WALKING TO DESTINY

11 Actions an Owner **MUST** Take to Rapidly Grow Value & Unlock Wealth

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CHAPTER SIX

Value ~~Versus~~ AND Income

Work For Me
Liv Warfield

I started to think how to take some time
To live life and still have peace of mind
When you strive for somethin'
You can make it happen, yeah
That's the way of life
That's the way it is

So I am gonna keep my head in the sky
Put one foot in front of the other
And guide my life
In this life there's struggle
You gotta keep pushin', yeah
It worked for me
It can work for you too

Business value is the primary long-term goal, not business income. This sounds like a subtle play on words, but in reality, it is a major paradigm shift. Most owners of lower to middle market businesses have "lifestyle" businesses. Lifestyle businesses usually generate a nice income for the owner. But focusing on income alone doesn't mean the business has transferable market value.

This shift in thinking needs to permeate your entire organization. Teaching your employees about the importance of value versus income will bring a different perspective to the business decisions they make every day. The next time one of your managers asks to hire someone, invest in new technology, or buy new equipment, ask them, "What value does this add to the company?" You're likely to receive a blank stare. They won't know what you are talking about because most of them are thinking in terms of fulfilling orders, making product, or paying bills. They don't understand the concept of value creation. And why would they? Have you ever introduced the idea of value creation to them?

Not long ago, I held a meeting with Chad, a key sales manager for one of my clients. Chad proudly laid out his sales strategy to me. He noted that he had the chance to land a massive new customer that would add a significant amount of revenue for the company. Chad was well-informed; he knew his gross margin and he was fired up.

"What value does landing that customer create?" I asked.

"Uh, are you kidding me? It will add about $4 million in sales and about $2 million in gross margin."

"That's fantastic, congratulations," I said. "But what value does that customer create in terms of its impact on the value of the business?"

He looked at me, confused.

"Okay," I said, "let's take a look. You know this customer will add about $2 million in gross margin or about 50% of sales, yes?"

"Yes."

"What do you think the SG&A expenses will be to land and manage this customer?"

After working through the numbers, we came up with a number of about $1 million: about 25% of sales.

"So the net EBITDA for this client will be around $1 million dollars, right?" I said.

"Yes," Chad responded, highly engaged in this new look at client acquisition.

"Okay, great. And what multiple of EBITDA are we using to value the business?"

"I don't remember," Chad admitted, "But I know you did a business valuation when we started this process last year."

"No problem. We came up with five times EBITDA," I responded, "So what is the value of this customer?"

"$5 million?" Chad answered excitedly.

"Yes, $5 million!" I said, "The generation of $1 million EBITDA is wonderful, but the real value of the customer to the business is $5 million, assuming we set the relationship up so that it is transferable at some point in the future. Sounds like you should pursue it."

"You better believe I will," said Chad.

This concept of value applies across the board. Every time someone says they want to hire someone, you can easily figure out what it will cost in terms of salaries, benefits, and SG&A expenses. If you only concentrate on the expense, you may think twice about hiring that person, because on the surface, it looks like a pure expense. But if you go a step further by asking your team to think about the value being created, it forces them (and you) to think deeper. Consider these questions:

- How will this person impact sales, gross margin, or efficiency?
- What incremental income will be produced by adding this person?
- What is the difference between the cost and the benefit?

This difference between the cost and benefit, multiplied by your EBITDA multiple, is the incremental value. When you look at everyday decisions this way, you might be more apt to make the investment. You may be more willing to ride out the incremental expense for a while until the returns come in—assuming you know how to execute.

Looking back at "The Perfect Exit," when Flexalloy invested 2% of revenue in technology, we certainly didn't expect the investments to pay off right away. That was a lot of money to invest in technology. However, two years later when Andy went to sell the company, the technology was a huge part of why our corporate buyer paid a premium. It just so happened that the corporate buyer was using the same technology as Flexalloy. Only there was a big difference between their technology and ours: Our tech actually worked. Theirs was a mess. They looked at Flexalloy's technology and thought, "If we could deploy this technology in all of our divisions the way Flexalloy has, it will create huge synergies." And that's why the value created from the investments far exceeded the cost.

I teach a short workshop, called *Financials for Non-Financial Managers,* to educate managers about the impact of small everyday decisions on cash flow, profits, and value. I do this because building value is a team sport that requires a paradigm shift and culture change. The only way to really change your culture and get everyone thinking the same way is to integrate value thinking into what you do every day. You need to adopt metrics and reinforce this focused thinking in your daily huddles, your weekly management meetings, your monthly accountability meetings, your quarterly reviews, and your annual strategic planning.

Business valuation should be a mainstay of your business planning. Business value is the baseline measurement of success. You should re-value annually (at a minimum). Even better, do it semi-annually or quarterly. As you read on and learn to navigate the stages of value, consider how well you are integrating this shift in thinking into the daily decisions being made by your managers.

THE FIVE STAGES OF VALUE MATURITY

There are five stages to creating a more valuable business: Identify, Protect, Build, Harvest, and Manage. As you progress through each of the stages using Value Acceleration, your value grows. I call this Value Maturity.

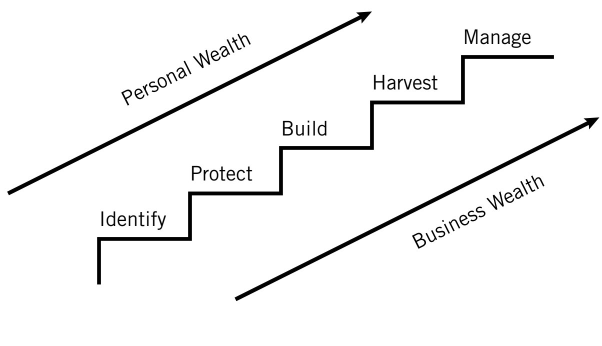

Exhibit J: The Five Stages of Value Maturity

IDENTIFY VALUE

Identifying value is always the first step and should never be skipped. It is completed in Gate One of the Value Acceleration Methodology. Understanding where your business benchmarks in the range of value sets the baseline for everything going forward. This is important for several reasons.

First, as you know, it is likely that 80 to 90% of your net worth is locked up in your business. Second, you need a system which is built to continuously focus your team on maximizing value. Third, the ability to unlock that value at some point in the future will make a significant difference to your lifestyle and, at exit, will fund your next act. Lastly, you need to know this valuation number for business planning, personal planning, and estate and tax planning purposes.

You should have your business professionally valued at least annually. The first time you do this will take a little work and expense. But thereafter, to keep score, you can simply update your most recent year's recasted financial statements; update your personal, financial, and business scorecard; and take another scan of the range of multiples in your industry. But really, you should be doing this continuously anyway. I'll go into this process at length in Section Three. For now, understand that the value of your business and how it benchmarks against others in your industry will identify the value factors that you should focus on to protect what you already have and accelerate the value of your business.

PROTECT VALUE

Once you have identified your baseline value, your next priority is to protect what value you already have by mitigating personal, financial, and business risks. Protecting value is accomplished by creating and implementing prioritized de-risking action plans. In reality, protecting value is the first step in building value. But due to its paramount importance to business owners, I recognize it as a separate stage of Value Maturity.

If you were to do nothing else, mitigating risk alone would improve your business value because valuations are based in part on the real and perceived risks from a buyer's point of view. Actions to reduce risk are common sense and the easiest to implement. You probably love the idea of growing your business, but before you get there, you are more likely concerned about the risks involved, especially if you are over 50.

Review the list below:
Which of these risks do you face from a personal, financial, and business standpoint?

PERSONAL	FINANCIAL	BUSINESS	
Death	Market Risks	Customers	Environmental/Safety
Disability	Diversification	Key People	Technology/Machinery
Divorce	Personal Loans/Debt	Business Interruption	Owner Dependence
Health	Personal Lawsuits	Economy	Data/Information
Accidents	Loss of Earning Power	Distress	Compliance/Legal
Family Tragedies	Long-Term Care	Partner Disagreements	Loans/Debt

Exhibit K: Risk Areas

Do you take mitigating your personal, financial, and business risks seriously? Ask yourself the following questions:

- Have I integrated risk management into my management model and personally today?
- Do I take risk seriously enough?
- How much am I willing to risk in order to grow?

Growth is not easy; it's also risky. To grow, you will likely need to put assets at risk (including personal wealth), take on debt, add people, add machinery, and expand facilities. You may need to strategically acquire another company. Understanding your tolerance for risk and willingness to complete actions that protect value is imperative before you begin building value through strategic growth investments. Consider the Five D's: Death, Disability, Divorce, Distress, and Disagreement. Most of us don't think these things will ever happen to us. But do you know that there is a 50% probability that you will be impacted by one of these Five D's? How prepared are you?

Several years ago, the landlord of a building I was leasing walked into the office to see me. We had become friends and I thought he was just stopping by to say hi. I had not seen him for a while and had been wondering where he'd been. He owned several businesses which were doing well and as such, he was well regarded by the business community for his success. He had a net worth of about $12 million and was only 42 years old. He sat down, and I could tell from his demeanor that this visit was not a social one.

"Chris, you will never believe what happened to me. I made a trip to my home in Florida a few weeks ago (note: this was only his third visit in the last five years because he was so busy all the time). I was really feeling run down and felt like I needed to get away before the busy season hit. As I approached the door, I got a sharp pain in my stomach and then I collapsed. I had to crawl into the house to get to a phone and I called 911. I ended up in the hospital for two weeks with an internal infection. I thought I was going to die. I'm here because I need to change my life. I can't do this anymore. I have to start taking care of myself. I want to start to divest by selling off my businesses, starting with the flagship. I can live off the real estate I own so I'll keep that. But everything else needs to go."

"Oh my God," I replied. "Are you okay?"

"No, I'm not. My life is a mess. The businesses are very dependent on me. I work all the time. I've alienated my wife and children. They wouldn't even make the trip with me."

"Wow," I said. "That's tough. I didn't know things had gotten that bad for you. I'm really sorry to hear that. But I think I can help you."

I explained the process we would need to go through and told him I would draw up the contracts.

After completing a personal, financial, and business assessment and determining where his business placed in the range of value (also known as the Triggering Event), we settled on a target selling price. But I told him I had concerns about his advisory team. His CPA was not cooperative and the process he was using to keep the books updated was ancient. I also noted he did not have a real wealth manager overseeing all his wealth. Everything was disjointed and unorganized. He had no written life-after plan or a financial plan reflecting the income he needed after selling off the businesses. And his attorney was someone he had been using since he started in business 20 years ago. The attorney had officially retired years earlier and was only doing his legal work to make some money on the side.

"The first thing we need to do," I suggested, "is upgrade your advisory team."

So I brought in a new CPA, attorney, and wealth manager who I had been working with through EPI's Northeast Ohio Chapter. The wealth manager, from a prominent local firm, explained that my client's personal financial planning was a mess, but he could get it together. We all got busy preparing him for his next life, starting with selling the flagship.

Over the next several months, my client was in and out of the hospital and his condition was getting worse, both from a health and personal standpoint. His flagship business was seasonal and with all the trips to the hospital, he had virtually missed it. As a result, his sales projections for the coming year were much lower. And because the business was so dependent on him, none of his managers were up to the task of managing the business. Things continued to decline.

I hurried to put a package together to get the business on the market. We agreed to use an auction process to get the business sold as fast as possible. Despite all of our efforts to maintain confidentiality, given the stature of this business in the NEO region, it wasn't hard for the strategic buyers to figure out why we were selling.

"I'm not touching that business," several potential bidders said, "I think I know who it is and he's going down."

The business world can be cruel when they know you are weak.

While this was all going on, my client's wife filed for divorce. This really complicated matters because two years prior, he had put 60% of the business in her name so that the business would qualify for special status when bidding on government work. She didn't have any involvement with the business, but now she and her attorney were quite interested. It was about this time that the real estate market collapsed, leaving his real estate exposed.

Then my friend disappeared. I couldn't reach him. I later learned that he had fallen into a coma and was unresponsive. After a month or so, he came out of it, but was in an extremely weakened state. With everything in his world collapsing around him, he declared bankruptcy and lost most of his $12 million estate. Today he is back; he is alive, but not the same man he was back in the day. His wealth is gone and so is his family and almost everything he once had.

This is a really sad true story. I share it with you because if you have not taken actions to protect your wealth, you could quickly lose it all, just like my friend did. This type of tragedy is never something you expect. But it can happen. It does happen. There is a 50% chance it will happen to you.

BUILD VALUE

I hope that story has compelled you to realize the importance of protecting value. Once you have, you can focus on *building* value.

The difference between protecting and building is that, in the Build Stage, you take a longer-term point of view, prioritizing more strategic actions to increase intangible capital over less strategic actions (a.k.a. de-risking).

Building value results from increases in cash flow (EBITDA) and improvements to your multiple. The multiple is the number assigned by the private capital market to the value of your tangible and intangible assets and the risks associated to your business. As I mentioned, protecting value is also the first step in building value. The second step is improving intangible capital. That is where the opportunity for accelerated value lies and where Value Acceleration can really help you.

Intangible assets are “knowledge capitals” and can be divided into four areas: Human—the value of your talent; Structural—the value of your systems and intellectual property; Customer—the value of your customer relationships; and Social—the value of your brand and culture. Understanding each of the Four Capitals (Four C’s) and how you can manage those value factors is critical in your value growth venture. They are broken down for you in Chapter 7.

HARVEST VALUE

At some point in your future, you are going to want to cash in or harvest the value of your business. I have specifically chosen the word "harvest" because it represents the activity of reaping, gathering, and storing something you’ve grown. As with any growing season, the completion of harvesting marks the end of the growth cycle for a particular crop. In this case, the crop is your business.

Considering your exit options, you may have decided to sell the business to a partner, employees, or family. Or maybe you’ve decided to sell all or some of it to a private equity firm, family office, or strategic buyer. Your strategy might even be an orderly liquidation, which is a valid option. The key word there is “orderly.” A review of the pros and cons of all your options is provided in Section Three. For now, understand that your Value Maturity is determined by how well you understand all of those options. Honestly, you are probably not aware of all your exit options: according to the EPI’s *State of Owner Readiness Survey,* two-thirds of all business owners aren't.

It is worth your time to explore the possibilities. Meet a few private equity companies or family offices. Meet with an investment banker. Meet with an ESOP specialist. Learn all you can and take your time.

I have had owners who brought me in to sell their business, and after reviewing all their options, went an entirely different route. I have had owners assume they will transfer the business to a son or daughter only to realize their best option was to sell it, extract the cash, and go in an entirely different direction. This new direction could even mean funding another enterprise that your children are more interested in.

If you haven’t already, read *Every Family’s Business: Common Sense Questions to Protect Your Wealth* by Dr. Thomas Deans. Tom's position is that selling the business is often your best bet, even if family is involved. And he takes a hard stance on gifting. If you are going to transition to a son or daughter, make them buy it from you at market value.

MANAGE VALUE

The most mature level of Value Acceleration is managing value. Manage Value is the last stage of Value Maturity, but that’s not because it comes at the end after you harvest. It’s last because it represents full maturity.

You should obviously be managing value through the entire process, not just at the end. If you have identified, protected, built, and harvested value from a personal, financial, and business standpoint, you have managed your value. Managing value begins with identifying it. Remember, to effectively achieve results, it's not just the value of your business you need to manage. You need to manage your personal value and personal financial net worth as well. If you actively manage value through the entire process, you emerge financially independent of your business, with lots of options when the time comes to exit, making the timing of that exit irrelevant. It also preserves those options whether or not the exit is on your terms and timeline.

VALUE MATURITY INDEX

A simple exercise I teach owners at the Roundtables is to create a simple scatter diagram. It can even be handwritten. Keep it simple.

Create a circle and then label five points around that circle.

The labels should be:

- Identify
- Protect
- Build
- Harvest
- Manage

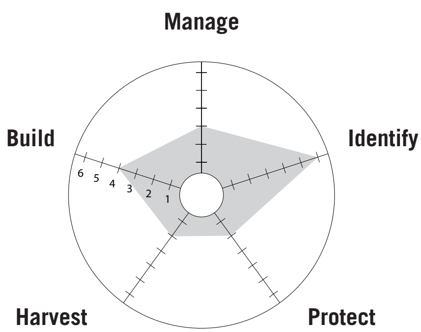

Exhibit L: Value Maturity Index

Now draw a line from the center of the circle to each label. Place six hash marks on each of the lines. Now, number each hash mark, starting from the center and going one through six (six should fall on the most outer layer of the circle).

Now it's time to score yourself! Go through each category and score yourself on how you have been developing your Value Maturity. Be honest. A score of five or six means you would consider yourself best-in-class. A score of one to two means you have done nothing at all or know nothing. A score of three or four rates you slightly above or slightly below average. Note: there is no average.

For example, for the Identify Value Stage, score yourself best-in-class if you:

- You have completed a professional valuation and personal financial and business assessment in the last year.
- You have correlated your assessment and financial analysis to determine where you place in the range of value for your industry.
- You and your core and extended teams deeply understand how a business is valued.
- You have a comprehensive understanding of personal, financial, and business value factors.
- You create prioritized, focused action plans around these value factors every 90 days (focusing on de-risking first), and give them equal attention.
- The 90-day personal and business actions are connected to your personal, financial, and business vision; three-year strategy and one-year initiatives.
- Your management and family are in alignment with your vision and plans.
- You have discussed your valuation with your partner(s), loved ones, and advisory team.

Score yourself a one if you have done nothing at all; award a six if you have fully fulfilled everything you can do in that category. You, like other owners, tend to be overly optimistic, but I'm sure you have a pretty good sense where you actually lie. Once you have gone all the way around the circle, connect the dots between the ranked numbers on each line. This will form another circle inside the outer layer. Now color in this inner circle. What do you see? The space between the outer circle and inner circle is your opportunity for improvement. The larger the shaded area, the higher your Value Maturity. But think positively: the larger the white space, the larger the growth opportunity!

Do this every 90 days. It will take 15 minutes of your time and will remind you of your progress. Each quarter, as you complete actions, your score should increase. That means your shaded area will increase, which means your value is rising. It's pretty straightforward.

To reiterate, there is no "average" and you can't use decimals. If you consider yourself "average," challenge yourself to go further and truly decide if you are slightly above or slightly below. It's hard to be that honest with yourself. It's too easy to say "I'm average." If you have to pick a side of the equator, it makes you think more critically.

Years ago, I learned this scoring system from Peter Hickey of MAUS, an enterprise valuation software entrepreneur, and have found that it initiates thoughtful conversations for owners. More importantly, it is really simple. More details on the value factors that qualify you to be best-in-class are spelled out in the next section.

VALUE ACCELERATION = FOCUS ON THE MULTIPLE

Value acceleration is achieved by focusing on the multiple, which, again, is largely based on the strength of your intangible assets. Calculated value is a fairly simple formula. Here's an easy way to remember:

> **CASH** *(recasted EBITDA)* × **MULTIPLE** *(tangible and intangible assets)* = **VALUE**

Recasted EBITDA (a.k.a. cash) times market multiple equals value (determining recasted EBITDA is pretty easy and I will show you how to do that in Section Three). Obviously, the more cash, the higher the value. Accelerated value, however, is accomplished by raising both the multiple and EBITDA. When EBITDA and your multiple increase simultaneously, you achieve an exponential increase in value.

Every industry trades in a range of multiples. These ranges differ depending on the size of your company, what industry you are in, the state of the private capital market, economic circumstances, and the supply of businesses available in your industry. The range of multiples, for example, in the health care industry is much higher than the range of multiples, say, in energy because of the economic circumstances and the supply of businesses for sale in each of these industries today. A larger company tends to trade at a higher multiple than a smaller company.

The private capital market determines the range of multiples for an industry. You cannot control this. The market controls this range. Weak companies trade at the lower end of the range and others, the premium businesses, trade at the higher end of the range. Your placement, or your specific company multiple in that range, is determined by the perceived strength of your intellectual capital and perceived risks associated to your business. Although you can't control the range, you can control where you place in the range.

YOU CAN HAVE BOTH INCOME AND VALUE

Most owners focus on sales and income only. This is understandable, but misguided. You have realities at play and you are probably asking yourself, "If I can make more income, why wouldn't I do it?"

Focusing on sales and income is important. I am not suggesting it isn't. However, focusing *exclusively* on income is a mistake. Focusing on the multiple is where real value creation lies. Your multiple not only accelerates value, but it also drives income. Focusing solely on income does not necessarily drive value.

If your business is completely dependent on you to be successful, how much value is there really? Not long ago, I evaluated a $44 million company. The owner turned white when I commented that his business might not have any value.

"How can that be?" he asked.

"Well," I said, "the business relies almost exclusively on you: your relationships with the customer and your ability to drive sales. You have not documented what you do that makes you such a great salesperson and you have no replacement. Past that, you admitted to me that there is only one other person who can drive sales and that the rest of your team was below average at best. You have no contracts with your customers or your suppliers. You have no documentation of your company procedures. You have no awards or community recognition of your accomplishments. You have no brand. The majority of your revenue comes from one customer. You really don't do any marketing. There are few barriers to entry and you don't hold a dominant position in the industry. You have no trademarks or intellectual property."

Stunned silence followed.

"So let me ask you, what exactly would a buyer be purchasing?"

Much of what has been written about exit planning focuses on the endgame. I can't emphasize enough that exit planning is not accomplished by focusing on the endgame. Successful exits are based on what you do every day. There is no reason you can't benefit today *and* in the future. You can do both. You don't have to trade away income for value.

PUBLIC SPEAKING

Walking to Destiny provides a roadmap and concepts which, when adopted, can increase readiness and attractiveness as business owners approach their exit. Chris Snider delivers keynote speeches, trainings, and workshops surrounding the topics of Master Planning and the Three Legs of the Stool, the Four C's, the Five Stages of Value Maturity, and Relentless Execution. This education is for:

- Top-tier professional advisors and consultants dedicated to helping their clients successfully grow and exit their businesses
- Legal, asset management, and accounting firms committed to successful wealth transfers
- Business owners looking to educate their executives and staff on how to grow value in the business and think like owners
- Community leaders wanting to educate their local business owner market on how to successfully transition their businesses
- Industry associations dedicated to preparing their members for succession
- Financial/professional associations looking to educate their members on how to perform exit planning services
- Entrepreneurs wanting to use exit strategy as a business strategy and stage their company for rapid growth and high market value

For speaking fees and availability, please contact Brooke Norman at (216) 712-4244 or BNorman@Exit-Planning-Institute.org.

Chris Snider is a frequent speaker in Chicago, Cleveland, New York City, San Francisco, San Diego, Las Vegas, Phoenix, Dallas, South Florida, St. Louis, Milwaukee, Atlanta, Los Angeles, and New Orleans. Discounts on travel are available for back-to-back bookings.

VOICE OF THE INDUSTRY

Christopher M. Snider, CEPA, CEO and president of the Exit Planning Institute, creator of the Value Acceleration Methodology™, and managing partner of Snider Premier Growth, is recognized as a thought leader and trendsetter in the field of value acceleration and exit planning. With a message that resonates with entrepreneurs across the country, Chris is a

sought-after speaker for many major companies and trade industries, and the associated organizations that are dedicated to serving the transition and growth needs of business owners. He built his career as a key value growth integrator for major companies, including The Sherwin Williams Company, FedEx Logistics, Nike, Dell, and Textron. Finding passion in changing middle market business owners' lives through rapid growth projects, Chris emerged a game-changer, noting a milestone project with a family-owned private company that he helped grow from $90 million to over $240 million in three years and successfully selling to a multi-national strategic buyer. Now with a wealth of experience and a proven value acceleration system, Chris has established a family investment company with his son, with ownership stakes in eight lower middle market businesses.

FOR BUSINESS OWNERS. BY A BUSINESS OWNER.

Walking to Destiny is not only your essential resource to understand what makes your business attractive and ready for transition; it is a business owner's handbook to learn how to rapidly grow value and ultimately unlock the personal wealth trapped in your most significant financial asset: *your business.*

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