Exit Planning Institute

Seeking to Reignite Sales, Earnings, and Protect Business Value? Start with the 4Cs

Many owners have questions about how they can minimize the decline in business value and reignite sales and earnings. It is important to first understand how business value is determined.

One way to determine the value of your business is to use a simple formula: Value = Earning x Market Multiple. Understanding this formula is important to devising a strategy that allows you to protect value today so value can built in the future.

To start this equation, we begin with understanding earnings. There are many forms of earnings: Net operating profit, net income before and after taxes, earnings before interest and taxes (EBIT), earnings before interest, taxes, depreciation, and amortization (EBITDA), among others. EBITDA is the form of earnings most often used for business valuation purposes. More accurately, recasted EBITDA is the most common form of earnings used to calculate business value. This can be referred to as the real number.

The real number is the actual earnings being generated for the benefit of the present owner(s) and the real benefit that would pass to a future owner. Recasted EBITDA then considers items like one-time, non-recurring expenses, discretionary spending by the owner(s) and any other normalized expenses of the business.

The reality for many business owners is that earnings, at least in the short term, will most likely decrease. With the math formula in mind, if earnings decline, your business valuation will most likely decline too. Many business owners are already initiating mitigating strategies and actions to minimize the COVID-19 impact on earnings.

What owners may not be considering deeply enough are strategies and actions to minimize the impact on the other side of the equation, the market multiple.

The market multiple assigned to a business is determined primarily by the Private Capital Market. All industries have a range of multiples assigned to earnings. The Private Capital Market determines this range. Stronger industries and market conditions are two primary factors in determining the range of multiples within an industry. Owners likely cannot control the range of multiples in their industry.

Given our recent market crisis, the Private Capital Market is assessing potential changes to the industry ranges. There are too many unknowns to predict the outcome of these range adjustments just yet. Most likely the industry ranges will be lowered. The only thing owners can do to influence how the Private Capital Market will respond is to do their best to mitigate negative economic impacts within their industries. There is no doubt that unfortunately, some industries will be hit harder than others.

Even if your industry ranges are lower post-COIVD-19, owners have control over where their business lands in that range. How does the business owner determine where their company lands within this range of multiples? It is primarily determined by the strength of the intangible value factors referred to as the Four Intangible Capitals (4Cs): Human, Customer, Structural, and Social.

As a business owner, it is important to understand that the 4Cs may help retain your place in the range of multiples post-COVID-19. The strength of your 4Cs will largely contribute to mitigating reductions in earnings. Your success in implementing these actions will directly impact the value of your business now and in a post-COVID-19 world. Even if the range of multiples in your industry decline, if your 4Cs are still strong, you may retain your previous position in the range. Your success at pivoting better than your competition at this time, due to your strong 4Cs, may raise your position in the range of multiples.

The 4Cs: Human, Customer, Structural and Social Capitals

Human capital is the value of the talent that you have in your company. The more talented your team, the better they will perform, especially in a crisis. All things being equal, the stronger your human capital, the more value the market is going to place your company.

Customer capital is the measure of the strength of relationships with your customers. Deep, integrated, tenured relationships, recurring revenue, contractual relationships, and diversified customer bases -- all are things that contribute to strong customer capital.

Structural capital is the back-end infrastructure of the company such as, your processes, your financials, your strategies, your information technology, your patents, and other intellectual property (IP). It is the documented know-how, know-what of the company that positions you to be fast and flexible.

Social capital is how you move information, how that information flows within your company, the attitudes of your management team and employees, the environment in which they work, and company morale. This is represented by the rhythm and culture of the company. Social capital is not just inward facing. It is also shown in how your company contributes to its community.

How do the 4Cs impact the market multiple?

Most owners walk into their companies each day managing the 4Cs. They likely care about their people (Human Capital). They care about their customers, their customers experience, and the revenue associated to that customer (Customer Capital). They care about running their business as efficiently as possible (Structural Capital). Lastly they are likely the heartbeat or tone setter of their culture (SocialCapital). They do this unintentionally. It's intuitive. It is a part of who they are as entrepreneurs, rather than doing so in an intentional and methodical way that is framed, reviewed, measured, and understood with analysis. By shifting this mindset from unintentional to very intentional, the business owner and their advisors can begin to score the 4Cs and understand their impact on their multiple thus their value.

Common Sense Scoring is used to score the 4Cs. This scale moves from a low score of one to the best in class score of six. The key to this scale is that there is no average. An owner must choose if they are slightly below average, a three score, or slightly above average, a four score. In each one of the 4Cs there are multiple value factors that will be assessed to determine the value of each of the 4Cs.

Using Human Capital as an example, some of those value factors an owner may score would be:

- Experience and tenure of the management team
- Formalized training and education programs
- Strength and favorable benefits program
- The performance review, feedback, and coaching process
- Clear and concise HR policy and procedures
- Non-Compete and Non-Solicitation Agreements for key employees

Most owners have a sense for what makes strong human capital, however, most are not defining and measuring it. If they are not regularly measuring it, it's not likely it is getting managed and tended to.

The above Human Capital example allows the value factors to be assessed that tell us the strengths and weaknesses inside of that capital. Each one of the 4Cs will have multiple value factors below them and this scoring process will repeat. With this data, we can begin to understand the value factor's impact on business value (the multiple) and create strategies and action plans to improve the weaknesses. By doing this, we can make this process very intentional and methodical while we build and raise the score. As a result, we raise the value of the business over time.

Utilizing the table below, which company is more valuable?

4Cs	Company "A" Scores	Company "B" Scores
Human	3	4
Customer	3	4
Structural	2	4
Social	2	4
Total Score	10	16
Average	2.50	4.00

Company "B" has stronger talent, customer relationships, processes, systems, technology, facilities, financial structure, and culture. This means that Company "B" has higher intangible value and as a result is very likely to receive a higher multiple in the range of multiples within their industry.

Company "B" is likely performing better financially as well. Beyond the most immediate tangible and intangible effects of a high scoring company, Company "B" likely has better growth potential, and is more predictable and less risker to a potential buyer, especially in a COVID-19 world.

Let us review Company "A", the weaker company, and apply the 4Cs score to the range of multiples in this industry. We can utilize the simple math formula to determine this company's value today and its potential

value. For this example, Company "A" has Recasted EBITDA of $5 million.
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Average Score	Risk Level	Multiple
1.00 or below	Very high risk	0.0 x Recasted EBITDA
2.00	High Risk	3.0 x Recasted EBITDA
3.00	Average Risk	5.0 x Recasted EBITDA
4.00	Below Average Risk	6.0 x Recasted EBITDA
5.00 or better	Low Risk	8.0 x Recasted EBITDA

Company "A" has an average score of a 2.50, thus would likely sell for 3.0 x Recasted EBITDA given the multiple ranges for this industry determined by the Private Capital Market. Applying the math, this company would be worth $15 million, but has a potential value of $40 million. This is quite a significant difference. The math equation would read for Company "A" as $5 million in Recasted EBITDA multiplied by 3.0, the multiple within the industry range. This would equal the company's value today or as stated, $15 million.

From this example, we can see there is an even greater benefit beyond just knowing where you place in the range of value and your present business value. A business owner can quantify how much value gain is possible using value acceleration. This number is likely higher given that if Company "A" was performing like Company "B", they would have better people, better systems, better customers, more efficiencies and likely be making more money, an increase in overall earnings.

Strong 4Cs and pivoting through COVID-19

Those companies that are actively working on and improving upon their 4Cs are likely positioned better in times of decline or need. Not only do they likely have premade contingency plans to execute upon, but they also have the systems, people, customers, and the products to do so. The closest any owner will likely get to a "playbook to navigating crisis" is actively understanding the impact of the intangible capital.

As we saw in the example above, Company "B" was likely better positioned to make an extreme pivot if needed during a time like the COVID-19 pandemic as opposed to Company "A". Why? Because they are more prepared. Likely Company "B" exhibits some of the following:

- Committed and engaged people
- Creative and collaborative leaders
- People who are cross trained
- Share common goals and have a visible core value system they live by
- Strong balance sheet with access to capital
- Well documented process and systems to deploy

- A detailed and written marketing strategy with documented data points which allows them to better understand customers and needs
- A detailed buyer persona
- Customer loyalty
- A strong brand and product(s)
- Documented contingency plans
- Updated and efficient systems in place

All these attributes of a ready and attractive company play a role in pivoting through hardships. They not only allow a business to grow in good times but grow in tough times. These attributes spawn a unique culture and company that knows who they are, who the serve, and deliberately go in that direction. This makes it easier to pivot if needed.

Furthering the conversation on company performance, raising cash flow, and creating exponential value

Let us look at our example again this time with the assumption that improving on the 4Cs would not only raise the multiple of Company "A", but also raise its earnings performance by 20% ($1,000,000) taking the company's Recasted EBITDA from $5,000,000 to $6,000,000.

Company "A"	Current Value	Potential Value	Value Gain
Average Score	2.50	4.0	+1.50
Recasted EBITDA	$5,000,000	$6,000,000	+$1,000,000
Multiple	3.0x	6.0x	+3.0x
Business Value	$15,000,000	$36,000,00	$21,000,000

The combination of increasing the multiple while increasing earnings results in a $21,000,000 value gain for Company "A" while dropping $1,000,000 to the bottom line in Recasted EBITDA. By increasing both your multiple and earnings you achieve accelerated increases in value.

When you improve the left side of the equation (earnings/Recasted EBITDA) while simultaneously increasing the right side of the equation, (the industry multiple) you get an exponential acceleration in value. This is what value acceleration is all about.

In conclusion

The Value Acceleration Methodology helps an owner and the advisors manage your real number and your intangibles (4Cs). Managing your tax number is important is also critically important, but your tax number is not necessarily the number used to value a business. Today many owners do not receive any feedback on the value of their intangible assets or their real number because they lack a system to provide feedback on.