

Deal Me In

Value Creation



SCHNEIDER DOWNS

SD Capital

As growth and sell-side advisors, we work closely with business owners to help increase the value of their organization and guide them through the sale process. Business owners are often initially skeptical of how impactful the value creation process can be. However, doubters turn to believers as they witness tangible evidence of improved performance and find themselves optimally positioned for a downstream monetization event.

Laying the Foundation: What is Value Creation and Why Does it Matter?

Simply stated, value creation is the process of building both tangible and intangible value into the business. It can be measured in real dollars – that is, what is my business worth? The most widely used measure of value is Enterprise Value (“EV”). EV is the value of the entire company – the amount of consideration that a third party would pay to buy the company. EV includes not only the equity value of the company, but its term debt and cash reserves as well. It is calculated as follows:

$$\text{EV} = \text{Equity Value} + \text{Debt} - \text{Cash}$$

In an M&A transaction, a buyer is most often purchasing the equity value of the Company. Rather than assuming the debt and cash on the balance sheet, the deal is structured so that the debt and cash remain with the seller who has the responsibility for satisfying the debt upon close of the transaction. This is referred to as a cash-free-debt-free transaction. Formulaically, it can be expressed as follows:

$$\text{EV} - \text{Debt} + \text{Cash} = \text{Equity Value}$$

Now that we have started to lay the foundation, there is one more formula to discuss: the EBITDA multiple. Multiples of EBITDA (earnings before interest, taxes, depreciation, and amortization) are derived across industry or market segments to approximate the EV of similar companies within that segment. The basic formula for EV using a multiple of EBITDA is:

$$\text{EV} = \text{EBITDA} \times \text{Market Multiple}$$

This is the key equation underlying value creation. Market multiples are quoted as a range of value – for example, the range of value for companies in the IT services space may be 7 to 10 times EBITDA. So, an IT services company with an EBITDA of \$2 million could have an EV range of \$14 million (7 multiple) to \$20 million (10 multiple).

The goal behind value creation is to improve a company’s relative position along the range of value. For instance, in the example above, the IT services company would aim to move the multiple from a 7 to an 8 or 9. As improvements drive the multiple upward, invariably EBITDA (or profitability) is also positively impacted. Thus, value creation can positively impact both factors that drive Enterprise Value and create the basis for an exponential increase in value over time.

Adopting a Value Creation Mindset

Value creation is not a one-time exercise, but an ongoing business mindset or strategy. It is complimentary to mission, as a well-run company can provide increased value or upside to all stakeholders, including customers, employees, as well as the business owners. Improved performance and profitability, for example, can drive more opportunities for employees to advance as the company grows over time. And customers are positively impacted when companies realize efficiencies in delivery or invest more dollars in R&D.

The value creation mindset is fundamentally a paradigm shift that entails focusing more acutely on those specific activities that add value to the organization and baking that mindset into the company’s tactical and strategic orientation.

Many middle market companies lack a clearly defined strategy. While owners may have a vision of the future, they lack the ability to clearly define the steps and process to achieve that vision. Frequently, when owners have multiple initiatives in process, none of them seem aligned to a clearly defined strategy. With so many projects in play, very little—besides excess cost and frustration—gets accomplished. Establishing a firm strategic direction with an execution framework based on value creation can help define which projects to pursue and prioritize. Defining and pursuing the top 2-3 initiatives at any given time will help create focus within the organization, drive measurable progress and value and allow the company to celebrate success as it goes.

The Value Creation Process

The value creation process consists of two distinct steps: (1) assessing the current state of the business and (2) remediating identified gaps while implementing value creation activities.

Assessment

The value creation process requires critical thinking and analysis across the organization. An organization begins the process through the lens of a buyer and identifies areas most likely to result in discounting and a reduction of the purchase price in a sale transaction. It also identifies upside opportunities for value enhancement, such as repositioning a product or service offering as a recurring versus project-based revenue stream.

The assessment process is not just a series of “canned” questions, but workshops and one-on-one interviews coupled with data review and analysis across all key functions of the company. It includes a review of operations as well as support functions, such as marketing/sales, human resources/talent management and accounting/finance.

Areas analyzed may include the following:

- Business Development/sales structure and go-to-market strategy
- Customer concentrations
- Customer contract composition – status of key contracts and special preferences
- Decision-making processes (governance structure)
- Employee agreements, compensation, benefits, and incentives
- Financial reporting – GAAP v. non-GAAP basis statements
- Intellectual property and perfection of ownership interests
- IT/ERP environment and other key systems (CRM, project management, etc.)
- Key business processes (policies and procedures)
- Management team composition and structure
- Market size and positioning
- Operating cost structure – fixed and variable costs
- Organizational structure
- Revenue streams – nature and composition, recurring versus non-recurring, gross margin by product/service line, etc.
- Strategic planning/budgeting process
- Working capital maximization

The analysis of each area helps organizations identify a series of value gaps and value creation opportunities.



Gap Remediation and Implementation of Value Creation Activities

Next, organizations rank each of the value gaps or value creation opportunities identified as part of the assessment process based on impact, timing, and cost (level of effort). They then formulate a targeted plan to address each gap and value creation activity and decide on key performance indicators to track and monitor progress.

In most value creation exercises, businesses give the highest priority to low effort, high impact items. They rank mid-term and longer-term items based on relative return and establish a plan to move the effort forward. Although organizations can make significant progress in as few as 6 months, the ideal time frame to create measurable improvement often takes 12-18 months.

Working with one federal government contractor, we moved from a single to double-digit multiple of EBITDA prior to the sale process. Our work for this contractor included the following value enhancements:

- Establishing an achievable strategy and execution framework with goals/objectives that could be driven downward, throughout the organization
- Eliminating an unprofitable product line (and treating related costs as an adjustment to EBITDA)
- Reconfiguring the management team to reposition individuals based on their relative strengths
- Filling a back-office resource need that would better position the company as a platform company
- Building out a formal business development process and implementing a CRM/pipeline
- Reviewing compensation and incentives and establishing incentives that align with the strategic direction of the company

In the value creation stage, it is also critical to establish a formal feedback loop for the key performance indicators that were identified to monitor progress. This provides a means for measuring success and allows for mid-course corrections, as necessary.

The Impact of Timing on Value Creation

Just like preparing a home for sale, certain improvements can be accomplished in a shorter rather than longer time frame. With more time and investment, more impactful changes can be made to drive value and return on investment.

But what if a business wants to sell now? Or sell in 6 months? Would they have time for value creation to be impactful? There is indeed an interplay between timing and value creation. Certain value creation activities, such as entering a new market or fully productizing a revenue stream, are harder to accomplish in a compressed time frame. And, while market timing is impossible to gauge, some owners want to pursue a monetization event sooner rather than later. What does the value enhancement process look like in those circumstances?

Even on compressed timelines, value creation is beneficial. The activities in this process would concentrate most on items which can result in limiting the amount of potential buyer discount. Examples of this may include the elimination of unprofitable revenue streams, key employee identification and lockups, receipt of all assignments for IP, preparation of assumption-based annual budget and forecast, etc.

In addition, there is still value in longer-term value creation activities that owners will not have the time to implement before the sale. Organizations can incorporate these activities into the Confidential Information Memorandum ("CIM"), providing the buyer with a roadmap for how additional targeted investment can translate to tangible increased value over time. This can help the buyer develop a strong deal thesis and an upside scenario, which often translates to an increased purchase price.

Industry Specific Considerations

While certain value drivers cut across industries (solid management team, good and impactful data, recurring revenue streams, strong repeatable processes, etc.), others are industry specific. For instance, value creation in the federal government contracting space may include emphasizing prime versus subcontractor work, full and open versus set-aside work, establishing a competitive indirect cost rate structure, creating a dedicated business development and proposal team, and building a strong backlog and pipeline. Understanding industry-specific value creation activities is critical and should be incorporated into the assessment process.

DIY vs. Third-Party

While some companies may attempt the value creation process on their own, the effort is typically fraught with pitfalls. Because the key to value creation is being able to impartially evaluate the business through the lens of a buyer, leveraging subject matter experts and others who have seen multiple businesses, are familiar with the sale process, and have a clear understanding of best practices for a particular industry helps set the table for success. Further, the time commitment can be significant. Working on value creation while still driving the business can be difficult. Lastly, the value creation process can result in some hard decisions, including restructuring or eliminating certain positions. While owners may recognize the need to make those tough decisions, they still may find third-party validation and ownership of such actions desirable.

Consulting costs incurred during the assessment and value creation process are add-backs to EBITDA in the calculation of Enterprise Value. Thus, the cost associated with the value creation exercise has no negative impact on Enterprise Value.

Conclusion

Whether an owner is seeking monetization or just wants to develop a solid lifestyle business, the value creation mindset can provide benefits. It creates a solid foundation to achieve a vision, create and enhance growth opportunities and drive improved decision-making and financial results. In summary, if done correctly, the value creation process results in a better run and more valuable business, helping maximize dollars realized upon exit.

About SD Capital

SD Capital is a premier, full-service, value advisory and investment banking practice that assists middle-market companies in creating and maximizing business value. We provide strategic evaluation and execution of various downstream sales and monetization pathways. With decades of combined executive experience running, owning and advising private companies our team is uniquely positioned to guide owners through the complex process of growing and selling their companies. Learn more at www.sdcapital.com or contact the team directly at contact@sdcapital.com.

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