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The importance of high certainty earnings to business value

Strategies that can be used to increase the value of your business…

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I have been approached many times with the question: "How do I maximise the value of a privately held business?" The answer is not obvious and will probably surprise you. The answer is: "Lock in existing profitable revenue with effective techniques."

Why?

Because recurring business is more important to your company's value than one-off sales. As the certainty in maintaining existing profitability increases, so increases the value of your company to a potential purchaser.

Here's an example to illustrate my point:

Take two identical businesses with the same level of turnover and profitability, making on average £1-million pre-tax annually. One company sells a product that does not receive repeat orders from regular customers, but instead relies on one-off purchases. In times of economic turmoil, turnover in this operation will vary and so will profitability. The potential purchaser of such an operation will want to ensure that profit made during the good times will compensate for suffering through the lean years.

This purchaser will require a rate of return on his investment to cover that risk of weathering the downturns, let's say 25% (pre-tax) per annum. This, in the simplest terms, means that he would not be willing to pay more than £4-million for this type of operation.

Now, let's take a comparable business that maintains the same average pre-tax profitability of £1-million, but deals with a dedicated customer base that is somehow tied to the business in a special way. Over the same time period, revenue and profitability should vary less due to the captivity of the clients by the business. The purchaser of such an operation will not have to bear the burden of increased vulnerability during the slow years and as such will be prepared to settle for a lower rate of return on his investment, let's say 20% pre-tax per annum. As a result, the buyer of this business would be prepared to pay £5-million for this company, a full 25% more than what the previous company was worth, even though both operations provide an identical average level of profitability over the same business cycle.

"The challenge to your business is not how to increase turnover, but how to increase the certainty in maintaining your current level of profitability. The number one job is to ensure that the profit you derive from the existing business base will still be with you tomorrow as you continue to forage on for new customers."

Now, I am the first to admit that this analogy is a vast oversimplification of business valuation and has not taken a vast number of other factors into account such as gearing levels, the time value of money, the position of the business cycle at the time of acquisition or possibly even the phases of the moon, But I hope you get my drift.

The real question you should be asking your financial advisor is: "How do I convert one-off revenue into ongoing, secure and predictable earnings flow?"

The answer is by using securitisation strategies that will keep new customers contributing to your profitability for a much longer period of time and hopefully on an indefinite basis.

Now, on to an example of this technique.

In businesses involving the sale of capital equipment, goods may be sold in conjunction with a guaranteed rebate agreement. In such an agreement, your customer will be allocated by the vendor the right to sell old equipment back to you the supplier within a specified time period as a credit offset against the price of new equipment. In conjunction with such an agreement, service and maintenance contracts are also negotiated. Why go through this amount of hassle? Because by ensuring that the customer regularly upgrades the products he purchases only from you enables you to seriously discount the initial price you are prepared to offer him to become a long-term profit generating customer. I must stress the aspect of tying in service and maintenance agreements to your overall business strategy. They should always be the cornerstone in increasing the value of your company.

Ask yourself these questions:

How do razor makers earn a crust? They sell blades at high margin and practically give away the shavers. What business do the manufacturers of computer printers rely on to survive? They make profit by selling ink cartridges. What business keeps the auto retailer in profit? They maintain cars for long-term survival

Get the idea?

The challenge to your business is not how to increase turnover, but how to increase the certainty in maintaining your current level of profitability. The number one job is to ensure that the profit you derive from the existing business base will still be with you tomorrow as you continue to forage on for new customers. Lack of space here limits my discussion of more examples of this concept, but please feel free to drop me a line if you wish me to pursue this topic in future.

When the time comes to exit your business investment through divestiture, the degree to which you are able to adhere to this philosophy will determine the rate of return you can expect to achieve from your hard work.

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