Value Acceleration:

Increase Business Value and Liquidity

BerryDunn

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Table of **contents**

01.

Consider the factors

Consider the following statistics:

- **Sixty-three percent of private businesses** are owned by baby boomers.[1]
- **Approximately 10,000 baby boomers** are reaching retirement age each day.[2]
- **Seventy-eight percent of business owners** expect to fund 80% or more of their retirement through the sale of their business.[3]
- **Only 20% to 30% of the businesses** that go to market actually sell.[4]

While a massive number of people are retiring each year and counting on the value of their business as part of their retirement plan, many are unable to generate any liquidity beyond normal compensation. They may even have a very valuable business, but can't convert any of that value into cash. What a terrible situation! They may feel like a sailor stranded on a desert island—surrounded by water but dying of thirst.

Attaining liquidity from your business and increasing business value are two topics that go hand in hand. Factors that increase business value often also increase the ease of selling the business, and vice versa.

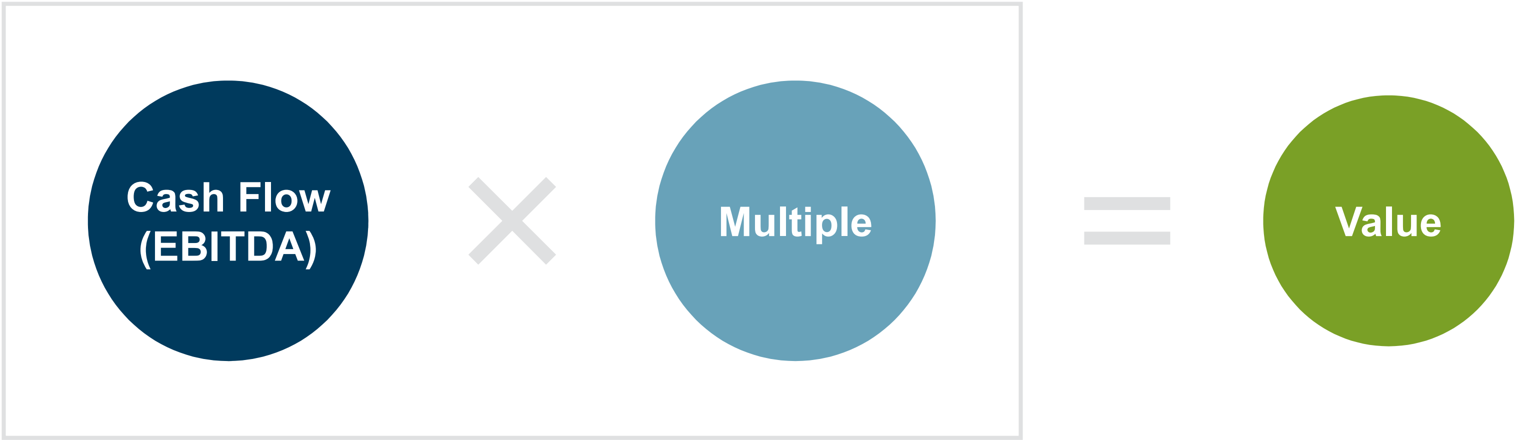
Businesses are often valued by using an income metric such as EBITDA (earnings before interest, taxes, depreciation, and amortization) and a valuation pricing multiple.

[1] Christopher M. Snider, "A Local Market Study: The State of Owner Readiness (Georgia)," Exit Planning Institute (2018).

[2] Matthew Frankel, "9 Baby-Boomer Statistics that Will Blow You Away," https://www.fool.com/ retirement/2017/07/29/9-baby-boomer-statistics-that-will-blow-you-away.aspx

[3] BizEquity, LLC, "About BizEquity," https://www. bizequity.com/aboutbizequity

[4] Exit Planning Institute, "The State of Owner Readiness™ Research," http://exit-planninginstitute.org/state-of-owner-readiness/



The most effective way to increase business value is for the business owners to focus on improving the multiple by reducing business risk. Five examples of effective ways to reduce business risk and improve the multiple are as follows:

1. Reduce reliance on the owner of the business
2. Incentivize key employees to sign long-term employment contracts
3. Diversify the customer base
4. Create sustainable and recurring revenue
5. Maintain audited financial statements

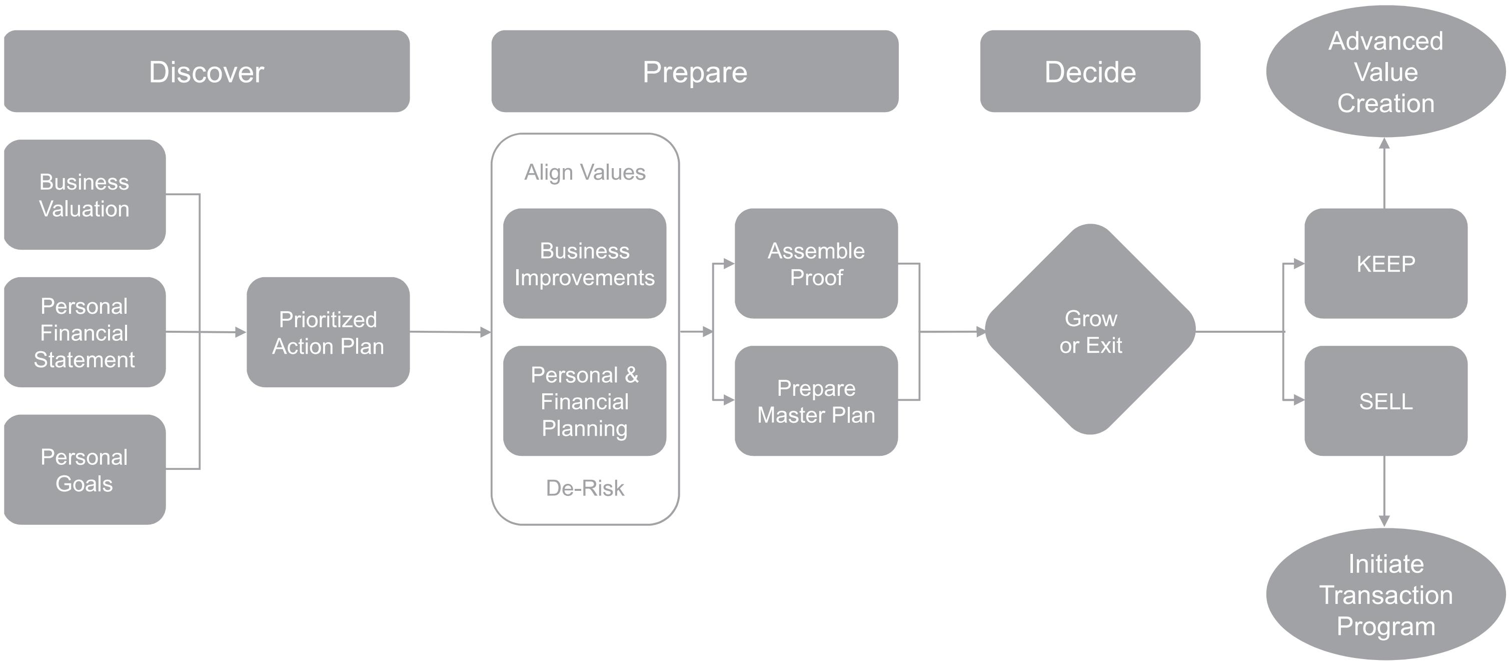
By planning ahead and implementing the above steps, business owners may be in a much better position for retirement. These five strategies are just a few of the ways through which people can increase the value and liquidity of their businesses. The value acceleration framework presented below gives businesses owners a complete set of tools to make businesses more valuable and transferrable.

02.

Align your goals

According to a study by PricewaterhouseCoopers, twelve months after selling, three out of four business owners surveyed “profoundly regretted” their decision.[5] This statistic highlights the importance of the value acceleration process, which focuses on increasing value by aligning business, personal, and financial goals. This process prepares business owners for transition, increasing the likelihood of a successful transfer.

The value acceleration process has three stages: **Discover, prepare,** and **decide.**



[5] Christopher M. Snider, “A Local Market Study: The State of Owner Readiness (Georgia),” Exit Planning Institute (2018).

The discover stage is where business owners take inventory of their situation, focusing on risk reduction and alignment of their business, personal, and financial goals. The information gleaned in this stage is then compiled into a prioritized action plan utilized in future stages.

In the prepare stage, business owners follow through on business improvement and personal/financial planning action items identified in the discover stage. Examples of action items may include the following:

- Addressing weakness identified in the discover stage, in the business or in personal financial planning
- Protecting value through planning documents and making sure appropriate insurance is in place
- Analyzing and prioritizing projects to improve the value of the business, as identified in discover stage
- Developing strategies to increase liquidity and retirement savings

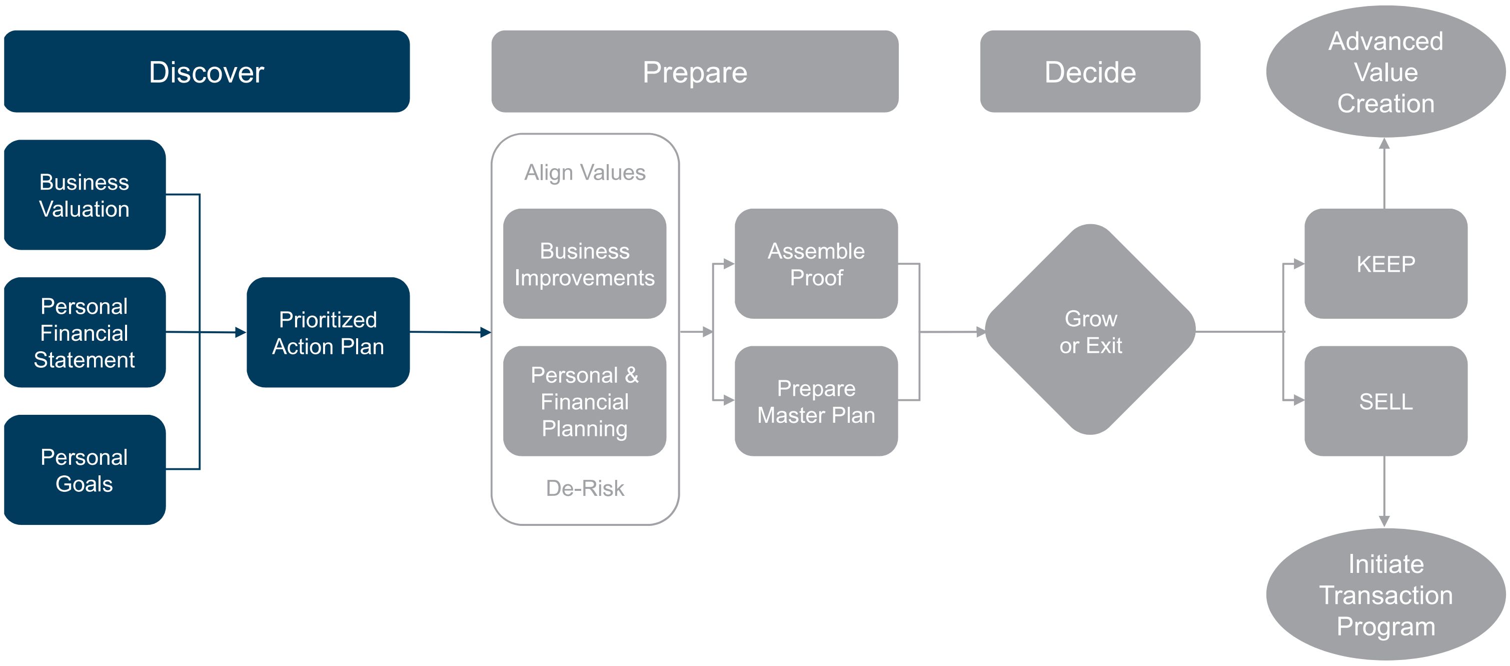
The last phase in the process is the decide stage. At this point, business owners choose between continuing to drive additional value into the business or selling it.

03.

Discover

The discover stage is the first stage in the value acceleration process. The discover stage is also called the “triggering event.”

In the discover stage, business owners take inventory of their personal, financial, and business goals. We refer to these three sets of goals as the “three-legged stool” of value acceleration. When taking inventory of their personal, financial, and business goals, owners should note ways to increase alignment and reduce risk.



The objective of the discover stage is to gather data and assemble information into a prioritized action plan, using the following general framework.

Every client we have talked to has plans and priorities outside of their business. Accordingly, the first leg of the three-legged stool in the discover stage is to explore your personal plans and how they may affect business goals and operations. What do you want to do next in your personal life? How will you get it done?

The second leg of the stool is exploring your personal financial plan, and how this interacts with your personal goals and business plans. What do you currently have in investments? How much do you need to fund your other goals?

The third leg of the value acceleration “three-legged stool” is business goals. How much can the business contribute to your other goals? How much do you need from your business? What are the strengths and weaknesses of your business? How do these compare to other businesses? How can business value be enhanced? A business valuation can help you answer these questions.

A business valuation is an essential component of the triggering event. A business valuation can clarify the standing of your business according to the qualities buyers find attractive. Relevant business attractiveness factors include the following:

- Market factors, such as barriers to entry, competitive advantages, market leadership, economic prosperity, and market growth
- Forecast factors, such as potential profit and revenue growth, revenue stream predictability, and whether or not revenue comes from recurring sources
- Business factors, such as years of operation, management strength, customer loyalty, branding, customer database, intellectual property/technology, staff contracts, location, business owner reliance, marketing systems, and business systems

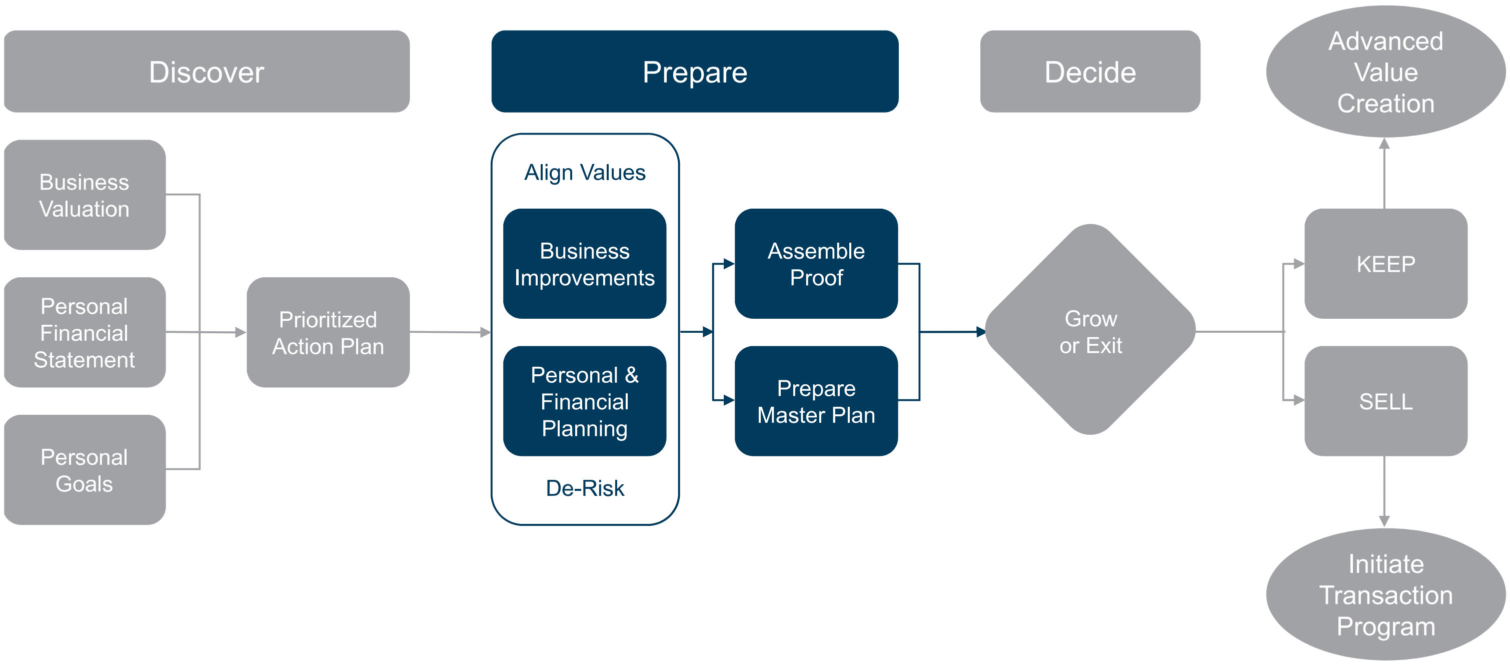
Your company’s performance in these areas may lead to a gap between what your business is worth and what it could be worth. Armed with the information from this assessment, you can prepare a plan to address this “value gap” and look towards your future plans.

04.

Prepare

What are the top three areas of improvement right now for your business? This is a question business owners should ask themselves regularly.

Ideas for business improvement are often uncovered in the prepare stage of the value acceleration process. The prepare stage focuses on how to increase business value by aligning values, decreasing risk, and increasing the intangible value of the business.



Align values

Aligning values may sound like an abstract concept, but it has a real-world impact on business performance and profitability. For example, if a business has multiple owners with different future plans, the company can be pulled in two directions. An example of poor alignment would be if a shareholder's business plans (such as expanding the asset base to drive revenue) compete with personal plans (such as pulling money out of the business to fund retirement). Friction creates problems. The first step in the prepare stage is to reduce friction by aligning values.

Reduce risk

Personal risk creates business risk, and business risk creates personal risk. For example, if a business owner suddenly needs cash to fund unexpected medical bills, planned business expansion may be delayed to provide liquidity to the owner. If a key employee unexpectedly quits, the business owner may have to carve time away from their personal life to juggle new responsibilities.

Business owners should therefore seek to reduce risk in their personal lives (e.g., life insurance, use of wills, time management planning) and in their business (e.g., employee contracts, customer contracts, supplier and customer diversification, etc.).

Intangible value and the four C’s

Now more than ever, the value of a business is driven by intangible value rather than tangible asset value. One study found that intangible asset value made up 87% of S&P 500 market value in 2015, up from 17% in 1975.[6] Therefore, we focus on how to increase business value by increasing intangible asset value. Specifically, we talk about the “four C’s” of intangible asset value: human capital, structural capital, social capital, and customer capital.

- Human capital is the intangible value associated with your workforce. Are you recruiting, training, and retaining top-level team members?
- Structural capital “captures the knowledge assets within your company, converting that mental process into company property, and therefore makes it transferable.”[7]
- Structural capital includes the knowledge and processes that allow your company to offer a competitive product or service. Structural capital is valuable to potential acquirers of your business when it is documented and transferable.
- Social capital “represents your culture, your brand, the way your team works, the rhythm of the day-to-day operations and communications, and the way you communicate with customers.”[8]
- Customer capital relates to the strength and transferability of your customer base.
- Factors that make customer lists more valuable include the presence of contractual agreements as well as customer tenure, diversity, loyalty, reliability, and transferability.

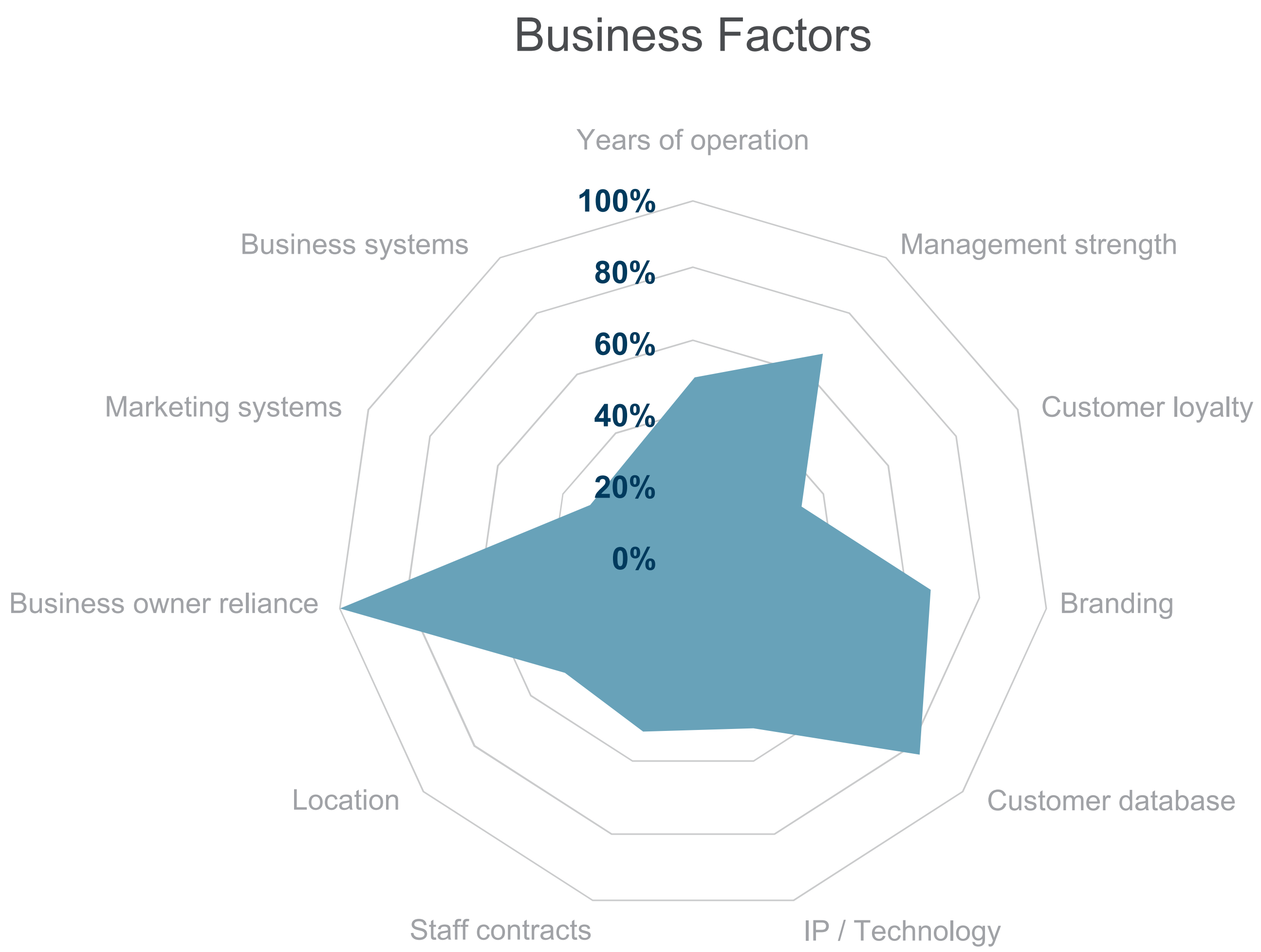
When working to increase intangible value, we offer the following tips. First, do a cost-benefit analysis before implementing any strategies to boost intangible asset value. Second, to avoid employee burnout, break planned improvements into 90-day increments with specific targets.

[6] Jorge Franganillo, “Annual Study of Intangible Asset Market Value from Ocean Tomo, LLC” https://www.oceantomo.com/media-centeritem/annual-study-of-intangible-asset-market-value-from-ocean-tomo-llc/

[7] Snider, Christopher M., Walking to Destiny, ThinkTank Publishing House (2016).

[8] Id.

At BerryDunn, we often diagram company performance on the underlying drivers of the 4 C's (below). We use this tool to identify and assess the areas for greatest potential improvements:



By aligning values, decreasing risk, and improving the four C's, business owners can achieve an increase in cash flow and business value, while securing liquidity to fund their plans outside of their business.

05.

Plan and execute

At this point in the value acceleration process, people have identified a number of action items to increase business value and liquidity. How these action items are introduced and executed may be just as important as the action items themselves.

We still need to protect value before we can help it grow. Let's say you had a plan, a good plan, to sell your business and start a new one. Maybe a bed-and-breakfast on the coast? You've earmarked the 70% in cash proceeds to bolster your retirement accounts. The remaining 30% was designed to generate cash for the down payment on the bed-and-breakfast. And it is stuck in escrow or, worse yet, tied to an earn-out. Now, the waiting begins. When do you get to move on to the next phase? After all that hard work in the value acceleration process, you still didn't get where you wanted to go. What went wrong?

Many business owners stumble at the end because they lack a master plan that incorporates their business action items and personal action items.

06.

Develop a master plan

A master plan should include both business actions and personal actions. Master plan business improvement action items may include:

- Customer diversification and contract implementation
- Inventory management
- Use of relevant metrics and dashboards
- Financial history and projections
- Systems and process refinement

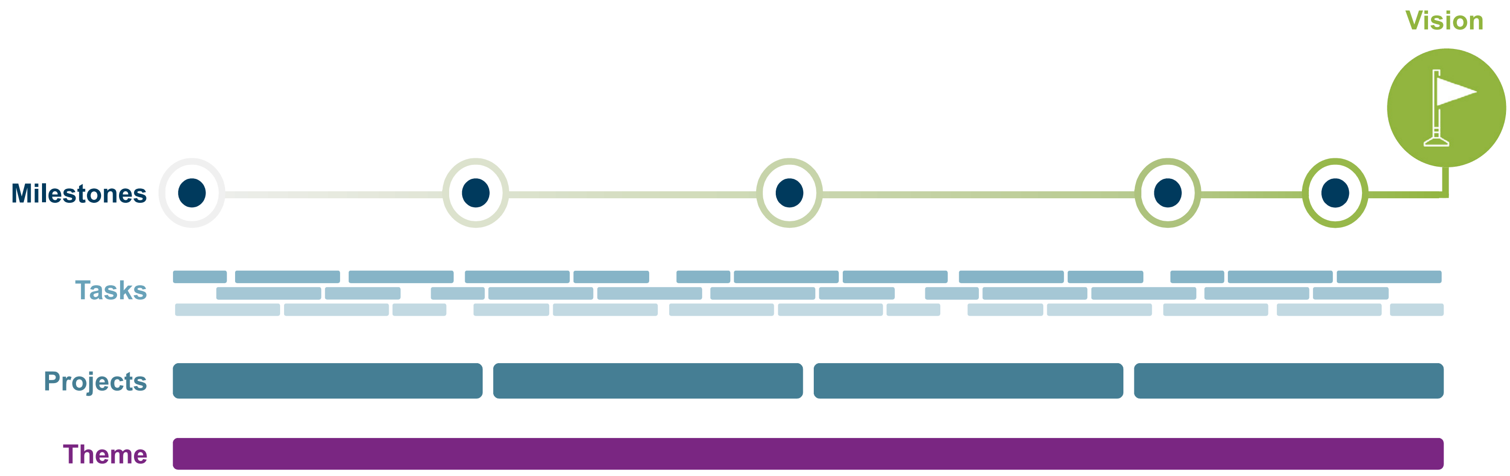
A comprehensive master plan should also include personal action items. Personal goals and objectives play a huge role in the actions taken by a business. As with the hypothetical bed-and-breakfast example, personal goals may influence your exit options and the selected deal structure.

Master plan personal action items may include:

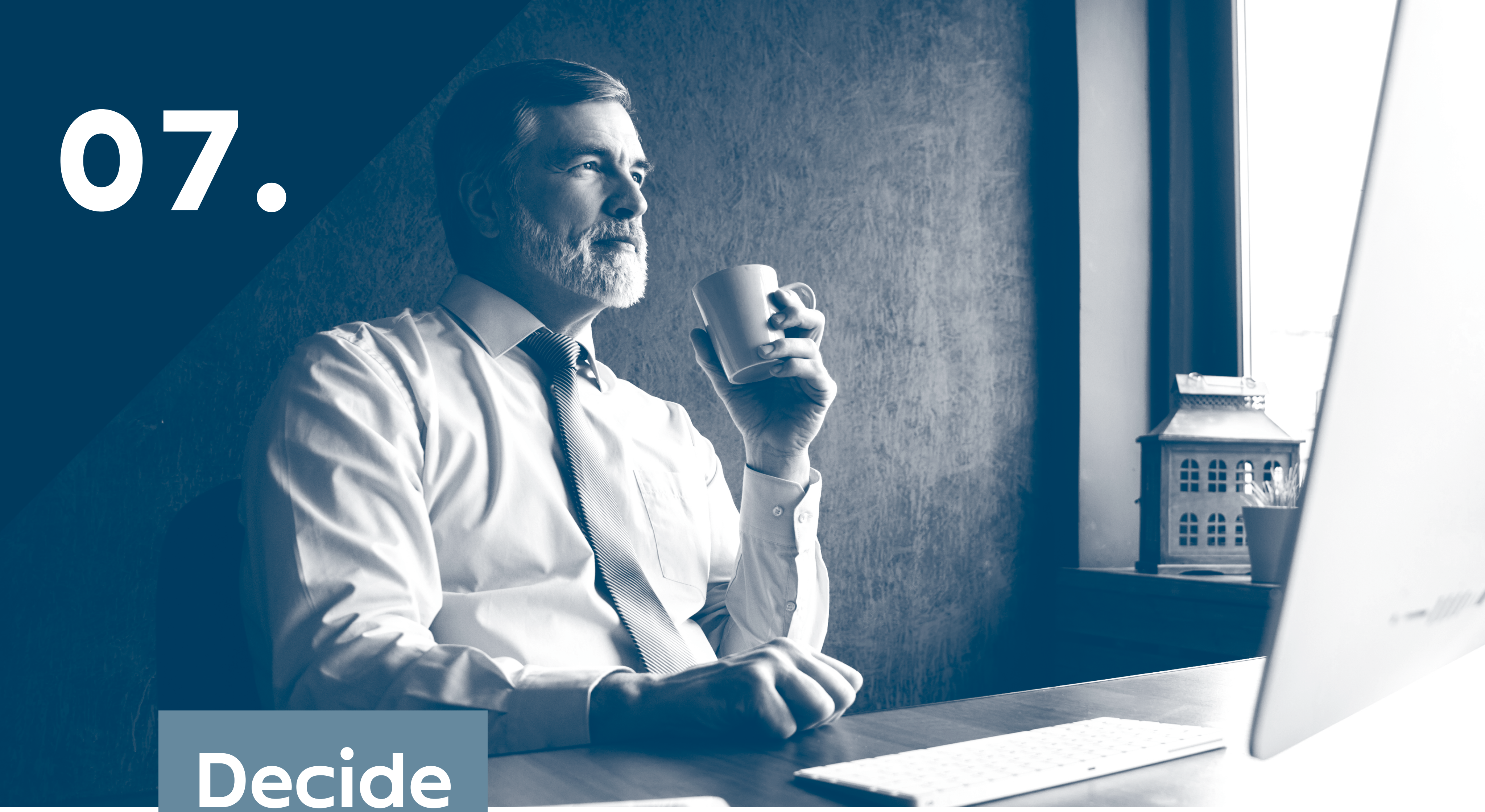
- Family involvement in the business
- Needs vs. wants
- Development of an advisory team
- Life after planning

A master plan incorporates many of the previously identified action items into an implementation timeline. Each master plan is different and reflects the underlying realities of the specific business. However, a practical framework to use as guidance is presented below.

The value acceleration process requires critical thinking and hard work. Just as important as identifying action items is creating a process to execute them effectively. Through proper planning and execution, we help our clients not only become wealthier but to use their wealth to better their lives.



Vision	Defining the “to-be” state. Where are we going and why?
Milestones	Key deliverables: reports, meetings, workshops, events
Tasks (<90 days)	Detailed steps to achieve prioritized actions, with clear responsibility
Projects (90 days)	Break themes into actionable 90-day elements
Themes (1 year)	Address areas of improvement for focus this year



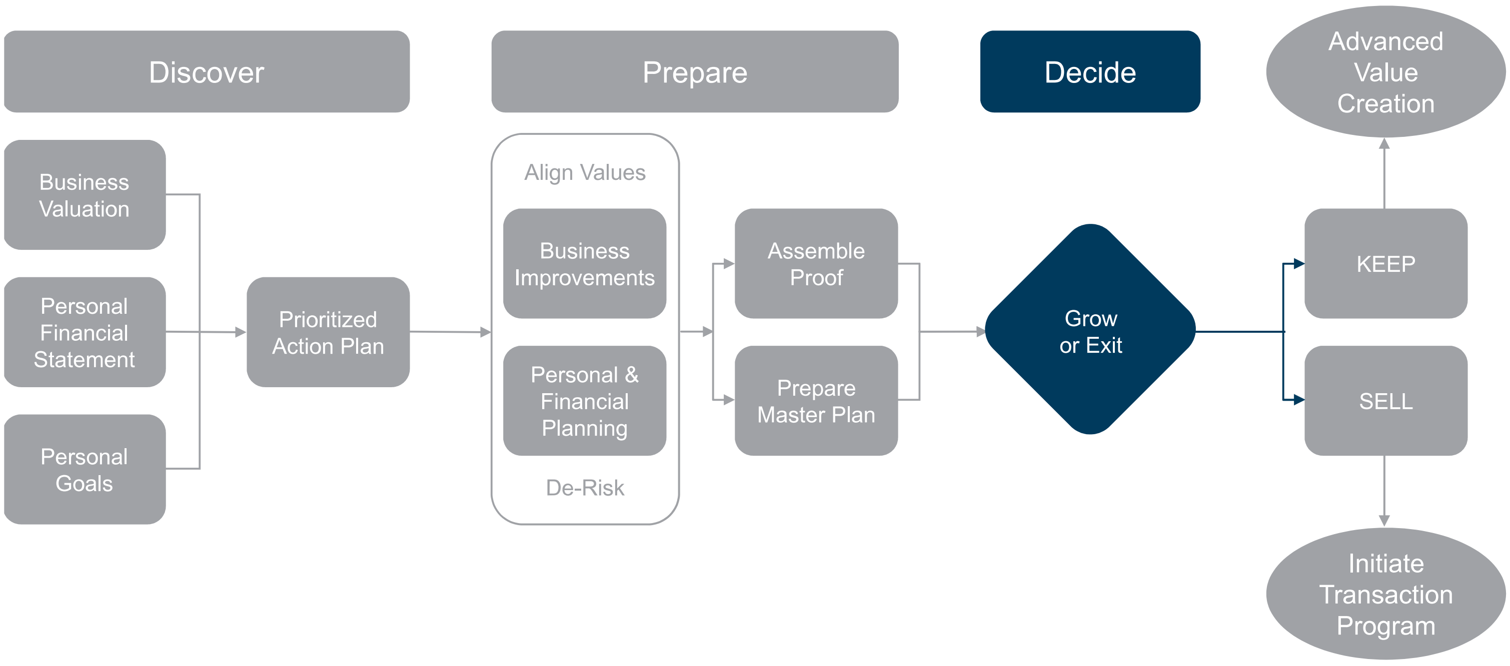
07.

Decide

In a closely held business, ownership means more than business value. Valuing your business will put a dollar figure on your business (and with any luck, it might even be accurate!). However, ownership of a business is about much more than the number. To many of our clients, ownership is about identity, personal fulfillment, developing a legacy, funding their lifestyle, and much more.

In the decide stage of the value acceleration process, people decide whether to grow their business or exit, and which liquidity options are available for each path.

While it may seem counterintuitive, we find that it is best to delay the decision to grow or exit until the very end of the value acceleration process. After identifying and implementing business improvement and de-risking projects in the discover stage and the prepare stage (see below), people may find themselves more open to the idea of keeping their business and using that business to build liquidity while they explore other options.



Once people have completed the discover stage and the prepare stage and are ready to decide whether to exit or grow their business, we frame the conversation around personal and business readiness. Many personal readiness factors relate to what ownership means to each client. In this process, clients ask themselves the following questions:

- Am I ready to not be in charge?
- Am I ready to not be identified as the business?
- Do I have a plan for what comes next?
- Do I have the resources to fund what's next?
- Have I communicated my plan?
- On the business end, readiness topics include the following:
  - Is the team in place to carry on without me?
  - Do all employees know their role?
  - Does the team know the strategic plan?
  - Have we minimized risk?
  - Have I communicated my plan?

Whether you choose to grow your business or exit it, you have various liquidity options to choose from. Liquidity options if you keep your business include 401(k) profit sharing, distributions, bonuses, and dividend recapitalization. Alternatively, if you choose to exit your business, liquidity options include selling to strategic buyers, ESOPs, private equity firms, management, or family.

One topic that often comes up when discussing the sale of a business is the use of earn-outs. In an earn-out, a portion of the price of the business is suspended, contingent on business performance. The "short and sweet" on this topic is that we typically find them to be most effective over a two- to three-year time period. When selecting a metric to base the earn-out on (such as revenue, profit, or customer retention), consider what is in your control. Will the new owner change the capital structure or cost structure in a way that reduces income? Further, if the planned liquidity event involves merging your company into another company, specify how costs will be allocated for earn-out purposes.

Another topic that often comes up is the use of rollover equity (receiving equity in the acquiring company as part of the deal structure) and the use of warrants/synthetic equity (incentives tied to increases in stock price). Here are some of the key points related to these topics:

- Make sure you know how you will turn your rollover equity into cash.
- Understand potential dilution of your rollover equity if the acquiring company continues to acquire other targets.
- Make sure the percentage of equity relative to total deal consideration is reasonable.
- Seller financing typically has lower interest rates and favorable terms, so warrants are often attached to compensate the seller.
- Warrants are subject to capital gains tax while synthetic equity is typically ordinary income. As a result, warrants often have lower tax consequences.
- Synthetic equity may work well for long-term incentive plans and for management buyouts.

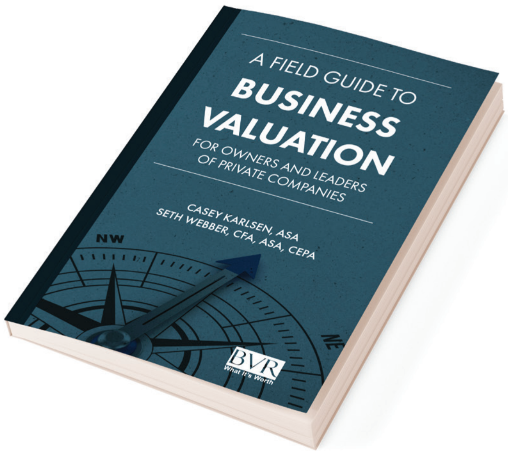
The value acceleration process is a valuable framework for business owners, management, and their advisors. We have found that through the value acceleration process, clients are able to increase business value and liquidity, giving them control over how they spend their time and resources.

Business valuation is our forte

Our credentialed business valuation specialists bring clarity to the complexities of valuation while adhering to strict development and reporting standards. We thoroughly analyze the financial and operational performance of a company to understand the story behind the numbers.

Looking for more?

Based on data from the field and our deep experience helping business owners estimate, preserve, and increase business value, we've published *A Field Guide to Business Valuation for Owners and Leaders of Private Companies.*



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wherever you are based, we look forward to working together.

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