M&A ADVISORY SERVICES:
➤ CREATING VALUE BY DELAYING THE DEAL

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The National Association of Certified Valuators and Analysts

The next generation

Pursuing an acquisition for the sake of improving the top line is risky. A company can focus on creating value by reducing their cost of capital and thereby improving their risk profile. Business valuation analysts are uniquely positioned to offer advice on risk and devise strategies for corporate clients to reduce risk exposure. These measures usually lead to improved sales, profitability and value creation. A solid foundation enables the firm to pursue strategic acquisitions with more confidence.

Recently, a lower middle market contract

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manufacturer was referred to me for guidance in assessing a potential acquisition target, developing an acquisition proposal, and negotiating a transaction. During my initial meeting with the client's board of directors, I learned that their reasoning for wanting to acquire another company was twofold: First, they needed an investment vehicle for their cash surplus, which had accumulated from being marginally profitable over many years, and; second, they were dissatisfied with a recent business valuation and thought an acquisition would help them build value more quickly than trying to grow organically.

After a couple days of assessing the client's capacity to successfully execute the contemplated transaction, a standard part of my firm's buy-side and sell-side due diligence processes, I had the unenviable obligation to deliver advice to the board that would erase, or at least defer, a potential six-figure fee engagement. The client's business valuation was low because the entire operational infrastructure of the company was weak. Management depth was thin, operating processes were not standardized, no formal strategic planning had been conducted, and some equipment was in need of major repair, among other factors. Therefore, any attempt to layer another business on top of the existing infrastructure would likely have devastating impacts on both the acquired business and the existing business. Accordingly, I advised them to use some of their cash reserves to make much-needed improvements to the existing business and to postpone any consideration of an acquisition for two to three years, during which time the core business could be strengthened and stabilized.

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However, rather than just sending the client away with some vague recommendations about improving their business, as we might have done in the past, we identified all the reasons why the company's valuation had come in so low and developed specific initiatives for the company to undertake to strengthen its operations and improve its value. We proposed our services to help them implement the recommended initiatives and also suggested some other professionals whom we knew who could help with certain challenges.

For starters, we recommended a business planning process that we could facilitate, specific management training offered by a leadership training firm, and lean manufacturing help that could be provided by the quasi-federal Manufacturing Extension Partnership (there's a chapter in every state). In effect, we converted the company to a consulting client while we prepared them to be a higher caliber transactional client in the future. In the process, we also strengthened our collaborative relationships with some other elite professionals, who may well reciprocate our referrals.

We also educated the company's board of directors about the different options for building business value and showed them a better way than making an acquisition. They were surprised to learn about the concept of cost of capital in the overall equation of building value, and it occurred to me that this concept should be part of every M&A advisor's toolset for educating their clients.

It is a well-documented corporate finance fact that in order to build value, a business must generate profitability in excess of its cost of capital. We also know, from various studies, research, and experience that most privately owned businesses do not meet their cost of capital thresholds and, therefore, are not creating value. Such fact is often manifested in valuation results but, without proper guidance, business owners are left believing that their only options for building value are either to grow sales or to reduce costs. In effect, they only understand one side of the equation, and therein resides the opportunity for us, as their advisors, to educate them and show them a better way.

Profitability > Cost of Capital = Value Creation

Focusing only on profitability, whether through sales, margin expansion, or acquisition, ignores the other half of the equation. Instead of trying to increase profitability, your clients could reduce their costs of capital, with your help, and begin building value immediately. Most business owners, however, have no idea about cost of capital, so we have an opportunity to educate them about it, to build a whole new revenue stream around it, and to elevate our overall service quality and reputation in the process.

Cost of capital is controllable, within a wide range, and can be significantly reduced by developing and executing a disciplined, methodical approach to doing so. Since cost of capital is a risk-adjusted measure of a company's optimal (as opposed to actual) cost of equity, cost of debt, and blended capital structure, lowering the company's risk profile will reduce its cost of capital and increase its value. Precisely, the company-specific risk factors that impact cost of capital can be identified, assessed, and addressed in a strategic manner to minimize, or eliminate, their impacts.

Reducing cost of capital can be an easier, more impactful, and less risky way to build value than growing sales or reducing costs. Why? Because it involves improving the overall quality of the company's operations, infrastructure, market positioning, and other aspects that form the foundation blocks for building value. Simply put, a higher-quality, lower-risk company commands a higher value. In fact, research indicates that most private companies could increase their values by 70-100 percent solely by lowering their risk profiles, which reduces their costs of capital.

Alternatively, if a company with a high risk profile attempts to increase profitability and value purely by growing sales or margins, it would be like building a third story onto a two-story house that has a weak foundation and structural problems. The company's risk profile would likely worsen, increasing its effective cost of capital and maybe even reducing its value. We've all seen examples of companies that grew faster than they could effectively manage, resulting in poor profitability, difficulty obtaining financing, , depressed valuations, and even bankruptcy under the pressures of growth. Most private companies would be better able to maximize their values by first focusing on building a solid foundation, and then on driving growth.

Reducing the company's risk profile and cost of capital, as a first step, will very often naturally lead to increased sales and profitability as a byproduct of the risk reduction process, because operations will be healthier, growth strategies will be more refined, and the threshold will be lower for new opportunities to be value creative. It also improves the

In the case of our client above, although our transactional fees are deferred for now, our approach earned us that client's loyalty and respect and will bring them back to us for a transaction when they are more prepared. At that time, the transaction quite possibly will be larger, easier to execute, and more successful for all involved than it would have been currently. In the meantime, the initiatives we recommended are being implemented, reducing its risk and cost of capital, while making it stronger, more stable, and more valuable. It is also generating consulting revenue for our firm, and others we referred, mitigating any sting from deferring the transaction engagement.

If you consider approaching your engagements differently and guide your clients as to how they can achieve the valuations they need by reducing their costs of capital, you can elevate your reputation, create new revenue streams, gain lifelong loyalty from your clients, build valuable collaborative relationships with other professionals, and shift your practice into the next generation of services. It works very well in our firm, and it will also work in yours, if you simply have the courage to trust it.

Ken Sanginario is the founder of Corporate Value Metrics and developer of the Value Opportunity Profile® (VOP), a cloud-based application designed to help advisors to maximize the value of their private company clients. Ken has more than 30 years of experience developing value creating strategies for middle market companies in transition and is a frequent speaker at national and regional conferences.

CORPORATE VALUE METRICS

4 Bellows Road | P.O. Box 167 | Westborough, MA 01581 | Office: 508-870-5805

WWW.CORPORATEVALUE.NET