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Valuation, Discount Rates and Management Actions
Steps to Increase Company Valuations
By David Cusimano & Michael L Fetters

A company's intrinsic valuation is based on its projected future cash flows and the perceived risk of the company achieving these future cash flows. The fundamental method for taking these projections of cash flows and risk and turning them into a valuation is discounted cash flow or DCF.

For most small businesses, company valuation is discussed in terms of multiples of critical financial numbers, namely revenue, net income and earnings before interest, taxes, depreciation & amortization (EBITDA). It is important to remember that the use of these multiples to discuss and negotiate a business acquisition are all based on the theory embodied in the DCF Model. In order to increase a small company valuation, business owners have two major foci for actions: 1) Improve the financial measures; and 2) Lower the risks. In this brief article we focus on the actions to lower risks, i.e. lower discounts rates.

Discount rates used in valuation are expressed as a percentage and represent the risk of receiving the benefit stream (i.e. the future cash flows) over time. The more speculative or higher the risk, the higher the discount rate; conversely, the less speculative or lower the risk, the lower the discount rate. The higher the discount rate, the lower the valuation for your business.

Discount rates used in business valuation are rates calculated by summing up the following factors:

- the risk-free rate of return
- the common stock equity risk addition
- the smaller company size addition
- the industry risk addition
- the company specific addition.

As a business owner, the risk addition you can immediately impact with targeted management actions is the company specific addition.

The risk-free rate of return includes the investors' required rate of return for the "riskless" use of their funds and a factor for inflation. The rate of return earned on long term U.S. Government bonds is considered a good proxy for the risk-free rate of return. As of September 2019, the rate of return on a twenty-year U.S. Government Treasury Bond is approximately 2.25%. Therefore, the risk-free rate of return for determining a valuation discount rate would be 2.25%

The additions to the risk-free rate delineated above (the common stock equity risk addition, the smaller company size addition, the industry risk addition and the company specific addition) are then each considered, a percentage calculated for each and all of these additions are summed with the risk-free rate to determine the discount rate used in your evaluation. Typically, the sum of all these calculations generates a discount rate resulting in a valuation that is 30-60% less than a similar publicly traded company. In other words, multiples of EBITDA are 30-60% less than EBITDA multiples for publicly traded companies. While the existence of some of factors listed above will prevent a private company from ever trading at the same multiple as a public company, substantial progress can be made by managers of private companies to close this gap.

To many, the valuation resulting from all of these calculations appears to be exact because it is a thorough process that results in a dollar figure. However, there is little empirical evidence to support the determination of the "specific company addition" in the discount rate calculation. From our experiences, the specific company addition results from the analysis of quantitative factors AND qualitative factors. Qualitative factors are considered because they ultimately drive the long-term outlook for company performance and the critical ratios.

Typical quantitative factors measured in a valuation are:

- Revenue
- Profit
- EBITDA
- Operating Cash Flow (OCF)
- Asset Efficiency

While many valuation experts point to these quantitative factors as the drivers behind a company's valuation, we view them as measures of the drivers of value. A business owner isn't able to come to work in the morning and simply start creating more profit or asset efficiency. Nor is the business owner able to delegate such tasks to a management team. No matter how much intensity, desire, or effort, there is no profit wand that can just be waived a little harder. And while improving each of the quantitative measures listed above will usually (but not always) increase a company's valuation and should be used as milestones for performance, numerous external factors are also involved. For example, a team can't make a customer buy from them, they can only encourage and persuade customers to buy. Customers may have their own reasons for not buying that aren't related to the company.

A second issue of solely focusing on these quantitative measures is the short-term-fix trap. Profit, EBITDA and OCF can be immediately improved by reducing expenses; e.g., firing employees, reducing advertising and cutting professional development programs. These are short term improvements which are likely not sustainable and in fact may reduce value over a period of years. Employee disgruntlement, lack of an inspiring vision and undercutting sales force efforts are likely to undermine company health, culturally as well as financially.
While we encourage CEO/Founders and/or executive teams to track these quantitative benchmarks, we think it more important to focus on the major factors used to determine the company risk premium that increase the discount rate and reduce a company's valuation. Fortunately, improvement in these factors will also generate sustained improvements in the quantitative metrics highlighted above.

To use a sometimes easier to understand EBITDA multiple example, suppose a company has $3,000,000 of EBITDA and could sell today at a 5X EBITDA multiple. We could approximate its debt-free value as:
$3,000,000 X 5 = $15,000,000

If leadership focused only on increasing EBITDA by 10%, they could theoretically increase the company value to:

$3,300,000 X 5 = $16,500,000

1 A business that pursues revenue growth that either (1) requires strengths outside of its core competencies or (2) pushes the operations of the company beyond their ability to consistently deliver quality, could actually increase risk and thereby lower its valuation - even though the revenue number is larger.

However as is our experience this laser focus on one metric can lead to short-term benefits and long-term undermining of shareholder value.

If the CEO/Founder and/or the executive team focused on internal risk reduction activities they could, by pulling levers completely within their control, increase the company's multiple from 5X to 5.5X. The value could now be approximated as:

$3,000,000 x 5.5= $16,500,000

And because leaders of companies that have lower risks typically are running stronger, more aligned companies, they usually figure out how to increase sales, gross profit, and EBITDA as well. And so, the following is likely:

$3,300,000 x 5.5 = $18,150,000.

The factors described below are the major influencers of company-specific risks and if improved will lower the risk premium and dramatically increase value.

Align Team Members Around the Vision

A recent Harvard Business Review article highlighted a study "Researchers analyzed 450,000 survey responses collected by the Great Place to Work Institute from employees at 429 U.S. companies, probing whether people feel their work has meaning… and a link between employees' engagement and firm financial performance ." They found that while "the actual purpose of the company can differ wildly… all that matters… is that it focuses employees on a goal beyond profit maximization."

When team members understand why the organization exists and that they are fulfilling a purpose beyond simply coming to work to do a job and get a paycheck, they'll help the company perform better on nearly every quantitative metric. They'll more often make better autonomous decisions, say the right things to customers, find expenses that aren't needed, and point out redundant assets that can be streamlined. An organization that excels in this area will be a dream to several acquirers who will likely bid up a valuation to much higher than a cash flow analysis alone would yield.

Build a Unique, Sustainable Value Proposition

An unfortunate number of businesses sell their product or service on price. Unless a business has a true supply chain competitive advantage that allows it to outcompete the best on the planet at delivering low costs (i.e. Walmart, Amazon) this will end up as a bloody race to the bottom in which a business might have large revenue but almost no profit. Businesses that understand their competitive advantage (or unique value proposition) and live by it earn higher margins. This should clearly define what opportunities the business should not pursue as much as what it should pursue. All team members should understand their niche. A business that will happily refer customers to others for requests that aren't in its core competency ironically have higher profitability than those who will stretch to pursue opportunities they might only be average in.

Our experiences have shown a good measure of how well a business is doing in this area is EBITDA margin. A business with an EBITDA margin of at least 15% for a product business or 25% for a service business has likely figured out some type of special process for using its core competencies to deliver an offering effectively to its target market. It likely has been able to hold competitors at bay and resist the need to cut prices to do so. Acquirers will notice this and will pay much more for these businesses.

2 https://hbr.org/2016/10/the-type-of-purpose-that-makes-companies-more-profitable

Reduce Dependence on Specific Individuals and Third Parties

When an organization is dependent on any one employee, vendor, or customer, risk to a buyer is high. A buyer will be justifiably concerned that they could be left with a disaster should one of these pivotal parties leave after a transaction. Landing a new A-list customer may be exciting, but a buyer will deeply discount the portion of revenue from that customer if this represents a large percentage of revenue. Every step taken to lower customer and vendor concentrations is a step toward increasing valuation.

Similarly, while a star employee might bring large amounts of cash today, their contributions will be deeply discounted by a buyer. Steps to systematize that person's efforts in a way that can be duplicated by others around them will not only create a larger number of strong team members for the company, but also lower the discount rate on all the revenue each one creates, thereby boosting valuation.

Reduce Dependence on the Owner of the Company

It's typical to find lower middle market private companies that are still run by their owners and/or founders. These people often have the deepest passion for the business and are often the highest performers in multiple functional areas of the business. Ironically, while the business may seem to benefit from this unusual combination of passion and talent, its market valuation is saliently hampered.

A buyer thinking of taking over a business which depends on its owner for day-to-day operations will be justifiably worried about what will be left if the owner is gone. Even if the owner is planning to stay on after an acquisition, buyers know that people sometimes act differently once they receive a large sum of money on closing day. The owner might remain completely engaged. Or maybe not. And this uncertainty will lower the amount that a buyer will be willing to pay.

So, the advice to "Work on the business, not in the business" rings very true for those trying to maximize their valuation. Business owners that build a strong layer of management just beneath them to work in the business while they spend their days working on the business will emerge from their competitors. Working on the business not only improves the chances of growth, but it also makes it much easier to convince a buyer that a valuable asset has been built beyond the owner.

Make More Revenue Recurring

When we hear of owners successfully exiting at outrageous multiples, nearly all of them are companies that have some type of recurring revenue component. A concern all buyers have is that revenue might significantly slow or stop all together after they purchase a business. Recurring revenue allays this concern and allows buyers to feel comfortable with paying more. While recurring revenue is the easiest to establish in industries like software, nearly every business can add some type of recurring revenue to its model regardless of its industry.

Improve the Operating Cash Flow Cycle

While many industries have immediate customer payment expectations (i.e. retail, software as a service) many have extended customer payment terms as the norm. Businesses that collect payments only after an extended period of time can have large amounts of working capital trapped in them. And businesses with this model will often need more cash injected for growth and this cash need can sometimes outstrip the operating cash flow coming in. Because buyers are essentially buying the cash flow that a business can produce, if they perceive a large working capital cash need for them to grow the business, they'll lower their valuation.

While businesses in some industries might not have the ability to flip a switch and start demanding customer payments on the spot, nearly every business can improve their cash cycle. Being selective about selling only to customers who pay on time or adding unique revenue streams that have better payment terms than the core business can improve the cash situation.

Improve the Quality of Financial Reporting
While buyers will assess all sorts of qualitative aspects of a business before they finalize a transaction, the number one tool they have to quantitatively assess what they are considering buying is a company's financial reporting. And a company's financial statements and other dashboard metrics will only be able to convey value to the extent that they are accurate.

This strengthening starts with increasing internal financial controls and reporting. Holding internal and external accountants accountable for delivering GAAP financial statements will provide better information for management decision making. And it will also improve a company's ability to raise debt and equity financing in the near term and sell for a much higher valuation when it is ultimately sold.

Businesses that invest in getting their numbers right earn higher valuations. Buyers will not only be able to better understand what is happening in the business, but they will be comforted that a team is already in place that values timely and accurate reporting. Depending on the size of the business, an investment in an outsourced or permanent CFO, and reviewed or audited financials can often yield an increase in valuation many times more than the cost of the service.

Document Business Processes and Streamline Storage Access
Many businesses run well because of the talent of specific individuals who have built know-how over the years within their heads. If there are clues to how they do what they do, they may reside on individual hard drives or even personal drop box accounts. While things may seem to be humming today, large risks are lurking not far below the surface. Acquirers will factor this in and either lower their valuation thoughts or pass altogether when this is prevalent.

Businesses that build clearly defined processes for each job function that allow another person to easily jump in should the incumbent leave or be promoted will function much better. This coupled with a shared and easily accessible document storage system that tracks processes and important document expiration dates will tighten nearly every aspect of what a business does and boost valuations into much higher multiples.

Conclusion

A candid assessment of each risk categories discussed above will reveal strengths and weaknesses across its activities. A leader looking to boost an organization's market value (as all should be) would do well to conduct this functional assessment through a lens of the drivers of value to a potential buyer. We recommend the following actions: 1) the CEO/Founder and executive team develop an assessment scale that is valid across all eight factors determining company-specific risk; 2) assign teams to assess each of the eight factors; 3) develop actions to reduce factor risk as well as 1-3 metrics to track progress in reducing each factor risk component; and 4) develop timeline to reduce each risk faculty and lower overall company-specific risk premium.

About the authors

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