LOOKING AHEAD – 2018

"Strategic Issues in the Apparatus Service Industry in 2018 and Beyond"

Q. How to Improve the Value of Your Business?
A. Work ON Your Business, not just IN Your Business.

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Working ***IN*** your business is making the decisions and taking the actions to keep your business going today, tomorrow, and maybe this week or month. Working ***ON*** your business is making the decisions and taking the actions that will improve your business in the future: next year, five years from now and beyond. Think for just a moment: if you are always working only ***IN*** your business, then the value of your business in the future will be exactly what it is today, inflation adjusted, if you want to get technical.

Business owners, general managers, and key management do some of both: working ***IN*** and working ***ON*** their business, their department or area of responsibility, but the latter often in a haphazard manner. My message: make working on your business a regular part of your management duties and responsibilities; you will increase the future value of your business.

What does working on your business really mean? Here are eight simple questions that you should be asking at least once a week to work on your business and, based on four decades of valuing and selling businesses, why the answers affect a business's valuation.

1. What am I doing to groom a replacement manager? The number one question I am asked when offering a company to a prospective buyer is "Who it going to run the company?" There is a big shortage of trained management personnel in this industry. During the late 1900's, industry trained managers stopped emerging from GE, Westinghouse, and the Navy. These were once the primary sources for industry related talent. For the past two decades, there has been a shortage of younger, trained talent in the industry and the working, available talent is aging out. Are you delegating more and more responsibility and authority to your successor and rewarding him or her commensurately? Are you mentoring that person? Do you have the programs in place to train that person in areas where he or she needs more education and experience?

2. What am I doing to develop the management team? For businesses to grow out of the mom and pop stage, more management talent is needed. Second only to Question 1 above, buyers ask me about the depth of the skills of the management team, both technically and administratively. Are you sending any employees to management seminars or courses such as basic accounting? Are your people given latitude for making decisions appropriate with their responsibility? When mistakes are made, as they will be, are they treated as teaching moments, not with nasty reprisals?

3. What am I doing to insure the health, job satisfaction, skills and safety of our employees? Every buyer looks carefully at the turnover rate, safety records, skill set, compensation levels, fringe benefit package, age and tenure of the seller's employees. Human relations (HR) are becoming more and more a cornerstone in successful businesses. In the past decades numerous federal and state HR laws have been passed including the Civil Rights Act (1964), OSHA (1970) ERISA (1974) ….. The list goes on and on. This year California (1/8 of the US population) enacted a series of new, impactful labor laws. Buyers want to see not just routine conformance to the laws, but also conformance in the practices of the company. Buyers know that good HR policies and practices are necessary to maintain the current workforce and attract the hourly and salary talent needed for future growth.

4. What am I doing to improve our marketing and growth? A company's growth rate is a key variable in every business valuation formula. Why do companies like Google and Amazon have such a huge valuation with minimal earnings? Growth! While the growth rates possible in this industry are far lower than high technology companies, growth is still very important.

Much of the preliminary discussion between buyers and sellers revolves around current marketing practices and what is being done to improve them in the future.

The four "P"s are a quick definition of marketing: Price, Products (or services), Promotion (sales efforts), and Place (getting the products or services to the customer). This definition naturally leads to four questions: How am I creating opportunities to improve pricing? What mix of products and services are best for our future customers? How can we change our sales efforts to become more effective? And, how can we deliver our products and services in a more productive way to meet our customer's needs.

Buyers assign value to concrete plans a seller has to improve the company's marketing. Early in my career, I was the repair division Controller for a motor manufacturer. My boss insisted each

of our 16 shop managers have at least five programs continuously in place to improve the marketing efforts in their shop. Given that many, if not most of the programs, were not successful, I asked him why he insisted on these efforts. His simple answer was a teaching moment for me. He said if he didn't insist on such efforts, there would be little or no such efforts expended. The managers would continue working ***IN*** their respective businesses, not ***ON*** their businesses.

5. What am I doing to reduce customer concentration? In this industry, particularly with smaller shops, the top customer may be 20%, 30% or more of sales, the top five customers 50%, 60% or more. Every prospective buyer wants to see the sales concentration of the top five or ten customers over the past two or three years. I once discounted the calculated earnings valuation of a company by over 70% percent since the top two customers represented over 90% of the business.

6. What am I doing to improve the state-of-the-art of our equipment, facility, manual and automated processes, IT and other resources to support growth in the future? These decisions involve capital expenditures, research and development, cost analyses, systems and equipment upgrades, etc. Buyers analyze the amount of money spent on these items as an indicator of how much they may have to spend in the future to make the company state-of-the-art. These decisions are long term and need to be matched with the growth, markets, product and services, and cash flow of the company.

7. What am I doing to improve the management reporting and control in the business? Buyers quickly get a sense of how well a business is controlled when they ask questions such as the following. How much is your increase in sales year to year? What are the reasons for the increase or decrease in profits from last year? How many direct labor hours are charged to jobs each month? What is the current backlog? What is the sales and profit forecast for the next three months? Are line-by-line cost controls and productivity measures in place? Buyers know that future growth and improvements in profitability are severely limited without proper reporting and internal controls.

8. What am I doing to consciously reduce the other risks associated with my business? Underlying all of the above questions is the concept of reducing the risks associated with buying your business. Risks can come in many forms: legal issues, environmental problems, insufficient insurance coverage, sexual harassment, etc., etc.

Allow me to jump to theory for just a moment. One accepted definition of the value of a business today is the sum of all the future earnings of the business discounted to a present value. The discount rate is the measure of risk applied to future projected earnings in business valuation formulas. A projected one dollar of earnings next year may only be worth fifty cents today in a higher risk business such a new business, very small business, or business with an erratic earnings stream. A projected one dollar of earnings next year may be worth eighty cents today in a larger, growing, mature company. The reciprocal of the discount rate is the multiple that buyers apply to earnings to get a value. The discount rates in the examples above would roughly correspond to a 2x multiple of earnings on a risky business and a 5x multiple on a less risky business for the valuation of the company.

In practice, buyers will make a decision about the current and future risks that they perceive are associated with a seller's business. That decision directly relates to whether or not the buyer will make an offer and how much that offer will be.

Pete, What about earnings? Do they not affect the valuation?

The answer is obviously yes. Todays' earnings and valuation are the outcome from the decisions made in the past. They are history. My message is for your future. Work ***ON*** your business on a regular basis, focusing on the questions above, and the results will improve your earnings and valuation in the future.

On the last page is a summary list of these questions that you might print and keep in a familiar place that you look at regularly.

Personal note regarding the 2018 EASA Convention:

I will be at the EASA Convention on Milwaukee in a few days. This is my fortieth year in the industry. It has been a great pleasure to work with owners and managers on business sales, valuations and succession. The good Lord willing, I expect to work a few more years.

However with a pinched nerve in my back, I will be walking the Convention floor less and finding good places to sit, probably near the refreshments area. I would enjoy visiting with old friends and making new acquaintances. Business conversations are always confidential. Look for the handlebar mustache. 

Best regards.

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"Over forty years advising business owners in apparatus service industries"

EIGHT SIMPLE QUESTIONS TO INCREASE THE VALUE OF ~~YOUR~~ *my* BUSINESS

By Pete Smith, C&S Associates

Questions I should ask this week about my business.

1. What am I doing to groom a replacement manager?

2. What am I doing to develop the management team?

3. What am I doing to insure the health, job satisfaction, skills and safety of our employees?

4. What am I doing to improve our marketing and grow the company?

5. What am I doing to reduce customer concentration?

6. What am I doing to improve the state-of-the-art of our equipment, facility, manual and automated processes, IT and other resources to support growth in the future?

7. What am I doing to improve the management reporting and control in the business?

8. What am I doing to consciously reduce the other risks associated with my business?