

Dealmaker

Providing business owners and managers with M&A market insight Spring 2010

Understanding the dynamics of business value



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The following article was taken from the first webcast in Grant Thornton LLP's leadership series for privately held businesses. That presentation, along with recordings of the other webcasts in the series, is available through the calendar of events at www.GrantThornton.com.

A successful business is usually more than just a job or even a career for its founder. It is also a source of identity, since the business is often driven and sustained mostly by the entrepreneurial vision of the business owner.

Emotional issues aside, however, the establishment of the value of a business is an intricate process that is part science and part art. Facts, figures and data play a crucial role in the establishment of so-called scientific value, which usually involves one or more of three traditional appraisal methodologies: the market approach, the income approach and the cost approach.

What happens, however, when you set aside scientific value and take a different approach? Are there simpler ways to understand, and increase, the value of your business?

$$\text{Value} = \frac{i}{r}$$

i = income or cash flow
r = risk-adjusted discount rate

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The basics

The reality of managing value is all about growing sales, containing costs and managing risk. In this context, the valuation equation is boiled down to some future income stream or cash flow and a risk-adjusted discount rate. The greater the income stream, the higher the valuation. The greater the risk associated with that income stream, the higher the discount rate and therefore the lower the valuation. This last point is important; we often see a disconnect between how the business owner perceives the risk associated with their income stream and how an outsider perceives that risk.

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Understanding the dynamics of business value (continued)

Clearly, more income and less risk will equate to greater value, but more income also allows you to reinvest in the business, reward employees and pay dividends to shareholders. Likewise, less risk allows you to secure cheaper capital more easily, plan for the future and generally sleep better at night.

This might all seem very obvious, but think about this example: Your largest customer wants to triple the business it does with you. But in return for the increased volume of business, it is looking for a significant reduction in pricing that will result in a much lower gross margin. Intuitively, this seems like a good thing; more sales must mean more profit must mean more value, right? Well, not necessarily. Someone else might view this as creating a lower-value business because of the impact on gross margin, as well as a customer concentration risk.

So what are some of the things that drive value? We can break them down into two types of drivers: external and internal.

External drivers tend to be beyond the direct control of the business owner and include things like the size of the market you operate in and how fast that market is growing, the competitive landscape that exists, how your sector performs in an up or down economic cycle, and finally — but seemingly more relevant today than ever — how far the government reaches into your industry through regulation. Try as you might, you can't control these things, but they certainly have an impact on value.

Conversely, internal value drivers such as those listed below are well within an owner's control because they tend to be company-specific:

- How big your company is and how fast it is growing
- The margins your company has and the sustainability of those margins
- Any proprietary products, technology or processes from which you benefit
- Your company's brand name and reputation
- The strength of your workforce, particularly your management team
- The extent to which you have made your business scalable through implementing repeatable business processes and robust internal controls



Growing the “i”

Revenue growth can clearly be achieved either inorganically — in other words, through an acquisition — or organically. Acquisitions are the more direct path but are not without risk. Organic growth, on the other hand, may take more time, but is a no less effective solution and one that may have less risk.

Organic growth can come from a number of areas but most commonly stems from one of four sources:

- **Product development** — Introducing new products to your existing markets
- **Market development** — Entering new markets (vertical or geographic)
- **Diversification** — Developing new products for new markets
- **Market penetration** — Increasing market share by selling more of your existing products within your existing markets

This basically describes the Ansoff Product-Market Growth Matrix, a tool created by Igor Ansoff and first published in his 1957 article “Strategies for Diversification” in the *Harvard Business Review*. Many companies use this matrix to assess opportunities for organic growth.

On the other side of the ledger, cost reduction is another way to increase net income. Cost reduction can come either above the line in cost of goods sold, having an impact on gross margin — things like improved productivity, efficiencies or sourcing strategies — or below the line in selling, general and administrative expenses, which tend to reflect more economies of scale and cost containment.

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Understanding the dynamics of business value (continued)

Managing the “r”

Similar to the value drivers, risks can be internal (company-specific) and external (systemic).

Internal factors affecting risk can for the most part be controlled, whereas external factors cannot. However, even if you can't control them, you can certainly take steps to mitigate the degree to which they can affect your business.

A company can reduce the risk associated with its income stream by having a diverse product offering; a diverse customer base; adequate protection of its technology, brands and key employees; a strong team; and robust internal controls. All of these things contribute to a sustainable and scalable income stream. Clearly there is a link between many of the internal value drivers and these controllable internal risk factors.

Looking externally, a company can reduce systemic risks by operating in diverse markets — whether those be different verticals or different geographies — having countercyclical businesses, or having something unique to offer the marketplace.

Does entrepreneurial spirit create or compromise value?

There is often observable conflict between the way that entrepreneurial businesses are run and how things work in larger, more institutional entities (for the most part, public companies). What we've seen time and time again with privately held entrepreneurial companies is that the very things that make them thrive and make them successful are the same things that ultimately cause large institutions to be nervous, and when someone is nervous the place they typically reflect that is in valuation.

The values and traits that make an entrepreneurial business thrive are typically instinctive in nature:

- Dynamic and creative environments
- Flat, decentralized and results-driven
- Focused on growth
- Less emphasis on input from advisors
- Tendency to act first, ask questions later

These characteristics, when viewed through an outsider's lens, may be perceived differently by institutions that place greater emphasis on structure and view your model as:

- Lacking internal controls
- Lacking a succession plan
- Risky and aggressive
- Lacking an acceptable ROI

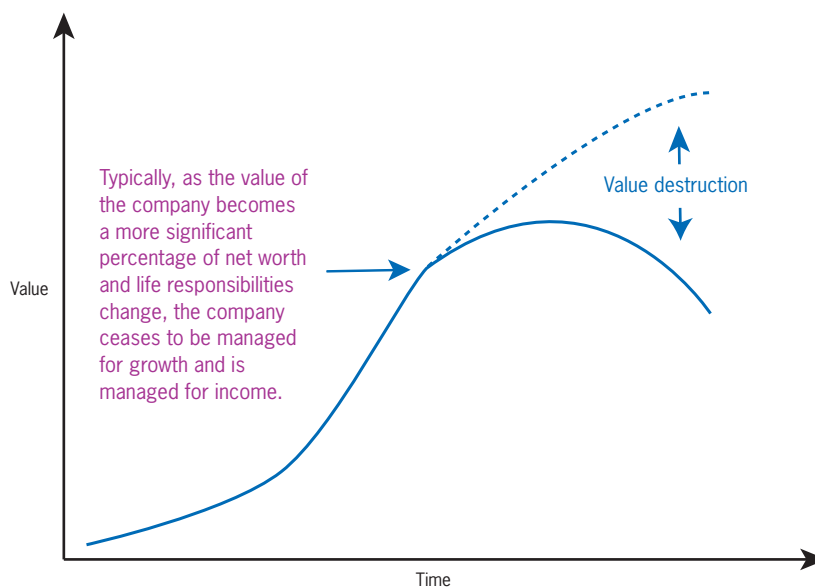
Your strengths, as such, may not necessarily translate into value.

Interestingly, this juxtaposition has been exploited with great success by private equity groups that have made a business of acquiring growing entrepreneurial companies; “professionalizing” them with systems, processes, management teams and the like; and then selling them to larger corporate institutions. In the process, they have created tremendous returns for themselves and their limited partners — returns that the business owners could have kept for themselves had they approached things differently.

In the early years of a company's life cycle, the entrepreneurial spirit rages and aggressive growth and risk-taking go hand in hand. But what we've seen time and time again is that this entrepreneurial approach can ultimately become compromised as the shareholders' risk profile changes.

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Entrepreneurs' attitudes towards risk change over time



Understanding the dynamics of business value (continued)

Typically, as the business becomes more valuable, it constitutes a more significant percentage of the owner's overall net worth. At the same time, the owner's life responsibilities often change and it becomes harder and harder for the owner to justify taking risks and gamble with the future of the business. The owner begins to manage the company for income and not growth. This is analogous to assets in a portfolio. Early on, your portfolio might be weighted 80% toward stocks and 20% toward bonds, but as you get older, that allocation shifts to more of the income-producing bonds and less of the risky growth equity.

It's no different with the company. Suddenly, growth takes a backseat and current income becomes the focus.

A company's need for capital can continue pretty much unabated, but if starved of that capital, the company can stagnate and its value can be destroyed with alarming speed. Companies inevitably reach critical forks in the road where important strategic decisions need to be made. Examples would be deciding to expand into new markets, especially internationally; investing in R&D to develop new products; expanding capacity; or switching sourcing or manufacturing to a lower-cost country, such as China.

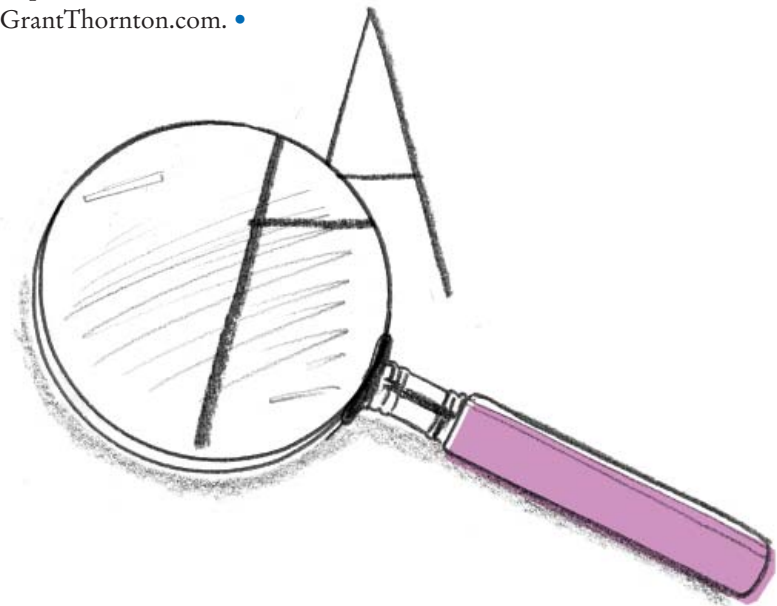
These are all key strategic decisions that require capital and some appetite for risk-taking. But all too easily, they can be postponed or delayed — or worse, ignored altogether — weakening the company's long-term viability and eroding its value. We've seen this time and time again, primarily in the context of an M&A transaction, where the owners prefer to defer the big strategic decisions to a new owner or have the M&A transaction itself solve the problem.

Conclusion

It can be a challenge for entrepreneurs to separate themselves from the company and view business value through another lens, but it's a worthwhile exercise.

When you wake up every day, you should be thinking about what you can do to increase “i” and reduce “r” and thereby preserve and grow the value of your business. For a deeper look at this topic, “Understanding private company value,” visit the private company leadership webcast series at www.GrantThornton.com. •

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M&A update for Q1 2010



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Each year, Grant Thornton International Ltd surveys hundreds of senior executives of privately held businesses (PHBs) worldwide and publishes its findings in its annual *International Business Report (IBR)*. This report discusses attitudes and trends with respect to domestic and international M&A activity.

The 2010 *IBR* revealed that Grant Thornton International member firms are reporting an increase in M&A activity along with an increase in market confidence, as the majority of PHBs believe that economic recovery has already begun or will begin during 2010. In addition, 10% of respondents expect a change of ownership in 2010, compared with only 6% a year ago.

Download the *International Business Report* at www.gti.org.

This year's *IBR* also showed that despite a positive economic outlook, business owners are naturally cautious about their plans to make acquisitions in 2010. The proportion of executives who intend to make acquisitions fell 11% compared with the previous year. Still, a significant number of PHBs are expecting to grow via acquisitions in 2010, with nearly one-third of businesses in North America planning to make acquisitions, as well as 26% globally.

M&A activity

North American M&A activity in Q1 2010 declined only 2.5% from the previous quarter (3,577 transactions in Q4 2009 versus 3,487 in Q1 2010). Although M&A decreased slightly from Q4 2009,

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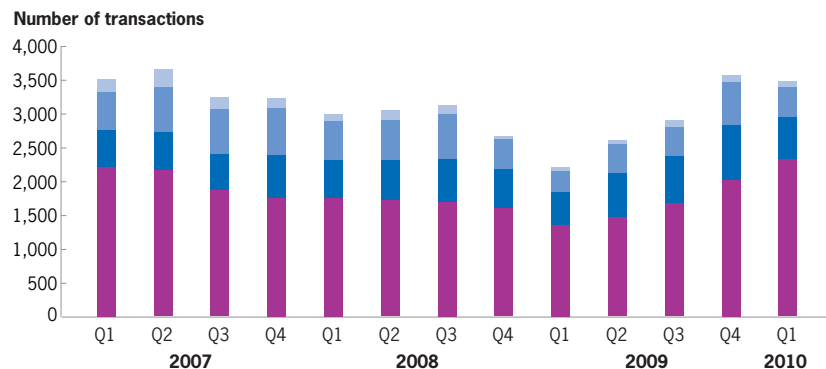
it was still the third most active quarter since 2000. With the economy emerging from a recession and credit markets loosening, M&A activity appears to be on the rebound.

Global M&A deal volume in Q1 2010 declined 8.5% from Q4 2009 levels. However, compared with Q1 2009, deal volume was 38% higher in Q1 2010, while aggregate deal value increased almost 42%.

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North American M&A activity by deal size

● >\$250M ● \$10M–\$250M ● <\$10M ● Undisclosed



Sources: GTCF research; certain information taken from Capital IQ

M&A update for Q1 2010 (continued)

U.S. valuation multiples increase

Median U.S. valuation multiples (enterprise value/EBITDA) stabilized in Q1 2010 and in some cases increased. Multiples for transactions valued under \$50 million remained at 7.0x, while multiples for deals larger than \$250 million fell slightly to 9.3x from 9.6x. Notably, valuation multiples in transactions valued between \$50 million and \$250 million rose significantly, to 8.1x from 6.4x. With multiples improving, business owners who have been holding out for better valuations may look to exit during 2010, especially in light of expiring tax cuts from the Bush administration and pending legislation from the Obama administration which could further increase taxes.

Private equity activity starts off strong in 2010

Higher valuation multiples could be the result of the return of private equity funds as viable acquirers. As financial buyers become more active, increased competition between strategic and financial buyers drives up transaction multiples.

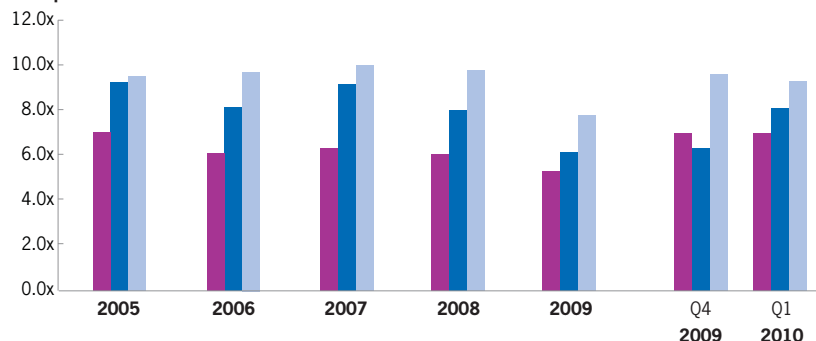
Grant Thornton Corporate Finance LLC estimates that sponsor-backed acquisitions accounted for 18% of total activity in Q1 2010 — up from 14% in Q4 2009. With the volume of private equity transactions growing for three consecutive quarters, it appears that financial buyers are a viable alternative for business owners looking to exit. Interestingly, there has been a decline in the number of minority deals; this decline may indicate that a larger percentage of private equity transactions comprised leveraged buyouts (LBOs) — itself a clear sign that credit is becoming increasingly available.

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U.S. valuation multiples by size

● >\$250M ● \$50M-\$250M ● <\$50M

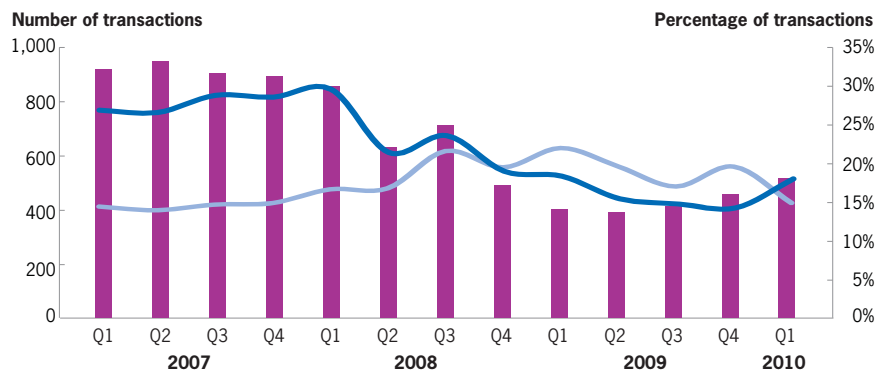
Enterprise value-to-EBITDA



Sources: GTCF research; certain information taken from Capital IQ

U.S. private equity activity by quarter

● Private equity volume
 ● Minority deals as a percentage of private equity (Pitchbook.com)
 ● Private equity as percentage of total M&A (Grant Thornton Corporate Finance estimate)



Sources: GTCF research, PitchBook Data Inc.; certain information taken from Capital IQ

With the volume of private equity transactions growing for three consecutive quarters, it appears that financial buyers are a viable alternative for business owners looking to exit.

Summary

This year's *IBR* reveals that the majority of businesses have an optimistic view of 2010. M&A within North America is off to a strong start, and as the economy recovers and confidence continues to build, activity should trend upward in 2010. Business owners who withstood the recession have seen valuation multiples stabilize — if not increase — in the first quarter of the year, which is likely to lead to a rise in M&A activity. In addition, credit markets are loosening, and lenders appear to have a stronger appetite for deals, as evidenced by the growth in LBOs. •

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