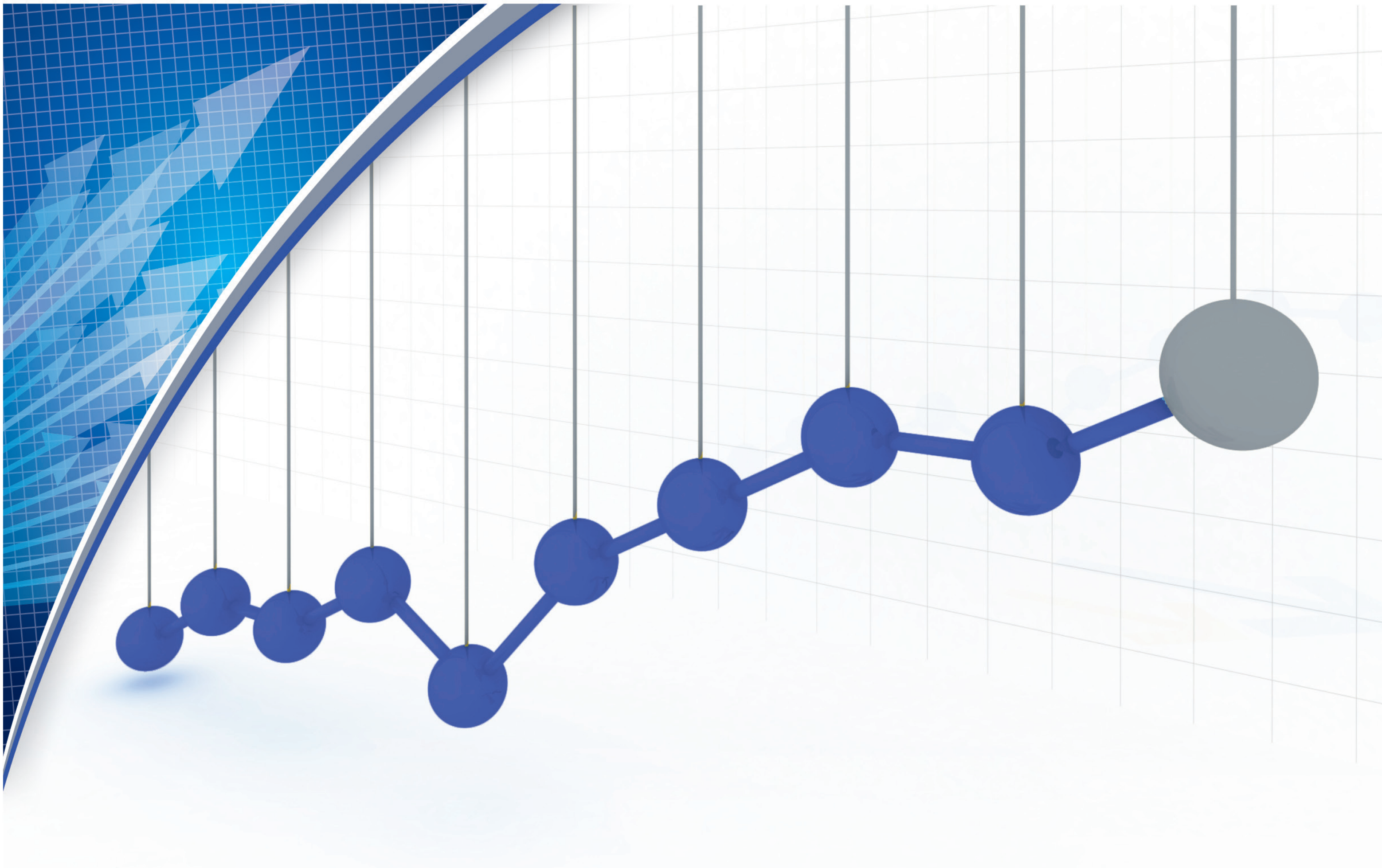

ROAD-MAPPING YOUR COMPANY TO ITS MAXIMUM VALUE

A White Paper Presented by:

CORPORATE VALUE METRICS

WWW.CORPORATEVALUE.NET

Why Road-Mapping is Critical to Maximizing Business Value

Suppose two companies, *Ace Widgets* and *Best Widgets*, are arch-rival competitors. They're exactly the same size, with only slight differences in their respective products. Both companies serve the same niche industry and have identical historical revenues and earnings.

Now, suppose that the industry they both serve is suddenly changing and there are significant growth opportunities available to each company. However, over the last few years, Best has taken the time to develop a high-calibre senior management team, while Ace is still primarily managed by its owner, with help from its Corporate Controller.

Best has also developed a comprehensive written strategy to capitalize on the growth opportunities, while *Ace* will continue to rely on its existing customer relationships for new contracts. *Best* has also developed an organizational structure, along with new processes and systems, which will be better able to support the growth, while *Ace* plans to just patch what exists as the needs arise.

Lastly, *Best* has an active outside board of Directors, which it can leverage to help capture the growth opportunities, and provide advice on managing the growth internally. *Ace*, on the other hand, has only a few informal Directors, who are basically there to agree with the owner.

Which company, *Ace* or *Best*, do you think has the higher likelihood of successfully capturing the profitable growth opportunities?

Which company do you think has a higher value, even before the growth?

If the owner decided to sell, which company do you think would be more attractive to an acquirer?

If one company ended up selling to a much bigger market participant with deep pockets, what do think would be the long-term fate of the remaining company?

Which company is more similar to **<u>your</u>** company?

The above scenario is playing out across corporate America at a growing rate, especially as baby-boomer business owners approach retirement age and begin looking for an exit. The differences described above are only a few of the many attributes that separate the strong companies from the vulnerable; the companies that will survive from the companies that will fail.

There are currently 6 million small-to-medium companies in the U.S. and 70% of them are expected to change ownership by the year 2025. Given the existing demographic trends, there will be many more sellers than buyers during the next 15 years. At a minimum, therefore, valuations will suffer. More likely, however, only the best companies will sell at any price. The rest will simply cease to exist, bringing NO value to their owners.

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So, how can you make sure that **<u>your</u>** company is more like *Best*; that **<u>your</u>** company is properly positioned to support growth opportunities; that **<u>your</u>** company can maximize its long-term competitiveness and maximize its value?

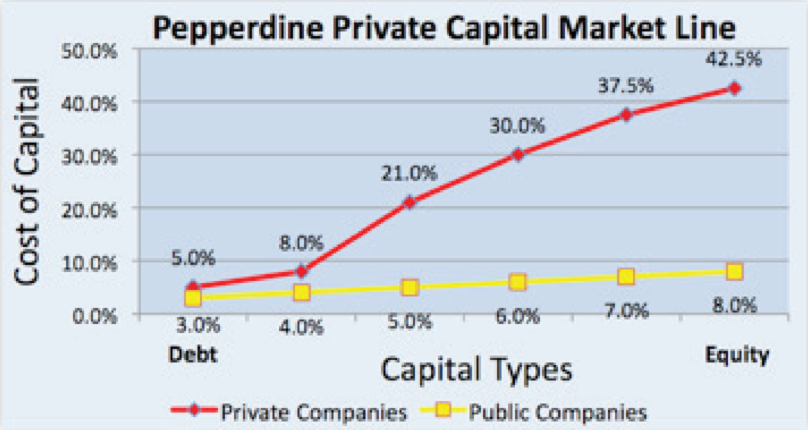
The answer is to maximize your company's value through the process of corporate Road-Mapping.

How does Road-Mapping build value?

Although a full discussion of all the intricacies of valuation is beyond the scope of this white paper, a few basics will clarify the most important aspects. At its root, a company's value is the measure of the cumulative net cash flow it is expected to generate in the future, discounted to today's dollars. The resulting calculation indicates the company's "intrinsic", or inherent, value.

The discount rate used reflects the amount of perceived risk in the company's future operations, and is also expressed as the company's cost of capital, or the rate of return that an investor would require in order to invest in the subject company versus another company; the higher the perceived risk, the higher the discount rate, and the lower the value. It then holds true that, if a company can reduce its risk, it can reduce its discount rate and increase its value.

In his textbook, entitled *Private Capital Markets*, renowned author Robert T. Slee explains that "an investment in a private company is typically riskier than an investment in a public company" because the private company's "specific company 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.



In fact, the difference in the cost of capital, or discount rate, is dramatic between a public and a private company. Author Slee teamed with Pepperdine University and its Doctor, John K. Paglia, to develop the Pepperdine Private Capital Market Line, presented below, which depicts the relative costs of capital (discount rates) between public and private companies. As shown therein, the cost of capital for a private company can be more than five times the cost of capital of a public company, the difference of which is largely attributable to the private companies' specific company risk factors.

To demonstrate the impact of such a difference on a company's value, suppose a company is generating $3.0 million of cash flow per year, has no debt, and is expected to grow at 3% per year for the indefinite future. At a cost of capital (discount rate) of only 8%, that company would have an overall intrinsic value of approximately $60 million. However, at a cost of capital of 42%, the same company would have an overall intrinsic 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% of the U.S. public equity market, is currently valued at an overall multiple of approximately 22 times the collective earnings of its members. However, in the private sector, many lower middle market businesses ($5M - $150M in sales) are being sold for multiples of only 4 – 5 times earnings, demonstrating the huge difference in values of public versus private companies.

It would be unrealistic to think that a private company could somehow capture the entire difference in value between itself and a comparable public company, as there are certain elements of its risk profile and, therefore, cost of capital, that cannot be mitigated, most notably not having a liquid market for its stock. However, it is not at all inconceivable that many private companies could increase the value of their companies by 80% - 100%, by managing their companies closer to the way that public companies are managed, thereby reducing their specific company risks.

How can a company move in that direction? Author 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? 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 private companies, therefore, is to identify, understand, prioritize, and address the risks in their businesses that would create the most value by their mitigation. How would they do that? By developing an internal Road-Map for methodically strengthening their businesses by reducing the risks that are depressing value.

Road-Mapping Your Company - a Five Step Process for Success

Step One

Understand the components of an effective corporate road-map. The rest of the Road-Mapping process will flow from the fundamentals as they are woven into the various functional disciplines within your organization.

Fully developed, these fundamentals will guide and help govern your company's activities, ensuring that everybody is moving together in sync, toward the same goals. The resulting impact is that your company's risk, actual and perceived, is reduced, thereby increasing its value. Without the fundamentals in place, the road-map becomes unclear and departments tend to create their own, often in conflict with other departments and with your overall objectives; a higher risk, lower value, proposition. **The fundamentals are as follows:**

1. Vision and Mission Statements which clarify the company's long-term objectives;
2. A Business Plan designed to fulfill the vision and mission;
3. Specific short- and long-term goals to execute the business plan;
4. Strategies, by functional group, to achieve the specific goals;
5. Tactical plans to support the strategies;
6. An effective Organization designed around the tactical plans, and;
7. Systems to leverage the organization.

These fundamentals may seem purely academic, with little real world application. However, the most well-run, successful, and valuable companies in the world have these fundamentals fully developed and in place. Do not make the critical mistake of thinking that these are only for the text books. They do, indeed, apply to any company that wishes to reduce risk and increase value. If you put yourself in the shoes of a prospective buyer, considering two companies, and one company has these fundamentals in place and the other doesn't, which one would you think is better run and a more attractive investment?

Step Two

View your company as a series of interdependent modules that can be separately assessed and enhanced. Although you can segment the company any way you wish, we suggest using eight specific major modules, which represent the core areas of any company. Each area is equally important to the overall support of the company. Although there may be more or fewer initiatives that must be addressed in one area versus another, unaddressed problems in any of the areas can damage progress for the entire company.

The eight modules we suggest are as follows:

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

Each of the eight major modules can then be divided into sub-modules for easier assessment and management. As an example, the finance module could be sub-divided into eight smaller modules, such as:

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

Once again, you can use any sub-modules that make sense for your company, and there is no magic to using eight. Some major modules may have more than eight sub-modules and some may have fewer.

Step Three

Once the company is appropriately sub-divided, develop a set of questions to assess each module, the results of which will form the basis of your road-map.

The questions can be developed or adapted from a variety of sources. Published best practices from business magazines and trade journals 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.

Other sources may include internal employees who have expert knowledge of their areas, the Company's Board of Directors, or outside advisors, among others. Many of the questions may seem like purely common sense once you see them, but when you actually take the time to answer the questions honestly, you may be amazed at how many elements your company is missing.

Step Four

Once the questions are developed and answered, there must be a method of objectively evaluating the answers. Once again, you can use any method you develop, as long as there is some way to quantify the answers into a grading system. This approach will allow you to understand the strengths and weaknesses of every area of the company relative to all other areas that were assessed.

It is important to understand the company's weaknesses in relative terms so that you don't waste time, money, and resources, improving an area that is already far more developed than other areas, until the other areas catch up. The old adage that a chain is only as strong as its weakest link is a perfect analogy for this process. Make sure to use this process as a lead-in to step five, below, and not as a means of finger pointing within the organization. The objective is for the company to improve and grow together, not to evaluate the performance of individuals.

Step Five

Once the weaknesses are all identified, it's time to create the Road-Map. First, rank the weaknesses in order of priority to be addressed. We recommend a three level priority process.

Level 1 would be the first priority, reserved for initiatives that are most critical to **Protect** the viability of the company, no matter what the company's growth objectives are. These would be issues such as lack of adequate insurance, poor legal structure of the entity, lack of safety procedures, and the like.

Level 2 would be second priority, and would include issues that, although they are not threatening to the company's viability, would **Enhance** the company's quality, efficiency, and overall value, even if no growth plans are contemplated. These 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 3 would represent initiatives that might only be addressed if the company was contemplating significant growth within the next couple years and you need to **Position** the company to be able to support such growth. These would include such initiatives as making sure the organization can scale to effectively accommodate growth, establishing an outside board of directors, developing written detailed strategies for each major discipline, and ensuring that the appropriate financing is available to support the growth within the company's targeted capital structure.

Within each level of initiatives, make sure to address the weakest sub-modules first, until all the major modules are brought up to the level of the module that was initially the strongest. After that, bring the major modules up to new levels together, so that the overall company becomes stronger across the board, all together. This will ensure that the chain is being strengthened in every link at the same time, as it does little good to strengthen one link of a chain without strengthening all the other links.

Based on the priorities established through the above process, develop initiatives to address the identified weaknesses, put time lines on completing them, and assign cross-functional teams to manage the efforts. Some initiatives (Level 1) will be a priority to complete within 12 months. Others (Level 3) may have a timeline of 3 – 5 years.

The important part is that the Road-Map be developed and be made a priority within the Company. Just as with any planning effort, factors may change along the route, which cause the Road-Map to change. However, it becomes much easier to monitor progress and make changes along the way, once the initial Road-Map is completed.

When Should this Road-Mapping Process Occur?

If you've never undergone a Road-Mapping process, it should happen **immediately**.

If you have already developed a Road-Map at some recent point, then you should update your assessment and revise your Road-Map on an **annual basis**, to measure your progress and recalibrate your Map.

Additionally, if you contemplate making acquisitions, raising new capital (debt or equity), or selling a product line, or a division, or exiting the whole company, having a Road-Map will make your company much more attractive to the party on the opposite side of your transaction.

Road-Mapping is **critical in any 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 the performance.

Lastly, if your company is contemplating a **rapid growth** phase, a Road-Mapping process is absolutely critical to your success in managing the growth. 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. Back to the chain analogy, any weak areas of the company are likely to become strained or broken when the pressures of growth are added, and many companies have actually failed because of just that.

Who Should Manage and Participate in the Process?

The Road-Mapping process, like any big change process within a company, must start at the top, and be mandated, supported, monitored, and incentivized, at the very highest levels in the company. There will undoubtedly be resistance to the process, at first. However, as word spreads that this is a permanent change in the culture of the company, and is not a project of the month endeavor, it will slowly take root.

It is also important to have one or two champions who drive and manage the overall effort. Generally the CFO and COO would be the best to lead the process, with department heads taking the tactical lead to develop teams, develop the assessments, and implement the whole process. They will, in turn, bring the best employees onto the teams, who will buy into it and propagate the new culture throughout the company.

If the process seems slow at first, do not despair. Any major undertaking that will have such a dramatic favorable impact on the company in the long run will require persistence and perseverance along the way. You may encounter a couple false starts at first, but it will eventually work.

In short, the entire company will ultimately participate in the implementation, which is best for ensuring that every employee feels some ownership for the results, and some responsibility for reinforcing the effort among their peers.

Sources of Standardized Assessments

If you have the drive and the internal resources to create a Road-Mapping process from scratch, then, by all means, pursue that avenue. Your team will become much stronger merely as a result of creating the process, let alone from implementing it. However, if you would rather leverage a Road-Mapping process that has already been developed, Corporate Value Metrics (**www.corporatevalue.net**) has developed a standardized assessment and prioritized initiative process called the Value Opportunity Profile® ("VOP®").

The process is facilitated by one of several highly experienced organizations who have collaborated on its development, and the assessment phase of the process, and development of initiatives, can be completed in a very short period of time and on a very cost-effective basis.

The VOP® also provides much more. An estimate of the current value of the company is calculated as part of the process, together with a quality profile and risk profile. Additionally, a "dashboard" allows you to see the projected impact of completing any identified initiative on the company's value, quality, and risk scores. As you make progress in completing initiatives, and as your business grows and changes, you can return to update your profile and recalibrate your initiatives, so that you always have a current indication of what your company is worth and always have a current Road-Map.

Whether you conduct the process from scratch or use a tool such as the VOP®, you will succeed in substantially reducing the risks inherent in your business; risks that significantly increase your cost of capital and reduce your company's value. By moving closer to the fundamentals that exist within public companies, the incremental value you will create can be overwhelmingly compelling.

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FINAL THOUGHTS

- A higher value for your company, often by 80%-100%;
- A healthier, more competitive company, better able to support long-term growth;
- A better chance of executing transactions on your terms and timetable;
- Happier, more productive and efficient employees; and
- Less stress and more peace of mind for the CEO/Business Owner.

Would you rather be more like *Ace Widgets* and suffer a slow and painful demise or, more like *Best Widgets*, and maximize your company's value and ability to sell at your discretion in the future?

For a more detailed description of the VOP® process and a tour of the reports it generates, please visit www.corporatevalue.net.

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