insights

PRIVATE MARKET PERSPECTIVES

Is your Private Company *Really* Managing For Shareholder Value?

By George Isaac

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By George Isaac, Family Business Management Consultant

In privately-held companies, realizing previously created equity value is often a secondary strategy until a succession planning, estate planning, or a business-ending liquidity event is under consideration. Cash, or other assets, must be distributed to your shareholders to "realize" shareholder value. In public companies, this is easy to accomplish: sell your stock in the market! This strategy is not available for privately-held companies, particularly family enterprises.

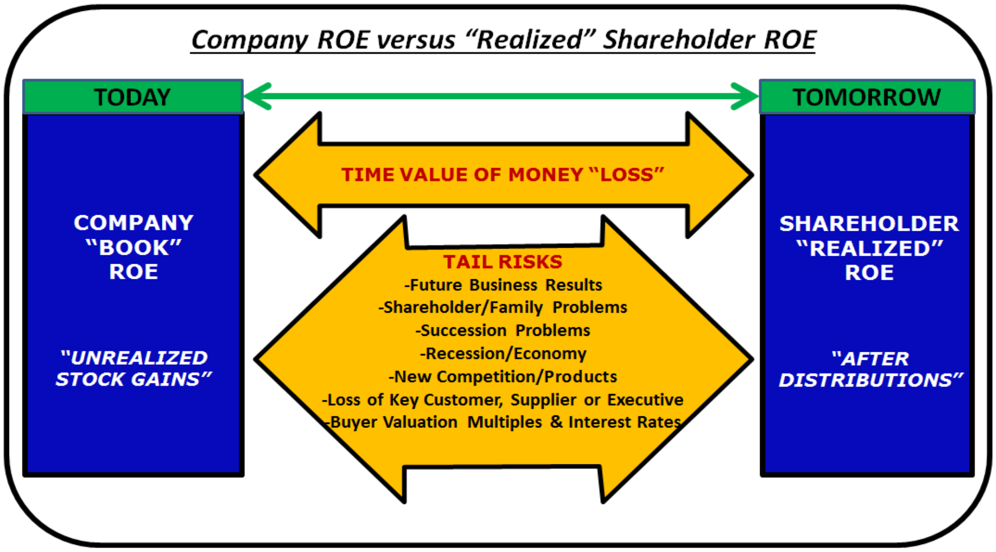
In fact, the topic of realizing shareholder value is seldom addressed. I know this from my experience as a family enterprise business consultant and prior board member of 14 such companies. The focus by such enterprises is always on *creating* shareholder value. The big disconnect is, until shareholder value is realized, any created value is just a paper gain; these are unrealized paper stock gains that can disappear in your investment portfolio like paper into a wastebasket.

The fundamental question CEOs and board members need to ask is "are you spending your most valuable resource -- your senior executive team's time -- addressing issues that both *create and realize* equity returns to your shareholders?" An understanding of the key levers that impact shareholder value is critical to developing the right business strategy, operational focus, and prioritization of work assignments among the senior management team. Any other focus results in suboptimal financial returns and increased investment risk for your shareholders.

Shareholder Value: Realized vs. Non-Realized

An investment is only as good as its ability to generate current and future cash. As CEO of my family's business, our board focused on company return on equity (ROE). Under that metric, we were successful, posting double-digit returns over several consecutive years. While we were successful within this metric, we failed to recognize the significant difference between ROE for the company versus ROE for the shareholders as illustrated in Chart 1. Like many family businesses, we opted not to distribute earnings except for tax liabilities so we wouldn't need to borrow money to grow our business.

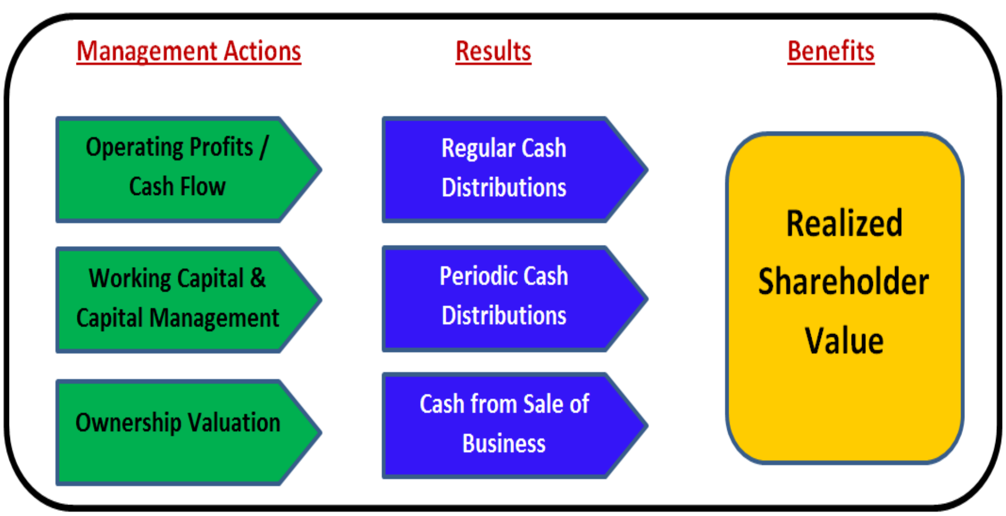
Chart 1 – Company ROE vs. Shareholder ROE



As a result, we missed the critical point: increases in a company's shareholder equity do not create investor return until cash is distributed; then it is *realized* - the earlier, the better -due to the time value of money. Until then, shareholder value is exposed to unforeseen tail risks and risk of loss. The unfortunate lessons learned from the economic implosion of 2008 resulted in many businesses' shareholder equity destroyed.

Because realizing shareholder value requires cash distributions, private company CEOs and their boards should focus on current and future cash generation and realization strategies. The three primary ways a company distributes cash to its shareholders, as illustrated in Chart 2, are:

Chart 2 – Realizing Shareholder Value



1. Regular distribution of cash - generated from ongoing operating profits plus depreciation.

2. One-time or periodic distribution of cash – derived from improvements in working capital management and restructuring of the business' capital structure.

3. Cash from sale of business – based on increasing the company's valuation and net after tax sales proceeds.

The goal, then, is maximizing shareholder ROE while minimizing the exposure to risks – that is, optimizing risk-adjusted returns. Following are detailed explanations of these three distribution methods:

Regular Cash Distributions

The primary generator for regular cash distributions is operating profits plus non-cash- based depreciation expenses. Operating profits, often called Operating Income, can be analyzed through the following sub-elements:

Revenues X Gross Margin % = Gross Profits

Gross Profits – S.G. & A. (1) = Operating Profits

Operating Profits + Depreciation/Amortization = Operating Cash Flow (2)

(1) Selling, general & administrative expenses.
(2) Debt service, taxes, & capital expenditure requirements must be also considered prior to cash distributions.

The successful executive evaluates these sub elements to identify significant opportunities when operating profits can be improved through increases in revenues, expansion of gross margins and reduction in S.G.&A. expenses. The focus needs to expand beyond current-year operating results against budget to include strategies that create longer-term sustainable improvements in operating profits.

The evaluation must address a multitude of factors, including current and future business and marketing strategies, product line profitability, customer profitability, reduction in operating, materials and logistics costs, labor productivity, outsourcing opportunities, distribution channel alternatives, administrative efficiency, discretionary spending, value engineering, etc.

Periodic Cash Distributions

Businesses can generate one-time or periodic cash distributions to their shareholders in two ways: (1) improvement in working capital management and (2) revisions to the business' capital structure.

The objectives in working capital management are decreasing the working capital required to support the business and increasing the working capital lines to eliminate using shareholder equity when financing receivables and inventories. Successfully achieving these objectives results in freeing up cash for potential shareholder distribution.

To accomplish these goals, consider evaluating the following levers: accounts receivables, inventories, accounts payable and working capital lines of credit. There are many ways to impact each, for example:

- For Accounts Receivables:
    - Offer quick pay discounts to customers;
    - Require deposits for certain types of longer lead time/build product sales;
    - Utilize more aggressive collections;
    - Change terms of sale.

- For Inventories:
    - Sell obsolete or slow-moving products;
    - Manufacture smaller production run sizes;
    - Re-evaluate inventory safety stock levels;
    - Outsource part of your manufacturing process;
    - Require your raw material vendors to deliver just-in-time and/or provide dated terms for payment;
    - Transfer ownership of certain raw materials to your customers and charge a contract manufacturing/assembly fee to produce.

- For Account Payables:
    - Delay payments to vendors;
    - Renegotiate better terms (this would require a review so as not to disrupt your supply chain).

- For Working Capital Line of Credit:
    - Fully utilize your company's line of credit so as not to use equity capital for receivables and inventory financing.

- Renegotiate better terms for financing such as an increase in advanced rates on receivable and inventory assets.

Another source for generating cash, in addition to working capital management, is revising a business' capital structure. For example, you could expand the use of debt or lease financing, organize the sale of non-essential assets, and initiate the sale and leaseback or financing of real property.

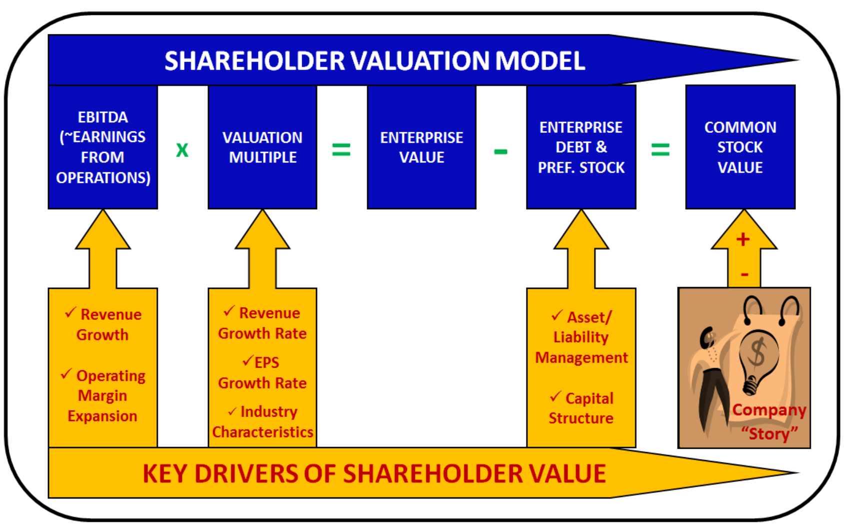
Prior to revising the business' capital structure, many trades-offs need to be considered, such as:

- Company's existing and projected debt levels and corresponding financial risk;
- Volatility of earnings/cash flows and ability to service debt;
- Current interest rates;
- Business opportunities for investment to increase revenue and earnings;
- Liquidity needs of shareholders;
- Shareholders' investment return and diversification objectives.

Sale of the Business

Creating long-term shareholder value from the sale of the business requires careful planning over two to three years to maximize the company's valuation. In addition to operating profits, other factors can impact the company's valuation, including revenue and earnings growth rates, operating margins, working capital consumption, capital structure, and general asset/liability management. The basic formula for business valuation is EBITDA multiplied by a valuation multiple less interest-bearing debt and preferred stock, as depicted in Chart 3.

Chart 3 – Company Valuation Model



It's the CEO's job to analyze each attribute in the shareholder valuation model when deciding which levers create the greatest opportunity for improvement, while also considering the time scenario of a sale transaction. The four levers that impact shareholder value are:

Operating Profits & EBITDA. The main driver of EBITDA is operating profits. EBITDA is defined as earnings before interest, taxes, depreciation and amortization and is used to determine the gross value of a business ("enterprise value"). Enterprise value is computed by multiplying EBITDA by a valuation multiple, which is similar to the price/earnings (P/E) multiple used to value public company stocks but is based upon EBITDA (P/EBITDA) versus net income. Once the enterprise value is determined, shareholder values are computed by subtracting the business' permanent debt and preferred stock.

Operating Margins. Both gross margins and operating margins impact shareholder valuations. A higher gross margin and/or operating margin business will benefit from a higher valuation multiple. These businesses provide greater leverage by generating increasing operating profits for every incremental dollar of revenues. They are also able to absorb cost increases or margin pressures from competition and still remain profitable.

Growth Rates. Both top-line revenues and bottom-line earnings growth rates impact EBITDA valuation multiples (P/EBITDA ratios). For example, a higher-growth company will benefit from a higher EBITDA multiple since earnings are expected to increase each year from the base year.

Capital Structure. Capital structure impacts shareholder value since enterprise value is reduced by the amount of permanent debt or preferred stock a company has on its books when shareholder value is determined. As a result, strategies to reduce debt and interest-bearing liabilities will increase shareholder value.

Interestingly, working capital lines are typically not counted as permanent debt and therefore do not reduce shareholder valuations. With that understanding, a strategy I have used successfully to increase proceeds to shareholders from the sale of a business is to: (1) decrease working capital assets and (2) increase working capital line of credit usage to its full extent. It should be implemented in advance of a company sale so the company has time to demonstrate it can satisfactorily operate with less working capital.

Other options to improve a business' capital structure include selling off non-productive or economically unattractive assets. And, sometimes, alternative financing arrangements such as sale and leaseback of facilities can increase shareholder value, particularly when considering the difference in valuation multiples between real estate and operating businesses.

Summary

By carefully examining the levers that create shareholder value, the CEO can significantly increase both *created* and *realized* shareholder returns without negatively impacting the long-term prospects of the business. When the CEO is not focused on realizing shareholder returns, the risk to the shareholders' investment increases since the shareholders' return is based solely upon a future sale. In this instance, many unexpected or non-controllable factors may impact the future business' valuation.

George Isaac has 30 years of CEO and boardroom family enterprise experience as well as having served on 14 public and private corporate boards and consulted on over 100 client engagements. His firm provides board and management consulting services to mid-market private and family-owned businesses, typically addressing issues associated with succession planning, corporate/family governance, realization of captive family business wealth, business strategy and operating performance improvement, and M&A transactions. See www.GeorgeIsaac.com for details or contact Mr. Isaac at 805.969.6602 or gisaac@gaicapital.com.