Association for Enterprise Growth

White Paper

The Enterprise Value Framework

Critical steps to growing the value of private middle market companies

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OVERVIEW

Enterprise Value (EV) is widely misunderstood in the private middle marketplace despite being the predominant valuation metric used by professionals today. Even professionals (attorneys, CPAs, bankers, etc.) regularly misuse EV so don't feel lonely if your grasp of EV is not particularly firm. It's somewhat surprising though as the conceptual meaning of EV is quite straightforward. While we get into more technical aspects of EV in Section 1, a simple way of thinking about it is the price a 3rd party would pay for 100% ownership of your company.

The real value of the EV paradigm however extends well past its equation. Going beyond traditional valuation methodologies' primary focus on financial results, EV analysis incorporates qualitative factors (quality of revenue, management, systems, barriers to entry, size of market, etc.) to determine the value of a private middle market company because such factors better predict future profitability. Indeed, qualitative factors have become paramount in determining a company's value relative to its comparable companies. In today's private capital markets, the range of values for comparable companies is broad, often valuing top companies 250% more than bottom companies. This concept is typically expressed as a multiple of cash flow and routinely referred to in the industry as the "Multiple." Well, it turns out, the Multiple is the most powerful part of the valuation equation and it is driven primarily by qualitative factors. Simply put, a purchaser will pay significantly more for a well-run company than a poorly-run company, all other factors (primarily financial results) being equal, because operational excellence improves the reliability of future profitability.

Qualitative improvement initiatives offer the most reliable way to consistently grow the value of middle market companies

This is great news for owners of middle market companies. At a practical level, this means owners can reliably grow the value of their business through initiatives to improve qualitative aspects of their company and not have to rely solely on sales growth or margin improvement. Naturally, the next question is how to identify, prioritize and execute the most valuable qualitative initiatives.

But, we're getting ahead of ourselves. Let's get into the details a bit more before we jump into process.

WHAT IS ENTERPRISE VALUE?

As stated earlier, conceptually EV is the price a 3rd party would pay for 100% ownership of your company. Technically speaking, EV is defined as equity plus funded debt minus cash beyond working capital. While the technical definition is critical when selling your company, the conceptual aspects of EV are far more useful as a framework to consistently grow the value of your business.

To illustrate this point, let's change hats for a moment - think of yourself as a buyer now. By paying for a company, you are betting the business will dependably generate profit at or above its current rate without the current business owners in charge. How do you evaluate the reliability of future profits? Well, you would analyze qualitative aspects of the company to determine the predictability of future profits. Higher qualitative grades in the form of operational excellence translates directly to a higher price you're willing to pay. Your qualitative analysis turns out to be the most important determinant of value. In fact, this is true for all buyer types - you, private equity or strategic. Hence, for the seller, initiatives to become operationally excellent have the greatest impact on the value of the company. And, not surprising, the pursuit of operational excellence also systematically improves company performance and more likely leading to further revenue growth.

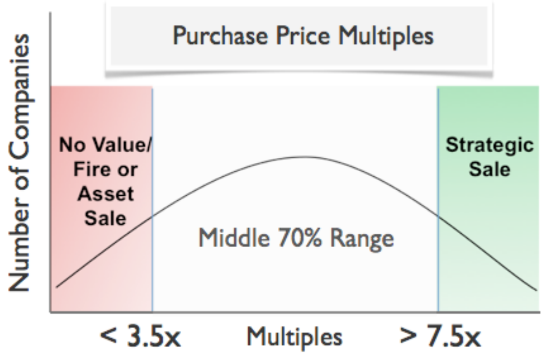
THE POWER OF THE MULTIPLE

This is where it gets interesting but we've got to get a little more technical first. Private capital markets use the below valuation multiple equation for benchmarking the purchase price of middle market companies.

Purchase Price Multiple = Enterprise Value / Trailing 12 Month Adjusted EBITDA

1. *Enterprise Value* is defined as equity plus funded debt minus excess cash beyond working capital.
2. *Adjusted Trailing 12 Month EBITDA* is defined as the most recently completed 12 month period of earnings before interest, taxes, depreciation and amortization adjusting out or in extraordinary expenses, normalized salaries and the like.

As an example, if a company with trailing 12-month adjusted EBITDA of $2 million is purchased for $9 million, then the Multiple of the transaction is 4.5x. OK, simple enough -- now let's look at Multiples on a historical basis. Based on over 2,000 reported middle market company transactions since the year 2000, the middle 70% range of Multiples was from 3.5x to 7.5x.



Source: Pitchbook, Pratt's Stats, BizComps

Yes, that's right! For middle market companies with the same EBITDA, higher quality companies commanded twice the Multiple (and thus transaction price) of lower quality companies. Importantly, this surprisingly broad range of value characterized all major industries including business services, manufacturing, healthcare, retail and media. What causes such a significant difference in value -- qualitative factors.

How does this help an owner grow company value? As illustrated below, it instructs owners to focus on qualitative initiatives to improve the company's Multiple which disproportionately increases a company's value relative to other initiatives such as sales growth or margin improvement strategies.

Comparing the value of a Company's Enterprise Growth Initiatives

Initiative Type	Baseline	Margin Growth	Qualitative Improvement	Margin Growth & Qualitative Improvement
Revenue	$15 million	$15 million	$15 million	$15 million
Adj. EBITDA	$2 million	$2.25 million	$2 million	$2.25 million
Qualitative Excellence	Average	Average	Above Average	Above Average
Multiple	4.5	4.5	6.5	6.5
EV	$9 million	$10.1 million	$13 million	$14.6 million
% EV Growth	NA	12.2%	44.4%	62.2%

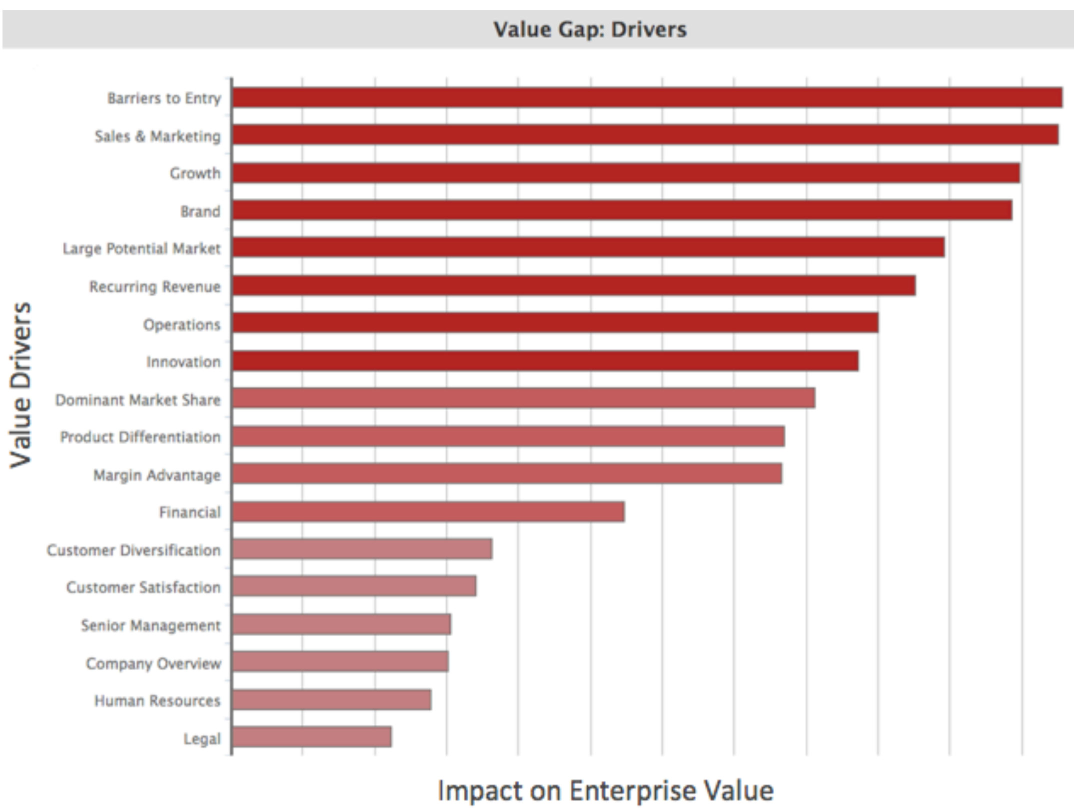
Remarkably, the above comparison only shows qualitative excellence improving from average to above average yet it still delivers over 30% better EV appreciation (44.4% vs 12.2%) than margin improvement only. How do we know this is accurate? The chart's figures are consistent with the market's largest dataset quantifying the impact on EV of qualitative improvements by private middle market companies.[1]

[1] Dataset includes thousands of private middle market companies with over $33 billion in revenue possessing on average $4.8 million of value gap. Value gap is defined as difference between a company's current value and potential value which may be addressed through specific qualitative improvement initiatives. Source: CoreValue Software - www.corevalue.com

Now that it is clear qualitative initiatives disproportionately grow the value of companies, the next question is how to identify, prioritize and execute the most valuable qualitative initiatives.

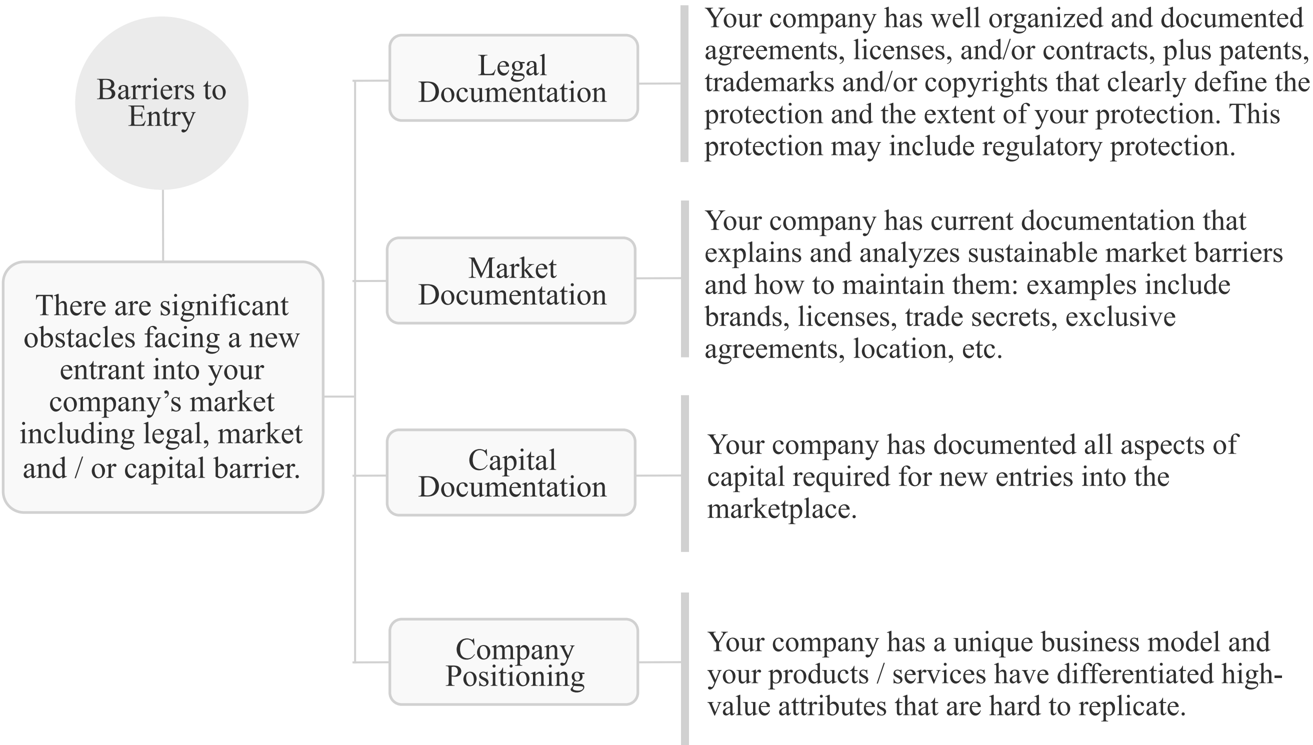
THE VALUE CREATION BLUEPRINT

The value creation blueprint is a proven process of systematically improving qualitative-based value drivers to substantially grow the value of private middle market companies. It begins with a formal company assessment that will provide: 1. The current market-based value of a company (e.g. sale to a 3rd party); 2. The intrinsic value of a company (e.g. the potential value of your company if it were in the top quartile qualitatively as compared to its peers), and; 3. Possible company initiatives ranked by importance to close the value gap between a company's current value and intrinsic value. A reliable, market-based assessment requires a specialized (typically certified) professional using a guided discovery process to uncover a company's unique qualitative profile. While each company is different in terms of operational aspects and market needs, listed below in order of qualitative importance are value drivers from the CoreValue Software middle market dataset[1].



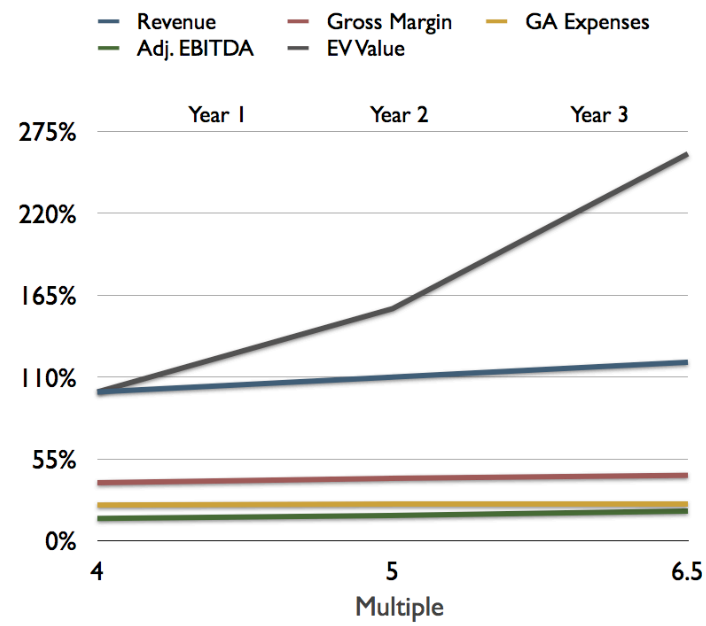
Courtesy: CoreValue Software

Based on the formal assessment, the company will typically choose the top 2-3 top value drivers to systematically improve through a series of initiatives which are evaluated and calibrated every 90 days. As an example, below are the high-level process steps to address the barriers to entry value driver:



When completed, the company will then tackle the next value driver through completion. This process will continue until the company joins the top quartile qualitatively compared to its peers.

While the entire value enhancement process may takes years, you will begin seeing results in less than 90 days. Over time, the process routinely results in the development of a culture of excellence in the company. On the right is a representative multi-year chart comparing key metrics to the growth of enterprise value.



HOW TO GET STARTED

Given the complexity of company factors, the best way to begin the enterprise value enhancement process is to assemble an advisory team of experts collaborating to achieve *your* unique business objectives. It's critical your advisory team develop and execute an integrated value enhancement strategy because an improvement focused on just one area might preclude options or improvements in others. There's no such thing as a standard plan or team, but there are processes you need to follow. To learn more about the "getting started" process, we have put together a separate resource entitled *Building the Right Advisory Team.*

Association for Enterprise Growth

About the Association For Enterprise Growth:

The Association For Enterprise Growth is a non-profit organization dedicated to educating business owners about the unique interconnected and interdependent issues impacting the value of their business and personal wealth.

The organization is structured regionally into councils of approximately 30 independent professionals each with proficiency and experience in a wide range of financial, legal and management disciples. These professionals operate as a cohesive group of specialists providing collaborative diagnostics, advice, planning, solutions, information, capital and connections to address complex growth, management and financial challenges to individual business owners.