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White Paper: 3 Paths to Value Creation

Executive Summary

Issue: *The efficient deployment of capital to maximize the value of a business is a critical challenge all business owners face. Unfortunately, entrepreneurs all too often make this decision based upon their "gut" instinct or where they perceive a "weakness" in the business that needs shoring up with additional resources. We recommend a more pragmatic, mathematical approach to solving the problem.*

Challenge: *When it comes to a mature business, value is driven by 3 key mathematical variables contained within the following equation:*

Value = Cash Flow / (WACC – Growth Rate)

It's all about the math. Understanding the magnitude of each variable, and accurately identifying the means of moving each within the business is the key to achieving maxim shareholder value.

Solution:

1. ***Cash flow is king, as any successful entrepreneur will tell you.*** *An entrepreneur would have to work twice as hard to move either WACC or growth rate to improve value by as much as cash flow.*
2. ***Reinforce business success, not failure.*** *This will increase growth rates (and reduce the denominator).*
3. ***Look for opportunities to reduce your WACC.*** *Swap expensive debt where possible and consider buy-backs of equity from shareholders with a high expected rate of return in your company.*

Targeted Mathematical Value Creation

Let's say you're an entrepreneur who's owned and operated a business for 15 years that is grossing $8 million a year and nets $400,000 a year on a normalized basis. You're approaching your 60th birthday, and you've been thinking about your succession plan and how to exit the business in a manner that allows you to retire and maintain the lifestyle you've worked so hard to achieve. Your financial advisor is telling you that to maintain a $280,000 annual spending budget ($400k pre-tax), you'll need about $9 million for the business. However, the investment bankers are telling you to expect roughly a quarter of that, or 6 times trailing twelve months EBITDA for a gross of $2.4 million. So, you've got two options. Sell and take a severe haircut on your lifestyle in retirement, or get laser-focused on growing your business to achieve your exit goals. While it may seem like a daunting task, it does not have to be. Our advice would be to focus on three key variables in your business that will have the most dramatic impact on your ability to exit at the valuation you need to enjoy the retirement you've worked too hard to achieve.

Value = Cash Flow / (WACC – Growth Rate)

The value of your firm is ultimately determined by three variables: cash flow, weighted average cost of capital (WACC) and growth rate of cash flow. The relationship between these three variables is proportional: cash flow divided by the difference between WACC and growth rate. This gives us three variables on the right side of the equation to improve in order to increase the number on the left side. We can make the numerator bigger or the denominator smaller—that is, we can increase cash flow, decrease the WACC, and increase the growth rate of cash flow. Over the course of 5 years with a 5% annualized increase in cash flow, a 1.5% annual reduction in WACC, and a 3% increase in the annual growth rate of cashflow, an entrepreneur can more than triple the value of a company! This is achievable with consistent effort and focus on improving each of the three variables.

Path 1: Increase cash flow

The numerator of our value equation is cash flow. Put simply, cash flow is the amount of revenue that can be distributed to your firm's shareholders after accounting for operating expenses, taxes, tax depreciation, capital expenditures, and increases in working capital. Tax depreciation is the only one of these you want to increase; all the other items reduce your cash flow and so should be minimized.

Operating expenses can be reduced by cutting the cost of production—perhaps through outsourcing to an area with lower labor expenses, as Apple has done successfully—or by improving the efficiency of existing processes, perhaps through vigorous R&D.

Taxes are a drag on your revenue, so relocating your income to a jurisdiction with lower taxes is a good idea when feasible. On the flip side, the faster your fixed assets depreciate in value, the less you'll have to pay in taxes. Accelerated depreciation, a technique whereby fixed assets depreciate more quickly in the first few years of the life of the asset and a sizeable chunk of the taxable income is moved a few years down the road, is a particularly smart move if you're looking to sell in the near future.

Reducing capital expenditures is another way to maximize cash flow—getting rid of unnecessary inventory, slowing payments to your creditors, or selling underperforming properties, as ESL Investments did with many Kmart stores in 2002.

Let's look at an example of how modest 5% increases in annual cash flow over a 5-year period can have a dramatic increase in value. Leaving WACC and Growth Rate static over time, Value increases 27.6% from $2,500,000 to $3190,704 by improving cash flow alone.

Assumptions:

1. Current EBIT = $400,000
2. WACC = 18%
3. Growth Rate = 2%

Current Value

$$\text{Value} = \$2{,}500{,}000\left(\frac{\$400{,}000}{18\% - 2\%}\right)$$

Future Value

$$\text{Value} = \$3{,}190{,}704\left(\frac{\$510{,}513}{18\% - 2\%}\right)$$

Path 2: Increase Growth Rate

The denominator of our value equation is WACC minus cash flow growth rate; first, let's discuss the latter. The sustainable long-term growth rate of a firm measures how much it can grow with the capital it currently possesses. Increasing the growth rate makes the denominator smaller and the total Value larger. As the growth rate is equal to the reinvestment rate times the return on capital, we have two areas upon which to focus.

The reinvestment rate is the percentage of cash flow that is invested back into the firm's operations rather than distributed to owners. The reinvestment rate can be increased by decreasing payouts and putting that money instead into new projects—R&D is again a strong bet for this area—and into new acquisitions, which will expand your capital base.

There are two ways to increase your return on capital: increase margins and decrease capital turnover ratio. You can improve margins with more aggressive marketing and R&D, for instance, in order to get

the most out of your invested capital. Capital turnover ratio is the ratio of sales to invested capital—that is, how much bang you're getting for your invested bucks. That can also be improved by focusing on marketing and efficiency—the stronger the brand and the leaner the process, the more you'll be able to get out of what you already own.

Let's look at an example of how a modest increase of the Growth Rate from 2% to 5% over five years can again positively impact value. Leaving WACC fixed, and using the new cash flow number of $510,000 in year 5, Value increases a total of 56.8% from $2,500,000 to $3,919,976.

Assumptions:

1. Adjusted EBIT = $510,513
2. WACC = 18%
3. Growth Rate = 4.9%

Adjusted Growth Rate Value

$$\text{Value} = \$3{,}919{,}976 \left(\frac{\$510{,}513}{18\% - 4.9\%}\right)$$

Path 3: Decreasing the weighted average cost of capital (WACC)

The final area to target when looking to increase value is also the most complex. The weighted average cost of capital reflects the return your debt & equity investors expect to get back on a regular basis, with each element proportioned based on the way your firm's capital structure is set up. The formula for determining the weighted average cost of capital is:

$$WACC = w_e \times k_e + w_d \times k_d \times (1 - t)$$

where:

w_e = Percentage of Financing from Equity

k_e = Cost of Equity

w_d = Percentage of Financing from Debt

k_d = Cost of Debt

t = Corporate Tax Rate

There are three ways to reduce your firm's WACC. The first is to reduce the equity cost of capital—that is, to make investing in your firm less risky to shareholders. The path to this reduction is to decrease beta, which is a measurement of your investment's volatility relative to the market as a whole. This can be accomplished by diversifying your firm's operations so as to stabilize your revenue in the event of a downturn in one area of an industry—again, acquisitions are one way to do this—and shifting from fixed costs to variable costs, such as by paying workers based on performance rather than on fixed salary.

You can reduce the cost of debt for your firm by making it less risky for creditors to lend to you. Fundamentally, this is accomplished by making the characteristics of your debt match the characteristics of your assets. One way to do this is by utilizing commodity-linked bonds, whose value at maturity is linked to the commodity or commodity basket with which your firm does business. Thus,

the value of your firm is positively correlated with the value of the commodity you're selling, reducing the risk of default in the event of a price downturn.

Finally, you can optimize your debt-to-equity ratio. Too much debt will reduce your firm's value and make you more likely to default—but too little debt is costly because you'll fail to take advantage of the tax shield for interest on debt. The optimal capital structure for your firm therefore aims to minimize the required rate of return by adjusting the mix of debt & equity.

Let's look again at how reasonable improvements in WACC can have a dramatic impact on your firm's value. Using the Year 5 adjusted cash flow and growth rates, now we assume you reduce your WACC by 10% a year for each of 5 years. By the end of the 5th year, your WACC could be just under 11%. While seemingly a trivial number, the impact is remarkable. The adjusted Value would now be $9,032,137! That is a remarkable, combined value increase of 261% over 5 years.

Assumptions:

1. Current EBIT = $510,513
2. WACC = 10.63%
3. Growth Rate = 4.98%

Adjusted WACC Rate Value

$$\text{Value} = \$9{,}032{,}137 \left(\frac{\$510{,}513}{10.6\% - 4.9\%} \right)$$

Conclusion

As a business owner, you don't have to "boil the ocean" to achieve your financial goals! Consistent, modest, year-over-year improvements will make all the difference. There are three ways to increase the value of your company if you're looking to sell in a few years: increase cash flow, decrease cost of capital, and increase growth rate. We've outlined several techniques for achieving this, and it's worth noting that several methods cut across multiple categories: increasing your acquisitions, diversifying your operations to spread out risk, and investing in research and development, to name a few.

ValueScope's team of highly experienced valuation & transaction experts offers numerous services to enable you to maximize your firm's value. Our powerful analytics will provide you the tools you need to make decisions about the direction you want to take your enterprise. Particular to the issue outlined in this paper, we can assist you in compensation analysis, to ensure that however complex your equity structure, it aligns with your company's objectives. We can help you optimize your operations, create more engaged employees, and get the most out of your capital investments. Our tax reporting services will help you make sure you're getting a fair deal. And when it comes time to sell your company, you can rest assured that our valuation and transaction teams are second to none.

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