



What Drives Value In Your Organization

BY BRENT TERHAAR,
PRINCIPAL, MANUFACTURING AND DISTRIBUTION,
LARSONALLEN

As we reflect on the past 12 months, many will remember the financial challenges brought about by the economy. Minnesota manufacturing companies certainly felt the effects of this as did many manufacturers across the country. There is no doubt that the decline in financial performance of most manufacturers led to a decline in enterprise value as well. The key questions are 1) how do I evaluate the impact? and 2) how do I improve it moving forward?

So how do you determine the value of a manufacturing company? While it is easy to monitor the change in value of a traditional stock portfolio, it is more difficult to determine the value of a non-publicly traded manufacturing company. The value of a company goes well beyond merely putting a multiple on the earnings of the organization or assigning a value to the assets of the business. Value can be viewed in many different contexts – organizational longevity, future growth potential, industry or customer penetration, operational excellence, barriers of entry to new competition, workforce capabilities, and geographic expansion, to name a few. These qualitative aspects of valuation can create a significantly different valuation for two similar businesses with comparable financial results. Sellers of businesses tend

to look to the past to justify enterprise value, while buyers will focus on understanding if past performance can be sustained in the future. The predictors of future performance tend to lie in the qualitative, versus quantitative, measures of a business.

Have all manufacturers taken the time to truly reflect on their company and say, “how do I enhance the value of my organization?” Now more than ever, it is important for organizations to put a critical eye to both the quantitative and qualitative performance of their business to determine the value of the enterprise. Why? Even if you have no intention of selling your business in the near-term (say three to five years), the answer is really quite simple. ***The attributes that make a manufacturer attractive to a potential buyer at a premium value are often the same attributes that make that manufacturer attractive to potential customers, supply chain partners and top notch employees.*** The qualitative performance of the business drives the quantitative (i.e. financial) performance. Do you want to hold and grow your business for the next 20 years? If so, make yourself the most attractive business to a potential buyer today and you are probably well on your way.

If understanding what drives value in your organization is so important, why aren't more businesses focusing on it? For most small business owners and managers, their day-to-day roles have them focused on working *in* the business rather than *on* the business. The daily stresses of meeting customer demands, managing cash flow, and growing sales typically take precedence over this self-evaluation process. Another reason is that business owners may not possess the understanding or perspective of what is valued in their organization by the outside world, which often reinforces past behaviors and leads to little if any substantive changes. This is a very dangerous proposition. As Bruce Barton put it, “When you are through changing, you are through.”

In uncertain times, determining the strengths and weaknesses of your company and understanding how those factors affect value and sustainability is critical. To increase your enterprise value and ensure sustainability, you must first understand what your strengths and weaknesses are. More importantly, you must look at your organization through the lens of your competitors, investors, customers and vendors. What you may think is valuable, others may see as a weakness that reduces the value of an organization.

There are many ways to look at the value of an organization – many people will attempt to put a dollar amount on a company based on financial models readily used in the marketplace. While these may provide an objective financial snapshot of value, they typically won't get to the essence of true value creation in manufacturing companies.

Determining value depends on what lens one uses to evaluate it. The perspective the evaluator has will drive his or her view of value. Regardless of the situation, there are three core principles that drive value in an organization including: 1) Financial Performance, 2) Markets and Customers, and 3) Infrastructure/Quality. The easiest way to think of this is based on three points on a pyramid – we call this the Value Pyramid. Manufacturing companies can use the Value Pyramid to assist them in evaluating their organization.

The Value Pyramid

Financial
Performance

Markets & Infrastructure/
Customers Quality

FINANCIAL PERFORMANCE:

Financial performance is the easiest to evaluate. Historical financial metrics can provide a baseline that is easy to benchmark against other companies. Consistent growth, strong earnings, and balance sheet strength (including working capital management) are all critical in evaluating the financial value of an organization. Is one more important than another? Yes, absolutely, but it depends on the situation. An organization that is in the market to acquire another company may view consistent growth as valuable to its organization. On the flip side, the selling company may see strong earnings as critical to maximize a purchase price. A bank may look at the strength of the balance sheet to determine lending limits.

Regardless of the situation, there is no doubt that companies that understand and manage their financial performance can create significant value. However, financial performance alone does not dictate value. Were increased earnings achieved at the cost of not investing in people, equipment, or facilities? Were strong short-term financial results an anomaly of customer or industry situations? It is important to understand the reasons for the financial results to truly gauge how financial performance impacts enterprise value.

MARKETS AND CUSTOMERS:

Customers are the reason companies are in business. The mix of your customers and the markets you serve can have a significant impact on enterprise value. Having a niche presence in a certain industry or being a key supplier to a customer may be strengths of your organization. These may also be viewed as weaknesses. Concentrations in specific

industries or with a few customers may leave a company vulnerable to erratic peaks and valleys driven by those industries or customers.

Typically, companies that serve multiple industries and have a diverse customer base will be viewed as more valuable. While this may create a more competitive environment compared to being a sole supplier to a customer, it also minimizes downside risk if something should happen with a customer relationship. Think of the auto industry – in the 1990s, supplying the auto industry with strong companies like General Motors was considered stable and valuable. Today, companies that serve the auto industry are struggling to survive, and GM is no longer the model of stability. Finding ways to penetrate new markets and expand your customer base are important to enhance enterprise value.

INFRASTRUCTURE/QUALITY:

A company's infrastructure, or lack thereof, can also have a significant impact on value. Organizations that have strong management and processes that are reliable and continuously improving are important. Many manufacturers work in sophisticated supply chains that require a high degree of quality infrastructure. Regardless of the size of your organization, if you are unable to adapt to the requirements of your supply chain, your value will be diminished.

In a manufacturing environment, companies that operate with a “Lean Manufacturing” mentality and an ability to quickly change are considered valuable. The key, however, has to be quality. The ability to change without maintaining quality is not enough. A quality product is no longer becoming a competitive advantage; it is a necessity of doing business. Food manufacturers see this more than any other industry. If quality is sacrificed in food production, a company's value is greatly diminished.

The key to the Value Pyramid is balance. ***The goal is to maximize the area of the pyramid.*** History shows that companies with a healthy balance in each point of the Value Pyramid create the most long-term value for their organizations. Think of companies like Walmart and Google. While extremely different in the products and markets they serve, both companies have strong enterprise value because they have balance in the three core principles of the Value Pyramid.

The ability to look introspectively and drive change is critical to enhancing enterprise value. Apple is a great example of the effects of not changing and of ultimately changing its perspective on what is valuable. In the 1980s, Apple was a leader in the home computer market. As a result, its enterprise value was strong. When home computing became more competitive, Apple was slow to change with the increased number of suppliers and products in the market. As a

result, the company's value declined. Not until Apple changed its focus and diversified with new products (iphone and ipod) and new markets (retail locations) did its enterprise value rise again. This required the vision, leadership, and willingness to change of its leaders.

Now more than ever, it is important to look introspectively to understand what creates value in your organization. Understanding where you are positioned today and creating a plan to focus on critical points to increase future value and sustainability is essential. Ask yourself, "What does my company's value pyramid look like? Is it balanced? What do I need to do to change my financial performance, markets & customers, and infrastructure/quality?" All are important steps in determining what your current enterprise value is and what you need to do to enhance future value.

Brent Terhaar is a Principal in the Manufacturing and Distribution group of LarsonAllen and the Principal-in-Charge of the firm's Dallas, Texas office. Brent grew up in a family business in central Minnesota and has spent his entire career serving small to medium sized, closely held manufacturers and distributors.