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| VALUE MAXIMIZATION |

# Managing to Maximize Value

## Are you working hard and flying blind?

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There are many subjects to address that would be helpful to CEOs and owners, however, none may be more important and influential than the key pillar of a critical triumvirate, called Value Maximization.

### Value Management

Value Maximization pertains to managerial decisions and actions that are not necessarily event-based, but rather, are related to increasing the value of a company, or more precisely, its long-term Equity Value. The challenge is to understand what drives value (and what detracts from value) so CEO's can "work smart" aside from working hard.

By the way, the other referenced pillars are Value Creation, which pertains to engaging strategic initiatives via optimally modifying an offering to create new value, and Value Realization, which pertains to preparing for and executing a liquidity event, whether in whole or part, to harvest existing value.

Collectively, this three dimensional continuum, Value Creation-Maximization-Realization, compose a managerial paradigm called Value Management. It is suggested Value Management should be an unrivaled imperative for CEO's and owners, and in time, become a prominent part of the lexicon and focus of Boards.

### Success Serendipity

Much of the growth & development achieved by companies is based on opportunities that arise within the marketplace. Put another way, to a large extent companies grow based on the vectors of "tides and currents" vs. directed navigation (and not all growth is good). The largest contributing factor to "success serendipity" is the lack of an informed understanding as to how the marketplace views and measures value. This is not based on negligence.

Most seasoned CEO's dictate navigation based on the known translation of certain actions into higher valuation outcomes. However, most presidents and owners of companies, especially smaller companies, do not have benefit of this type of frame of reference, and therefore, are in a sense "flying blind."

Since most presidents and owners operate in the trenches every day attending to the "fires du jour," and only become exposed to the sentiment of the marketplace at certain inflection points (which is usually the wrong time), it is hoped this will provide an initial framework to enrich decision-making related to Value Maximization.

### Valuation Predicates

Before addressing a variety of value drivers/detractors, it might be useful to briefly confirm the two elements that predicate all valuation outcomes. These two elements are the quality of earnings and the growth profile. The former pertains to the stability, repeatability, concentration, etc., of earnings, and the latter pertains to the risk/reward profile of those propositions that will lead to new earnings growth.

Literally every aspect or dimension of a company can be ultimately extrapolated to a positive or negative quality of earnings or growth profile impact. These factors predicate a "seemingly abstract" purchase price, or earnings valuation multiple, and if a classic valuation method is used, the discount rate in the net present value equation. In short, CEO's and owners should always think about decisions and actions in relation to these two factors.

### Universal Drivers

There are two sets of drivers that can be managed to maximize value over time. The first set is "universal drivers." These elements are applicable to virtually all

companies, are related to operating and financial matters, and impact the certainty/uncertainty of the quality of earnings. Each can be managed, modified, or transformed over time to make a company more valuable. Here are the top dozen:

▶ **President/Owner Redundancy**
The degree to which a company's performance is dependent on its president/owner, the greater the enterprise's risk. The key person should become redundant so the business can operate without disruption should this individual(s) not be available.

▶ **Middle-Management Strength**
The degree to which a company can possess multiple centers-of-expertise specific to each key discipline, the lower the company's inherent risk. Should certain functionalities be strong and others materially less so, the imbalance will create internal stresses and execution risk.

▶ **Customer Concentration**
The degree to which a company is dependent on a limited number of customers, the greater the risk associated with future revenues. The theoretical objective is to develop an even distribution such that no single customer accounts for more than 15% of revenue.

▶ **Offering Composition**
The degree to which a company can bundle value by maximizing the value-add provided to its customers, the less risky the offering. Creating multi-dimensional offering distinctions will minimize competitive threats, i.e., one-trick ponies do not last too long, and insulate, if not expand, margins.

▶ **Vendor Concentration**
The degree to which a company is dependent on a specific supplier or vendor, whose status could materially impact a company, the greater the risk. As such, multiple sources of supply should be established at all times to obviate supplier concentration.

▶ **Intellectual Property Preservation**
The degree to which a company can create, expand, insulate and protect its tangible (e.g., special assets), and intangible (e.g., brand equity) intellectual property, the greater the barrier-to-entry and earnings preservation, and the lesser the competitive threat.

▶ **Discrete vs. Contractual Revenues**
The degree to which a company can obtain contractual obligations spanning multi-year periods from its customer base regarding the rendering of its service or supply of product, vs. discrete purchase orders, the greater the certainty of future revenues.

▶ **Customized vs. Commercial Systems**
The degree to which a company can use prominent commercial systems as its core related to its ERP and other matters (some customization is fine), the more a company is perceived to be scalable and less dependent on systems that may have certain failure defaults.

▶ **Financial Reporting & Cost Accounting**
The degree to which a company can have its financial reporting validated by a third-party, the greater the integrity of its financial statements. Further, the more comprehensive the cost accounting system, the presumed higher quality of its pricing practices, margin benchmarking, etc.

▶ **Data Aggregation vs. Segmentation**
The degree to which a company can dissect both its revenues and true gross profit, in lieu of lumping data into large customer or offering buckets, the greater the transparency and perceived insight into the sources of greatest present and future return.

▶ **Strategic Development Activities**
The degree to which a company maintains an active strategic development process, inclusive of the ability to make and integrate acquisitions (which is a rewarded skill), the greater the perceived ability to achieve new opportunity or address competitive threats.

▶ **Regulatory & Legal Compliance**. The degree to which a company can comply with all governance, regulatory and legal requirements, inclusive of exceeding such requirements where possible, the lower the perceived risk of contingent liabilities related to stock ownership and otherwise.

## Strategic Driver

The second focus of Value Maximization pertains to not only having a formalized process to engage strategic development, which has been cast as a universal driver, but actually developing an agenda and executing strategic propositions. In this instance, the discipline of Value Creation is partially integrated into the modality of Value Maximization evidencing the seamlessness of the Value Management continuum.

A recent article in the *Wall Street Journal* titled "Good Earnings No Longer Enough"[1] emphasized the importance of earnings outlooks, which in turn, are predicated on the Value Creation agenda and execution capability of a company. This further validates the importance of embracing the strategic driver to maximize value.

The quality of the propositions composing any Value Creation agenda, as defined by their risk/reward relationship, impacts the growth profile factor related to valuation. The black-box of Value Creation is selecting the optimal opportunity from typically many choices, which by definition, will be best aligned with the risk/reward profile of that particular company.

While the different forms of strategic Value Creation entailing expanding the core, developing an adjacency, and considering related diversification were introduced in my winter 2013-14 article ("Proactive Acquisitions), such activities will produce the greatest Value Maximization impact, and therefore, should be a normalized practice.

Understanding the sentiment of the marketplace in regard to value drivers/detractors and the basis of valuation are the paramount requirements of managing to maximize value successfully. Attention to the universal drivers will result in less enterprise risk. Attention to the strategic driver will result in more opportunity. Fly smart, not blind.

[1] Published May 8, 2014