Grant Thornton

An instinct for growth™

Succeeding at succession:
Establishing the value of your company

A Grant Thornton series for privately held businesses: Part one

In a recovering economy, succession planning is rarely top of mind for business owners. More often, privately held businesses – which include family enterprises, investor- and entrepreneur-owned businesses and professional firms – focus on enhancing cash flow, reducing costs and managing day to day operations.

On some level, this focus on short-term survival makes sense. Yet, despite seeming logical, this type of approach puts privately held businesses at risk of being blindsided by the future.

To avoid this risk, you need more than a short term plan. You also must lay the foundation for long-term growth by strengthening the value of your business. This is true whether you aim to pass the business to the next generation, sell, merge or pursue a public listing. It is even true if you have yet to articulate your succession planning goals. This is because the establishment of a sustainable business model can help you achieve a wide range of business and personal objectives – from maximising the sale price of your business, minimising taxes and creating ownership opportunities for key employees, to maintaining an ongoing role in the business, sharing in future upside or leaving a lasting legacy.

Value enhancement also plays a critical role in succession planning. To structure a tax efficient exit, set up a funding mechanism for successors, justify future cash flow projections, or maximise the proceeds of a sale, you need to establish your business value. In essence, understanding your value drivers is the first step to reaching your succession planning goals – whether you intend to keep the business in the family, transition to management or sell to a third party.

Arriving at the magic number

As arriving at business value is as much an art as a science, business owners do not always know the value of their company. Professional valuers use various methods to assess business value. Income approaches, for instance, calculate a discounted cash flow (which uses projected financial performance to evaluate how a company will perform over time) to determine the net present value of a business. Asset based approaches determine value by adding the sum of the parts of the business to arrive at a net asset value. There are also market based approaches that determine value by comparing a business to similar companies within its industry.

While these represent the primary approaches to business valuation, variations exist depending on the context for the valuation (e.g. financial statement reporting, tax planning or transactional purposes). Valuers also typically take a wide range of factors into account when establishing value, including:

- financial history and business forecasts
- industry and market trends
- management structure and skills
- tangible assets, including real estate
- intangible assets, including goodwill, supplier relationships, name recognition, patents and trademarks, proprietary technology, etc.

Notably, each valuation approach is likely to establish a different value for the business, and each of those values would be correct. This is where the art of business valuation comes in; where value becomes the price the market will bear; where a willing buyer and a willing seller find equilibrium.

For instance, if you plan to sell your business to a third party, it is likely you will want to maximise the sale price. To accomplish this, you need to present a compelling vision of what the business could become under someone else's ownership rather than an historical perspective of how you arrived at the current state. You then need to generate competition amongst potential buyers and tap into the emotion that comes with a bidding process – the fear of losing. A compelling story and competing bidders are more likely to result in a price that is significantly above any scientific value.

Conversely, if you are transitioning to a family member or employee, you may prefer a valuation that reflects what the business and your successors can afford. Too high and it may hamper their ability to buy into the business. Too low and it may leave exiting shareholders without sufficient future cash flow.

As both of these cases make clear, valuation is not an exercise that should be confined to estate planning or sale scenarios. Privately held businesses need to understand how their value drivers can affect both short and long term performance and take the necessary steps to enhance the viability of the business over time and both improve and preserve its value. This could include cleaning up your balance sheet, ensuring you have the right management in place, trimming expenses, strengthening internal processes, introducing new products, expanding to new markets or investing in other strategies to drive profits, growth and sales. Each of these are important regardless of the strategic transition objectives.

In short, business owners need to think about their ownership in the business in the same way they would consider any other investment– by maximising the value of this asset according to their income or growth requirements.

Keep in mind, too, that there are tradeoffs to make. One business owner may value the continued health of the company and the happiness of the workforce to such an extent that they are willing to take less money out upon retirement.

Another owner might place such a premium on maintaining family management of the business that they might pass over more qualified successors – a decision that can affect the long term value, profitability and viability of the business. These variables demonstrate that many privately held businesses lack a clear understanding of their organisation's value or value drivers.

"To maximise profits and value upon a succession, privately held businesses should start planning for succession several years in advance. Don't wait for a year of super profits, or a year of weak performance, to plan an exit. Start early so you can transition on your own terms, while you are in control."

Paul Motta
Sydney

Understanding your value drivers.

In any strategic process, it is essential for business owners to understand the factors that enhance business value.

When properly identified and managed, value drivers can help you improve cash flows, attract investment capital, strengthen your compensation structures and differentiate your business from the competition.

As these activities can shift business value in a relatively short period of time, it is incumbent upon privately held businesses to be aware of the elements that typically drive value:

Track record

Business value is affected by a company's history of sales, growth and profitability. It also varies depending on a company's cash flow and its profit margins relative to industry peers.

Market factors

At any point in time, certain sectors tend to attract greater review than others. Your business' value will be influenced by the sector in which you operate, as well as your ability to capture market share and compete effectively.

Value proposition

Another driver of value is a unique value proposition that clearly sets you apart from your competition. It is worth noting that this type of intangible value driver is very hard to replicate.

Unique assets/intellectual property

Organisations with an established brand, patents and/or proprietary technology or processes can generally use these assets to drive value.

Business model

Value typically varies depending on the strength of your business model and your ability to scale that model in other locations or markets. Proven business models also help to mitigate risk, which can improve value.

Management and systems

Business value generally also hinges on the strength of a company's systems and a management team. Strength and depth of the team beyond the founder can be critical, as can business processes that are repeatable and scalable.

To strengthen these various value drivers, privately held businesses typically need to find ways to enhance cash flow while minimising risk. Companies that hope to maximise value upon transition should consider planning at least three to five years before a transition. For their part, companies interested in growing the business over time should manage their value drivers on an ongoing basis – regardless of whether they have yet developed a succession plan.

"Leading businesses can often manage their value drivers to improve cash flow and minimise perceived risk. For example, running alternate scenarios lets you focus on the things you can control and be cognisant of the things you can't control that you need to mitigate."

Mauri Mucciacciaro
Perth

Maximising value: lessons learned.

Once you understand your value drivers, you should be able to form an unbiased opinion of your organisation's value.

In reality, however, this rarely happens. Business founders often link the value of their companies to the time and effort it took to build the business, which frequently results in an over-estimation of the company's worth. This is also true of privately held business owners who have received unsolicited bids, especially where they do not have a strategy for selling the business. In other cases, owners hesitate to commit to a firm value because they are simply not ready to exit the business.

Despite these concerns, experience shows that privately held businesses must be nimble and strategic if they hope to achieve their succession planning goals. With more than 30 years' experience helping privately held businesses establish value upon succession, Grant Thornton Australia has learned several key lessons to foster success.

1 Know what to expect

Although succession planning specialists help businesses transition to a new ownership framework on a regular basis, most business owners engage in succession only once. As a result, many privately held business owners do not know what to expect upon exiting their business.

Owners may not understand how much after tax cash flow they require upon retirement. They may be unclear on how to compensate their employees upon transition.

If they feel successors lack sufficient training, they may worry about the company's future viability.

If they are engaging in a sale, they may be hesitant to share sensitive information with potential purchasers or respond to extensive information requests. For these reasons and more, it is important to work with experienced professionals who can prepare you for what to expect upon transition to ensure you can meet your succession planning goals.

2 Decide on your priorities

As privately held businesses mature, they may begin to experience tension between the company's best interests and the owners' best interests. In many cases, businesses reach a stage when they require additional capital at a time when shareholders are looking for ways to reduce their personal risk. This tension can make businesses vulnerable to value destruction and threaten the company's long term viability.

If you are experiencing this challenge, it is important to decide on your priorities. If the business is more valuable to someone else than to you, it may be time to consider selling. If it is more valuable to you than to someone else, perhaps you should maximise current income and consider transitioning to the next generation. Either way, keep in mind that your business is ultimately one asset in your portfolio. By establishing value independently, you may gain the outside perspective you need to decide if you would prefer to hold or sell it.

3 Be honest about your weaknesses

Privately held businesses with a history of strong performance tend to predict future growth with reference to the past. Unfortunately, this tendency can create a false sense of invincibility. Because independent succession planning professionals look at your business with an unbiased lens, they can often pinpoint risks that threaten the company's ongoing viability. For example, something you perceive as a strong customer relationship can be viewed just as easily as a customer concentration risk, particularly if a significant percentage of your sales are tied to this customer.

Privately held businesses that heed this warning may be able to exit their business on an upswing. Those that ignore the message, however, risk suffering an irretrievable loss of value.

4 Recognise the power of innovation

Anyone who has established or built up a business understands that growth is rarely achieved without innovation — and innovation requires some measure of risk. To ensure their organisations are positioned to pursue growth opportunities as they arise, business owners should adopt processes and systems that encourage innovation and reward measured risk taken within the context of an enterprise risk management framework.

5 Strengthen your management team

One way to strengthen business value is to ensure you have the strongest possible management team in place. If you plan to scale back your involvement in the business, professional managers can maximise sustainability by running the business in your absence. Strong business value can also help you attract and retain essential management resources. In addition to giving external managers an incentive to join a privately held business, a high valuation can encourage highly skilled family members to maintain family ownership, even if they have other career options.

6 "Professionalise" the business

Yet another strategy for enhancing value upon transition involves putting systems and processes in place to ensure your business runs as professionally as possible. There are a range of activities to help you achieve this goal – including developing a formal business plan, bolstering your management team and establishing an independent board of directors. You should also ensure that the business operates on a standalone basis by implementing scalable and repeatable systems and processes. By working with professional advisers, you can identify the strategies and processes that can help you best emphasise value.

"The value of a business to an owner is directly linked to the owner's goals and aspirations. For example, if the goal is to transfer the business' ownership to the next generation of the family, it's less likely to generate the same value as a trade sale to a third party, and would need to be recognised early in the succession planning process."

Cameron Bacon
Melbourne

Helping you enhance value.

Given current economic realities, privately held businesses in all sectors are looking for ways to strengthen their performance. That's why it has become increasingly important to work with professional advisers who can help you understand how to control your value drivers.

Whether you would like to improve your cash flow, reduce business risk, strengthen your internal controls, revise your compensation structure or explore your exit options, Grant Thornton member firms can help. As a result, you will be positioned to gain access to a wider range of succession planning options. From estate and tax planning to transaction advisory and wealth management, we can help you build an effective transition strategy.

With our global reach, proven track record, integrated suite of services and in-depth knowledge of privately held businesses, our practitioners truly act as your trusted guides to help you navigate the succession planning process.

"The earlier you articulate your strategic vision, the better it is for your business value. With a strong outlook for the future, you can avoid reacting to circumstances and instead, position your business to reach its full potential."

Stacey Smith
Brisbane

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Find out how our professional advisers can help you establish, improve, preserve and transfer your business's value. Please contact your local Grant Thornton Partner as listed below.

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