately assess their impact on our clients' values, and can do more to help clients mitigate them.

EXHIBIT 2: THE PEPPERDINE PRIVATE CAPITAL MARKET LINE



For example, the high rate of technology obsolescence in the cell phone industry (industry risk) might appear to be purely systematic. However, a cell phone component designer/manufacturer might be able to mitigate some of that risk by developing a robust product innovation program, and working with the original equipment manufacturer to ensure that its components remain relevant. With such a program in place, the industry risk could be treated, at least partly, as unsystematic (controllable), rather than systematic.

As another example, the small company size risk premium is generally assigned as a systematic factor. However, within any given size bracket, any particular company could be structured, and could operate, at a higher quality level (lower risk) than its standard size bracket would dictate. It would likely not be able to function several levels above its size, so it could not entirely eliminate its size risk premium, but some degree of the risk is certainly within its control to mitigate.

In order to understand the magnitude of the unsystematic risk components in private companies, consider the research of Robert T. Slee, author of the textbook *Private Capital Markets: Valuation, Capitalization, and Transfer of Private Business Interest (2nd edition: John Wiley & Sons, NJ, 2011)* in which he presents a depiction (Exhibit 2) of the relative costs of capital for private companies versus public companies.

In the above graph, the public company line depicts the cost of capital

as the company moves from an all debt capital structure (3 percent) to an all equity structure (8 percent). The private company line, on the other hand, depicts the relative costs of different sources of capital by themselves, as follows:

5%	=	banks
8%	=	ABL
21%	=	mezzanine
30%	=	private equity
37.5%	=	venture capital
42.5%	=	factoring

As Exhibit 2 indicates, the cost of capital for a private company can be four to five times the cost of capital of a public company. To demonstrate the impact of such a difference on a company's value, suppose a company is generating $3 million of cash flow per year, has no debt, and is expected to grow at 3 percent per year for the indefinite future. At a cost of capital (discount rate) of only 8 percent, that company would have a terminal value of approximately $60 million. However, at a cost of capital of 40 percent, the same company would have a terminal value of only approximately $8 million; a whopping difference of $52 million.

A quick look at the public market bears out the above disparity. The S&P 500, which represents about 75 percent of the U.S. public equity market, is currently valued at an overall multiple of approximately 19 to 20 times the collective earnings of its members. However, in the private sector, many lower middle market businesses are being sold for multiples of only three to five times earnings, demonstrating the huge difference in values of public versus private companies.

Why the huge value disparity? Roughly a third of the difference relates to a combination of the systematic portion of the risk premiums for liquidity and size that are borne by private companies. The other two-thirds, however, relate to unsystematic risks that are within the control of the business owners and, therefore, within our purview, as their advisors to help mitigate.

In his textbook, Robert Slee explains that "an investment in a private company is typically riskier than an investment in a public company" because the private company's company-specific risk is perceived to be much higher than that of a public company. Why? Public companies are required to be more transparent, typically have better developed organizations, more fully developed strategies, and better systems, to name but a few factors. In short, they are perceived to be better managed and are, therefore, less risky and worth more than their private company counterparts.

How can a private company begin to close the gap? Slee points to characteristics such as, "Does the company have the look and feel of public companies in its market segment. [Is there] credentialed management depth? [Is there] an active board of directors? Has strategic planning been developed to implement both short- and long-term goals? [Could] all public reporting requirements, especially in the financial area, be met with timeliness? Does the subject company perform financially above the average in its market segment?" These are just a few of the many characteristics in which public companies are typically superior to private companies.

The opportunity for valuators, therefore, is to identify, understand, prioritize, and address the risks in our clients' businesses that would create the most value by their mitigation, and to develop value road maps for our clients to methodically build value in their businesses by reducing the risks that are depressing value.

The Morningstar build-up model presented in Exhibit 3 will help to clarify the components of the opportunity for us and our clients. Although the percentages used in the table are slightly different than the percentages reported in the Pepperdine Private Capital Market Line above, the differences, which reflect the most recent data available, do not materially affect the overall analysis.

EXHIBIT 3: THE MORNINGSTAR BUILD-UP MODEL

Range of Controllable Risk Premium

		Source
risk-free rate	2.41%	Morningstar 2013 valuation yearbook
equity risk premium	6.70%	Morningstar 2013 valuation yearbook
public company cost of equtiy	9.11%	Morningstar 2013 valuation yearbook
35% liquidity premium	3.19%	various published pre-IPO studies
large private co that is public-ready	12.30%	
unavoidable size premium	8.90%	Morningstar 10th decile (10y) premium
small private comp that is public-ready	21.20%	
cost of venture capital equity	40.50%	Pepperdine Private Capital Market survey - 2013
difference = controllable cost of capital	**19.30%**	**unsystematic risk premium potential**

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Based on the 2013 *Morningstar Valuation Yearbook*, the risk-free rate and equity risk premium, combined, total 9.1 percent. Adding a liquidity premium for companies that are pre-IPO, about 3.2 points (35 percent premium), results in the cost of equity of a large private company that is public-ready, or about 12.3 percent. Lastly, adding a size premium of 8.9 percent for the Morningstar size bracket of 10y results in the cost of equity for a small private company that is public-ready, totaling 21.2 percent. Any incremental cost of equity above the 21.2 percent must relate to unsystematic risks.

If we view the range of potential unsystematic risk premiums as the difference between the 21.2 percent and the 40.5 percent reported as the cost of venture capital in the most recent Pepperdine study, we can then develop a method of assessing any given company's position within that range, since that is the range that is theoretically controllable by business owners if they change the behavior of their companies. As an aside, one could even assert that the actual range of costs of capital is even higher than the Pepperdine study indicates because the study only reflects actual reported transactions. The 40 percent of companies that attempt, and fail, to transact would, undoubtedly, have even higher costs of capital, but those companies have not yet been empirically surveyed.

You may notice my inclusion of the size premium above as the Morningstar 10th decile 10y premium of 8.9 percent, rather than the 10y premium of 11.65 percent, the latter of which covers companies up to about $96 million of value. The reason stems from my belief that a company that would otherwise fit the 10z category, if structured and operating with the quality of a company that fits category 10y, could warrant the lower 10y risk premium. In effect, a certain portion of the size premium should be considered as unsystematic (controllable), and a certain portion should be considered as systematic (unavoidable). In fact, I believe that using the overall 10th decile premium of 6.03 as the systematic portion might even be appropriate, which would increase the overall controllable cost of capital to more than 22 percent, versus the 19.3 percent above.

To continue the previous example, if our subject company with $3 million of cash flow could approach the risk profile of a small private company that is public-ready, and reduce its cost of capital from 40 percent down to even 24 percent, its value would increase from the $8 million range to almost $15 million, or an increase of approximately 80 percent. Not all companies, of course, will be starting from a cost of equity as high as 40 percent. However, I believe that most private companies in the lower middle market could increase their values by 70 percent, or more, over a three-to-five year period, by moving closer to the way a public-ready company is structured and operates.

We have the company on the lift. All we need to do is slightly change our process while it's there and the value we can add to our clients, and to our practices, is immense. VE

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