

Creating Value in a Business

By Rob Slee

Finance theory states that a business does not increase in value until it generates a return on invested capital greater than its cost of capital. On this basis, most private business owners are not increasing the value of their firms. This is true for highly capital intensive companies, as well as for those minimally invested, such as service companies. And this lack of value creation spells serious trouble for America, as the majority of the United States' GDP and employment is generated by private businesses.¹

Owners are having problems with both the risk and return sides of the value creation equation. Two recent surveys show that cost of capital for private companies is 2-3 times higher than for large, public firms. Thus, most private companies are literally one phone call away from oblivion. The "return on equity" side of the equation is also underwhelming. It turns out that Michael Gerber is correct when he asserts that many owners do not have entity value creation as a goal.² Further, they don't teach private value creation in schools, and so most owners have no framework by which to consider this important activity.

Lost in this conversation is that business appraisers are not helping business owners create value in their businesses. It seems impossible to believe that an entire industry of valuers have nothing to say about real-world value creation. How can this be? There are numerous reasons.

First, the valuation body of knowledge is based upon legal and compliance requirements, and not value creation. Legal and compliance authorities such as the Internal Revenue Service and Courts are concerned with value that has already been established, and not with the further creation of it.

Second, most appraisers emanate from the field of accounting. Accounting is about cost; finance is about value. Few accountants even know there is a new field of study called Private Finance, let alone have studied and commanded it.³ Most of the concepts introduced below come from Private Finance – which is defined as the study of how managers of private companies make investment and financing decisions. Without this Private Finance knowledge, appraisers feel comfortable projecting public return expectations and theories to the private markets. This is inappropriate, as public and private markets are not substitutes and therefore are driven by different, unrelated factors.⁴ The difference in behavior between the markets has now been recognized and somewhat accepted, such that indiscriminate use of the public guideline method is now under attack.

The next step toward relevancy in private business appraisal is the development and use of a value creation model based on empirical expected returns of private capital providers. Fortunately such a model and empirical data now exists. This article promotes use of the Incremental Business Value model which uses cost of capital data generated from the Pepperdine Private Cost of Capital surveys.⁵

The Value Thing

What does it mean to create value in a business? Surprisingly the answer isn't as obvious as the question first suggests. Let's look at business value in two ways. First, we have market value – the highest price that the subject would attract in the open market. This is the value world in which most business owners will ultimately transfer their businesses. So when a business sells for "\$XXX," it happens in the world of market value.

But there's another value world that is also useful. This is the world of incremental business value, also known as economic value. This is the place in which daily / weekly / monthly decisions are made. How do managers know – as they make decisions – if they are increasing the value of their businesses? Right now, managers don't know, as they commonly rely on either gut feel or payback to make investment decisions. But there is a rather simple construct they can use – called Incremental Business Value (IBV).

Incremental business value (IBV) is the result of generating a return on investment in excess of the company's corresponding cost of capital. When a company generates positive IBV, that company is generating revenues beyond the corresponding economic costs. This is important because positive IBV creates shareholder value; negative IBV destroys value (on a dollar-for-dollar basis).

So how does a manager create incremental business value? All he/she needs to do is generate returns on invested capital greater than his/her company's cost of capital. Here's the formula:

$$IBV = \text{Returns} - (\text{Investment} \times \text{Cost of Capital})$$

where:

Returns: Recast earnings before interest, taxes, depreciation and amortization (EBITDA) generated by the project or business

Investment: the total amount of investment made in a project or business. Investment comprises all expenditures in a project or business that have a long-term impact.

Cost of Capital: the expected rate of return that capital providers in the private capital markets require in order to fund to a particular investment. All types of capital (banks, mezzanine, equity, etc.) have a cost. Cost of capital considers all of the various types of capital.

Let's consider each of the IBV variables more fully.

Returns

Every project or business generates a promised or actual return. In either case, the Return is captured on a pre-financing cost and pre-tax basis. This is why EBITDA is typically used. Further, EBITDA is recast for seller discretionary expenses and one-time expenses.

Investment

Investment comprises all expenditures in a project or business that have a long-term impact. The concept of Investment is much more expansive than accounting terms such as book value. For example, Investment incorporates spending on “nouns” – people, places and things.

Examples of Investments in People are: Foregone salaries of the owners during periods when the business does not generate sufficient cash flow to pay such; training of productive employees; and long-term bonuses paid.

Examples of Investments in Places are: leasehold improvements; buildings owned by the business; and other structural improvements.

Examples of Investments in Things: subsidized losses from the business; original acquisition cost of fixed assets (undepreciated); and expensed infrastructure for the business such as computer systems.

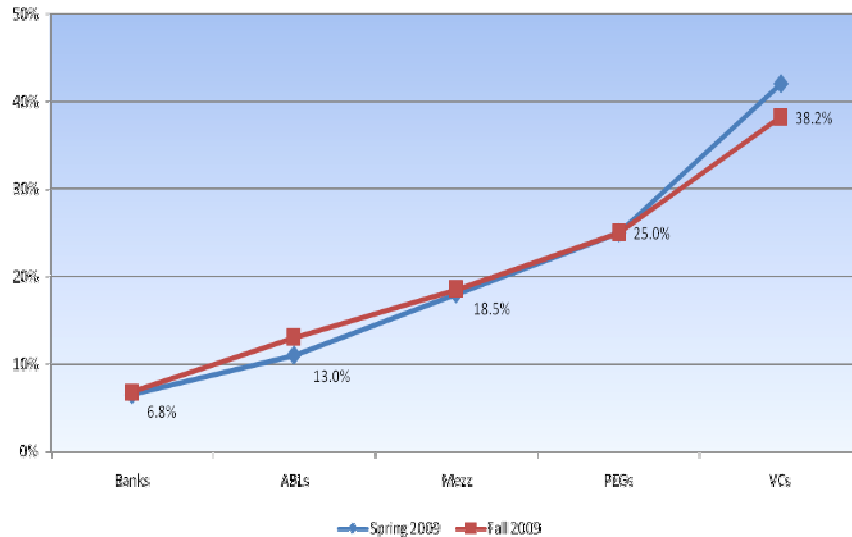
Cost of Capital

Every type of capital has a cost. These costs represent the expected returns of the particular capital providers. Several points must be made about the expected rate of return. First, this return is the expected rate of return *to the provider*. In other words, capital providers require a certain "all-in" return to compensate them for taking the risk of extending the credit or making the investment. This expected return is different than the effective cost to the borrower or investee. The major difference between the expected return to the provider and effective cost to the borrower are various transaction costs. For example, the borrower may incur legal, brokerage, environmental and other costs in effecting the transaction.

Second, expected returns are used to feed IBV rather than realized returns, even though there are often substantial differences between the two rates. Expected returns are used because capital providers offer credit and structure deals based on what they expect to receive from the investment.

Third, it is now possible to graph expected returns for the major capital types, including banks, asset-based lenders, mezzanine providers, private equity, and venture capital. This graph is called the Pepperdine Private Capital Market Line (PPCML), as shown below. The author and John Paglia of Pepperdine University surveyed the private capital markets twice in 2009. The return expectations of the investors who issue private securities are located on or near this line.

Pepperdine Private Capital Market Line Cost of Capital by Financing Source



The PPCML is stated on a pretax basis, both from a provider and from a user perspective. In other words, capital providers offer deals to the marketplace on a pretax basis. For example, if a private equity investor requires a 25% return, this is stated as a pretax return. Also, the PPCML does not assume a tax rate to the investee, even though many of the capital types use interest rates that generate deductible interest expense for the borrower. Capital types are not tax-effected because many owners of private companies *manage* their company's tax bill through various aggressive techniques. It is virtually impossible to estimate a generalized appropriate tax rate for this market.

Examples

#1 *IBV Used in Project Decision-Making*

Assume a business owner – let's call her Jen – wants to hire a salesperson but first wants to understand if this new hire will add value to her company. Hiring the employee promises to add \$75,000 per year in pretax profits. Project investment, or the cost of hiring the employee, is approximately \$150,000. This Investment includes the salary and fringe benefits of the employee, plus the cost of hiring the employee, plus the indirect labor to support the employee. She next considers the return she needs to receive to feel good about the investment. Jen looks at the PPCML and decides that a 25% return on capital is appropriate. Jen's company has no debt and she believes that as the only shareholders, she should require a comparable return on equity as institutional private equity shareholders.

A word of warning to my accounting friends: IBV mainly relies on Private Finance concepts, as the following examples show. Thus, IBV does not rely on traditional accounting concepts, such as reported earnings or book value. Attempts to marry traditional accounting with IBV will not work. This may explain why many business owners don't feel comfortable in relying on accounting constructs to make good business decisions.

Jen uses the following formula:

$$\begin{aligned}\text{Incremental Biz Value} &= \text{Project Return} - (\text{Investment} * \text{Cost of Capital}) \\ &= \$75,000 - (\$150,000 * 25\%) \\ &= \$75,000 - \$37,500 \\ &= \$37,500\end{aligned}$$

This "employee" project promises to generate an incremental business value of \$37,500. Let's stop here and review what IBV is telling us. It says that by undertaking this investment successfully, Jen has generated \$37,500 more than the cost of capital in her business. IBV does not say how much *Market Value* is generated by making the investment. Market value is a separate value world from IBV, although the author believes that over time, generating positive IBV will increase the market value of the company as well.⁶

#2 Determining Overall IBV for a Company

Now assume Jen wants to determine IBV for her company – Jen's Designs. Jen prepares the recast EBITDA below:

Jen's Designs, Inc.			
Item		Y/E 200X	Y/E 200X Recast
Sales	\$22,500,000		
Gross Profits	5,850,000		
SG&A Expenses	5,056,000		
Pretax Earnings	\$744,000		
+ Depreciation	356,000		
+ Interest Expense	0		
+ Amortization	700,000		
EBITDA		\$1,800,000	
<i>Adjustments</i>			
+ Excess Owner Comp ¹			350,000
+ Management Fees ²			200,000
+ Officer Insurances ³			5,000
+ Excess Accounting ⁴			6,500
+ Excess Rent			8,700
+ Excess Health Insur.			8,200
+ Casualty loss			35,000
+ Donations			74,000
+ Other			312,600
Total Adjustments			\$1,000,000
Recast EBITDA			\$2,800,000

¹Excess compensation for Jen

²Management fees are charged each year by another company that Jen also controls

³Officer Insurances are added back since they are discretionary

⁴Some accounting services are performed mainly for another company Jen controls but are billed to Jen's Designs

The recast EBITDA for Jen's Design is \$2.8 million. Jen already determined her company's cost of capital as 25%. Investment is the remaining variable to be determined.

Jen prepares the following exhibit that describes the Investment in her company:

Jen's Designs, Inc.	
Item	Y/E 200X
Original Acquisition Cost of Productive Assets	\$3,000,000
+ Expensed Portion of Computer System	100,000
+ Training Programs for Existing Employees	350,000
+ Leasehold Improvements	400,000
+ Unpaid Compensation to Jen	250,000
+ Other Expensed Investment	500,000
Total Investment	\$4,600,000

Total Investment in Jen's Designs is \$4.6 million. Now IBV for Jen's company can be determined, as follows:

$$\begin{aligned}
 \text{Incremental Biz Value} &= \text{Company Return} - (\text{Investment} * \text{Cost of Capital}) \\
 &= \$2.8 \text{ million} - (\$4.6 \text{ million} * 25\%) \\
 &= \$2.8 \text{ million} - \$1.15 \text{ million} \\
 &= \$1.65 \text{ million}
 \end{aligned}$$

The Company is generating \$1.65 million in incremental business value. Once again, this positive IBV number means that Jen is generating returns that exceed her company's cost of capital. And generating positive IBV should ultimately also lead to positive market value creation.

The IBV process helps managers make better investment decisions. I think all owners should establish each month whether their companies are creating value. This Incremental Business Value report becomes the 4th monthly financial statement (P&L, Balance Sheet, and Cash Flow).

Most private companies, however, are not currently generating incremental business value. There are a number of different strategies that all companies can use to increase IBV, as the following table shows:

Actions that Affect Incremental Business Value		
Goals	Value Drivers	Strategic Requirements
<i>An increase in Recast EBITDA</i>	Higher revenue and growth	Patent barriers to entry, niche markets, innovative products, etc.
	Lower costs	Scale economies, captive access to raw materials, higher efficiencies in processes (production, distribution, services) and labor utilization, effective tax planning, etc.
	Increased asset utilization	Efficient asset acquisition and maintenance, higher utilization rates of fixed assets, efficient working capital management, divestiture of negative value-creating assets, etc.
<i>Employ additional high yielding capital</i>	Decrease cost of capital	Invest in only positive IBV projects
	Decrease capital base	Withdraw or liquidate underperforming businesses
<i>A reduction in capital charge</i>	Reduce business risk	Consistent and superior operating performance compared to competitors, long-term contracts, etc.
	Employ a reduced cost of capital structure	Maximize use of debt to support equity, possibly use less costly equity substitutes, such as mezzanine debt
	Reduce cost of debt	Reduce surprises (volatility of earnings), consistently test the market cost of debt
	Reduce cost of equity	Consistent value creation will reduce cost of equity

As the chart indicates, companies increase IBV if they increase Returns while using capital more efficiently.

Conclusion

The combination of scarce capital and global competition requires private business owners to make better investment and financing decisions. Since our universities are mainly preoccupied with teaching students how to manage large public companies, managers of private companies are left to their own devices to create business value. Unfortunately for America, Main Street companies are not devising well.

But there are strategies and tools that can help business owners make better investment decisions. Incremental Business Value can be used as a basis for management bonus plans, for project performance and for company value measurement. For private companies project investment decisions are an especially noteworthy application because the recast EBITDA of the project can be derived and applied against the cost of capital employed.

For the first time we have empirical data concerning private return expectations. Using this data, along with Incremental Business Value, will help American private business owners make better investment decisions, thereby enabling them to compete better and also add value to their companies.

Endnotes

¹Trottier, *Middle Market Strategies* (Wiley), Chapter 1.

²Gerber, *E-Myth*, (Harper Collins), 1988.

³The field of Private Finance was launched with the publishing of Slee's textbook, *Private Capital Markets* (Wiley) in 2004.

⁴Robert T. Slee, "Public and Private Capital Markets are Not Substitutes", *Business Appraisal Practice* (Spring 2005).

⁵Pepperdine Private Capital Markets Project Survey Report, February 2010, John K. Paglia, bschool.pepperdine.edu/privatecapital.

⁶For a discussion of economic value and market value correlation, see: Slee, *Private Capital Markets*, Chapter 9.