Business Transaction Marketplace

Information about Transition Planning, Business Valuations and M&A **June 2009**

Increasing Business Value

The current economic recession is causing business owners and their management teams to "get back to the basics". Here's one of the basics for any business. Simply make increasing business value one of the primary goals of the company.

Increasing business value is accomplished by:

I – Increasing operating cash flows
R – Reducing business risks
g – Increasing growth

The above are the valuation components to the *Gordon Growth Model*: **I / R-g = V**. This is also the *capitalization of earnings* method under the income approach for valuation purposes.

This issue of *Business Transaction Marketplace*^SM will discuss some typical business value drivers, the management decision process where the goal is to increase business value, and some value creation strategies. An article on [Maximizing Business Value] might also be of interest to you.

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Value Drivers

Here are sixteen (16) typical Value Drivers, broken down into four (4) categories, which are common to privately held businesses that sell products or services:

Intangibles
- Well defined purpose, vision and mission statements
- Management's knowledge, experience and depth
- Motivated and dependable work force
- Key employees are bound by non compete agreements

Operating
- Repeat customers, and a customer list
- Proprietary products: patents, copyrights
- Large market share
- Diversified: products, customers, geographic

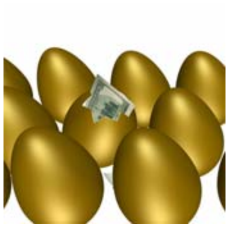
Investment
- Commitment to human capital (training, benefits, etc.)
- State of the art technology equipment
- Additional capacity for growth (space, manpower, etc.)
- Capital budgeting processes in place

Financial
- Key management have incentive compensation plans
- High margins due to efficiencies, etc.
- Strong liquidity position
- Optimal financial leverage

Business Plan – The “Map” for Management Decision Making

A business plan is the “map” that management uses to identify and implement value creation strategies. It’s like running the bases:

First Base: *Where are we now?* Recognizing the Company’s current strengths, weaknesses, opportunities and threats; then, establish priorities
Second Base: *Where do we want to be?* Deciding what strategies to implement
Third Base: *How do we get there?* Implement value creation strategies
Home Base: *Goals are met or modified.* Measure outcomes, then feedback again through the process



Value Creation Strategies

Here are fifteen (15) value creation strategies, broken down into five (5) functional areas common to privatley held businesses that sell products or services:

Management Strategies

- Develop and communicate the Company’s purpose, and its mission and vision statement.
- Institute a policy of reviewing the Company’s strategic business plan quarterly.
- Join trade organization for your industry; volunteer for committees that monitor industry trends.

Products and Services Strategies

- Make it a planning objective to assess whether to perform in-house research & development (R&D), versus outsourcing or acquiring R&D.
- Require written POs for purchases over a set dollar limit; always compare to receiving reports.
- Review product/service pricing annually with department heads in operations, marketing and finance.

Marketing and Sales Strategies

- Specifically identify current marketing strategies in the following areas: Product, Price, Promotion, Place.
- In one paragraph, describe what “problem is solved” or “need is satisfied” by the Company’s product or service.
- Put the Company’s price catalog on the Company’s website; allow for internet purchasing.

Finance Strategies

- Develop a one to five year financial projections tied to the Company’s business plan.
- Separate cash recording, cash depositing and bank reconciliation duties amongst employees.
- Annually, assess if the “timing is right” to sell the Company to achieve the maximum exit price.

Administration Strategies

- Develop job descriptions for the key management and other workforce positions.
- Use exit interviews with terminated employees as a tool to improve the Company’s personnel practices.
- Tap into state and federal job training programs and work incentive job credits.

Marketplace Alert

When allocating the purchase price in a business transaction, it’s critical to understand the tax consequences to the seller because of differing tax rates for allocated items. Personal goodwill is taxed at a 15% captial gains rate, whereas a non-complete would be taxed to an individual at a 35% ordinary tax rate. A taxpayer tried to undo the purchase price allocation post transaction, arguing he really meant the allocation to be to personal goodwill, and not to a non compete. The Court didn’ buy it, costing the taxpayer over $200,000 of additional taxes. *Irwin Muskot v. U.S (1st Cir 1/29/09).*

The lesson here is to document an allocation to personal goodwill early on in negotiations, from the term sheet or LOI, through the definitive purchase and sale agreements.