Top Ten Destroyers of Value

Introduction:

You work 20 years building your business and the day comes when it's time to sell. You feel you've built something valuable, but how do you get others to see that value, and furthermore, to pay for it?

By selling time, it's too late to maximize the value of your company. You really need to start two or three years in advance polishing your "shiny red apple." Your objective is to create value to the buyer.

Below are the top ten destroyers of value in the buyer's eye. Don't let these destroyers take money away from you!

You

You are not your business

When considering the value of your business, you need to take yourself out of the equation. Your business should be an asset you own, that generates cash, *not* an extension of yourself. It should be able to operate without your daily and direct motivation, involvement, or leadership.

If the business cannot function without you, that's a problem. If no one else can fill your position or create the same results, that's a problem. If the business cannot function with you on an extended vacation, that's a problem. You have a company that is not worth much without you—which means no one will pay you much for it.

Create a Company; Don't Work a Job

In the "E-Myth," Michael Gerber states, "If you cannot separate yourself from the business, then you have a job not a company." Your company should work for you; it should generate revenue and operate independently for the most part.

So, how can you ensure that a business can continue to operate and flourish without your involvement? Hire strong people, create valuable content and procedures, develop a brand that is not synonymous with you—all of these things will help you create an asset, not a liability.

1. No Recurring, Consistent Revenue

The Problem

A lot of entrepreneurs survive off the "pops"—those moments of big return, when a calculated investment finally pays off, the moment when you land a big fish that has big business to offer you, the moment when you get a "Win." But these are conditional occurrences that are inconsistent, sometimes unexpected, and may be dependent on a particular sales person, economic climate, or a referral based on *your* connection

The Solution

Instead of waiting for the stars to align, smart owners increase business value through the creation of a smaller, consistent revenue stream. This typically means a monthly payment from a wider audience. You might have a monthly membership with access to helpful content or you might have monthly, recurring work where businesses have contracted you for a lengthier amount of time at a discounted rate.

Creating a recurring revenue streams means consistent cash flow and a business that is less affected by change. Instead of relying on one big fish or several "pops," these owners cast a wider net to obtain many little fish that are constantly putting food on the table.

You're in a business with customers. These customers have needs. Find a way to consistently meet your customers' needs. Add value to their lives, at a rate they feel is fair and unobtrusive, and you'll end up with a higher and more consistent cash flow that a buyer will be willing to pay you top dollar for.

2. A Highly Concentrated Customer Base

An Unhealthy Relationship

You've heard the old adage, "Don't put all your eggs in one basket." Oftentimes, too many businesses have all their eggs in too few baskets; in fact, many companies depend on only a few customers for 50-80% of their revenue.

If this sounds like you, you probably view these customers as loyal. Maybe you've had them for many years. Maybe they've signed a long-term contract or a non-compete clause. But, in any relationship, it is unhealthy to depend on one person (or client or business) to sustain you. You need them, and that makes you vulnerable. You need them, and they know that. So, friendly or not, these customers are able to demand resources and time for no additional cost—because you can't afford to turn them down.

Assessing the Situation

Let's say these customers are loyal to you. Well, you still have a problem. The majority of your revenue is tied up in a handful of people, and what happens if they go bankrupt? What if they change leadership, and the replacements go in a different direction? What if the marketplace becomes more competitive or technological advancements threaten the industry? Well-positioned business owners account for these changes by diversifying and expanding their customer base; they cast a wider net mitigating their risk, making their business more stable, as well as more valuable to a seller.

Ways to broaden your customer base:

1. Put resources into acquiring new customers and expanding your hold on the market.
2. Build a "Cash Cushion" so that you're not dependent on those few big fish while you're finding the smaller ones. If they leave you, you won't be hemorrhaging on the side of the road.
3. Make switching providers more difficult with Long Term Supply Contracts or Preferred Vendor Agreements.
4. Make sure all your employees have signed non-compete clauses with strict penalties.
5. Create an immediate back-up plan: what would you cut if you lose a critical client or customer?
6. Dependence on Key Employees without Non-Compete Agreements

<u>Disclaimer:</u> *Non-compete Agreements must adhere to state and national employment regulations, and a labor law attorney should be consulted to verify conditions. You should consider Non-compete Agreements for employees, clients, shareholders, suppliers, and partners. Oftentimes, the buyer will require the seller to sign one as well.*

Protect Yourself

This destroyer is very similar to the one listed above but focuses more on your employees instead of the customer. Non-competes are intended for the key management team—CFO's, COO's, sales people—anyone who has a direct relationship with a consultant. (Certain states, like New York, prohibit non-compete agreements from too far down the line). The objective is to protect the owner, and the new buyer, from fundamental employees leaving to join a competitive company or becoming the competition in their own right.

The following is a specific example of how a non-compete might protect you from a client hiring a leading sales person or member of your team.

An Example with Cathy the Consultant

If you have a consulting firm, it is problematic when clients hire consultants out from under you. If a client pays $150/hr for Cathy the Consultant, and she works 20 hours a week, 50 weeks out of the year, Cathy will cost the client $150,000 for 1,000 hours of work. You, as the owner of the consulting firm, are getting a 40% cut of the

$150/hr for supplying Cathy, so this benefits you. You are filling a client's need, which benefits him, and providing business to Cathy, which benefits her.

But now Cathy and the client have made the connection, and they don't need you. If the client wants to cut you out of the equation and hire Cathy full-time, this benefits the client and Cathy but damages your business. If the client offers Cathy a $200,000 salary, Cathy is happy because she has consistent work with one client and does not have to worry about any gaps in employment hours. The client is happy because he now has a full-time, salaried employee working roughly 50 hrs a week, 50 weeks out of the year. So, now, instead of Cathy costing $150/hr, she costs him $80/hr ($200,000 salary/2,500 hrs of work=$80/hr).

You, however, have lost an income stream; plus, you have to find, hire, and train a new employee, costing even more money. If this pattern continues, and employees keep leaving with clients, you no longer have a consulting firm.

Non-compete Agreements are time and geographically limited; they prohibit key people, for typically a period of one to two years, from taking trade secrets to a direct competitor or business from existing customers.

3. Not Maintaining Good Records

Creating an Accurate Valuation

If you purchase our **Exit Strategy Checklist**, you will see there are almost 200 items you need to prepare for a business valuation. Most of these are documents and financial statements that will be assessed by your team, the potential buyer's team, and probably a third party assessor. If you do not maintain meticulous records, the buyer or assessor will not be able to determine an accurate valuation of your business.

Several years ago, we were hired to position a company for sale. The owner complained that he couldn't understand his financial statements. One month he'd have profit, the next month loss.

Step 1: Clean up Financial Records

After cleaning up this client's financial records, we discovered hidden profits we were able to unlock with accurate records, consequently increasing the value of his company.

When you do not maintain good records, you do not maximize profits and cash flow and, as a result, do not maximize the value of your company. Get good records and you'll probably find additional profits.

Step 2: Establish Credibility

If you, as the seller, have good records, then I, as the buyer, have more confidence in the verbal representations that you give me. Maintaining good records lends credibility to your entire package. If you're sloppy with records, you may be sloppy with facts you give me. Give me reason to trust you and not discount your company off the bat.

Step 3: Reduce Risk to Increase Price

A buyer will pay more for a company with reduced risk. The higher the transparency, the better the information, or at least the better the information will be perceived and considered by the buyer. Clearer information means a lower risk to the purchaser which will lead to a higher price for your business!

Not maintaining good records decreases value! Don't let this happen to you.

4. Not Understanding Financial Ratios and Relative Performance

The Purpose of Ratios

Ratios are important; they determine value. As a business owner, they help you understand patterns, function, and the relationship of a part of your company to its overall success. As an assessor responsible for business valuation, it is vital to understand and calculate the right financial ratios for any situation. These ratios can evaluate a company's financial stability, productivity, profitability, return on investment, or employee performance.

Ratio Analysis helps you analyze financial statements, identify trends, recognize areas of growth or weakness; they help you measure the overall state of your finances and value of your company. They are also used by outside valuators and potential buyers of your business to compare your performance to others in the industry. Consequently, it is critical to use the correct ratios and to understand their significance.

Even if you are not planning to sell immediately, it is important for you to begin calculating these figures to determine your company's performance and value.

For more information on understanding your ratios, check out our R-Series tool which can be found in our SCFO Lab .

5. Sometimes it's OK to Pay Taxes!

Make your business more valuable

Understandably, business owners want to pay as few taxes as possible in order to keep as much cash on hand. However, skirting the system and flirting with below-the-line deductions will make your business look less valuable to a seller as it suggests a lower income than probably exists. It can also hurt your credibility as these actions can be interpreted as being "dishonest" with your taxes.

Don't minimize value by minimizing taxes

There are plenty of expenses and deductions that are worthwhile and necessary such as supplies, raw materials, travel, entertaining clients, half the cost of meals, laptops, vehicles for work, etc. However, when owners try to put family members on payroll, deduct personal expenses and purchases, or move money around to make it look like they've given more to charitable donations than they have, they inadvertently decrease the value of their business. By minimizing profits to minimize taxes, they end up minimizing the value of their company.

How to get more value for your buck

Let's say you have equipment that is good for 6 years, but you decide to buy new equipment after 5 years in order to minimize taxes. You are choosing to minimize taxes rather than maximize reported profits. You are thinking short-term—you want cash to grow your business, but it can cost you considerable money in the long run.

Think of it this way, a buyer cares about income and profit, and an assessor is going to place a value on your business. If you take too many tax deductions, it looks like you don't have enough valid income. Consequently, your business will not be valued as much in a sale.

Look at the following table.

Scenario	Taxable Income	Business Valuation	Purchase Price
Scenario A	$500,000	4x net cash flow (4x $500,000)	= $2,000,000
Scenario B	$425,000	4x net cash flow (4x $425,000)	= $1,700,000

In Scenario A, the owner has demonstrated taxable income of $500,000. If his company receives a multiple of earnings valuation of 4x, his company would be worth $2,000,000.

In Scenario B, the owner has run excessive personal deductions and expenses to minimize taxes, showing a taxable income of $425,000. That $75,000 reduction in profit will cost him $300,000 in the sale of his business.

6. Not Understanding an Outside Investor's Viewpoint

Sellers vs. Buyers

Entrepreneurs are meticulous planners, who have carved out a piece of the industry for them by building a company with measured, researched steps. They must know the market; they must anticipate the needs of their customer; they must be innovative and flexible, responding to changes in the marketplace, technological advances, and future competitors.

An outsider, or potential buyer, might view some of the seller's decisions as exceptionally risky; however, they do not have the direct experience and market knowledge of the owner.

The Differing Perspectives of a Seller and Buyer

Risk is relative. An insider's perspective and an outsider's perspective inherently varies—one's on the inside, with confidence, information, and experience while the other is out, navigating a potentially foreign world. The insider and outsider have different goals; the outside investor's primary focus is to not lose capital. They are worried about the motivations of the seller, the changing market, and the unknowns.

Value is determined through the eyes of the buyer

When approaching business valuation, the seller must assess their company from an outsider's point of view. They must remove emotional attachments and consider the investment as objectively as possible. The seller must understand that his perception of risk will be magnified in the eyes of the buyer. Once the risks are understood and safeguarded, investors and protectors will give greater consideration and higher valuation to the potential business acquisition.

By having as many completed items from the **Exit Strategy Checklist**, you reduce risk to outside investor and improve the valuation of your company.

7. Not Optimizing the Use of Capital

Don't leave value on the table

Small business owners are often wary of using credit or taking on debt; however, in most cases, they are leaving opportunities and returns on the table. All good things in moderation and this includes debt. With low interest rates, it is easy to obtain loans at a competitive rate, which would provide the quick capital you need to grow your business.

Overcapitalization is bad

Company A has no debt and tons of cash, which the owners see as good. In reality, they are overcapitalized. A buyer wants to leave just as much liquidity as necessary for the company to operate. As the seller, you should do the same. Optimize your use of capital to make sure you're not overcapitalizing your business.

Undercapitalization is also bad

Company B is not efficiently utilizing their assets because they are cash constrained. When you're undercapitalized, you can't invest in new equipment, processes, or talent. You don't have the money to invest in the company. Use some debt, minimize cash conversion cycle, and retain some equity to adequately fund the needs of your company in order to become as profitable and valuable as possible.

Some other benefits to taking on debt or using credit:

- Establishes relationship with lender for down the road.
- Improves credit rating for your business.

- If retained earnings are not distributed, you have more liquidity than necessary. If you have too much capital, you may be too conservative. A buyer would strip out earnings, so you should reduce returned earnings before the buyer to improve your return on equity.

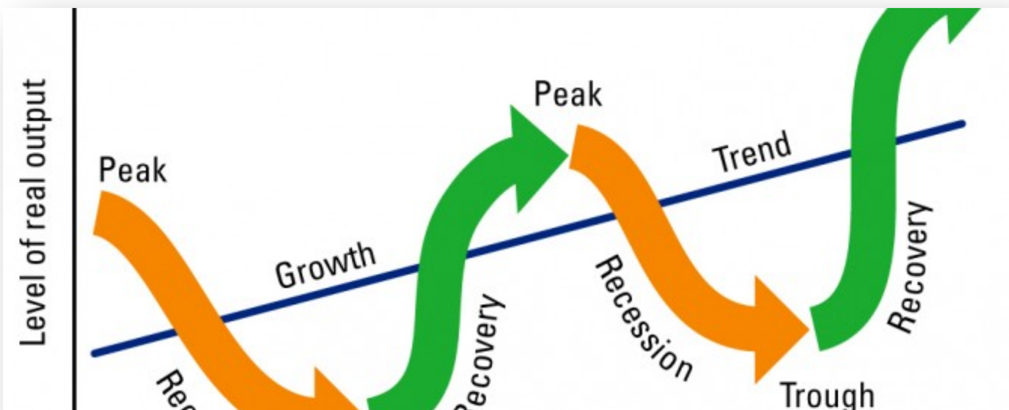
8. Not Understand Economic and Business Cycles

How the economy affects your business

The local and national economy not only affects your cash flow but also the value of your business. During an economic expansion, opportunity is ripe and almost all businesses look better to investors. During a recession, investors scrutinize a potential acquisition even more and will be pickier about details they may have considered inconsequential during an expansion. Other factors, such as population growth or increased regulation, will also affect your business's value.

Just as the economy ebbs and flows, so does the value of your business. Your company may receive a lower valuation simply because of economic conditions—even if the business is more profitable!

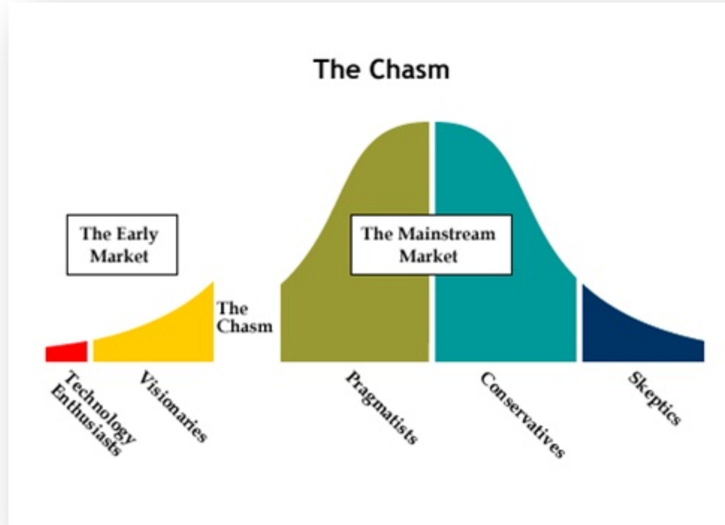
It's called a cycle for a reason. Nothing good lasts forever, and nothing bad lasts forever. Mike owned a staffing company. When times were bad, he couldn't sell his business; when times were good, he didn't want to sell or he wanted a higher price than investors would pay. There's an old saying, "Greed lowers IQ." When times are good, don't be too greedy.



10A. Understanding the Economic Cycle

Another thing a seller must understand is the cycle of their industry.

With technology advancements, companies have had to adjust or die out. But most importantly, they need to understand where they are, in their industry, because that will affect their multiple when they choose to sell.



10B. Understanding the Business Cycle

"When you're Finished Changing, You're Finished."

If you had an IT consulting company fifteen years ago, you maintained clients' servers on-site. Later, you had to evolve and purchased your own server to manage the clients from a remote location earning a monthly maintenance fee. Now, the Cloud is disrupting the server and companies that manage servers have to adjust. Microsoft is currently trying to compete with the Cloud and reinvent themselves with the creation of Office 365 and the recent purchase of LinkedIn.

As a seller, it is imperative to know where your business stands with the local economy and specific industry. Regarding the above bell curve, if you sell on the upside, you will receive a higher multiple than if you sell on the "mature" side.

Conclusion:

There are many factors that impact the value and marketability of your business. Some sound simple, but most can be extremely challenging to change. Not understanding and creating a plan to change or mitigate these risks can be devastating when it comes time to sell or exit the business.

Having gone through this process on our own and personally witnessing other entrepreneurs learn very painful lessons, our mission is to educate and teach entrepreneurs about the process and help them create a winning strategy to exit their business and monetize the years of hard work and sacrifice.

We hope you have enjoyed and learned from reading our *Top 10 Destroyers of Value* and hope you have seen a window into the importance, time, and detail that it takes to develop and create a successful exit strategy.

Whether you decide to market your company at this point or not, addressing these issues is imperative to maximizing your current value. Polish that apple to get the highest return on your hard work!