EXIT PLANNING SOLUTIONS

THE DEFINITIVE GUIDE TO VALUE DRIVERS

HELP YOUR CLIENTS ACCELERATE BUSINESS GROWTH AND VALUE

BUSINESS ENTERPRISE INSTITUTE
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WHY VALUE DRIVERS MATTER

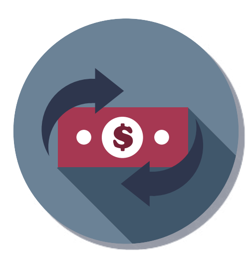
Regardless of the Exit Path your business-owning clients choose to pursue, one thing remains constant: All successful business exits require the installation and maintenance of *Value Drivers.*

Value Drivers are elements of a business that increase the business' value and appeal to buyers. This eBook will present the nine most important Value Drivers you must help your clients install to give them the best chance to exit their businesses on their terms.

The most important Value Driver that business owners must install is next-level management. As you learned in our previous eBook, successful business exits require business owners to delegate responsibilities to people outside of themselves. This eBook will show you how next-level management often determines the fate of your clients' exits, because it is often next-level management—not your business-owning client—that installs the other eight Value Drivers.

Growing the business and its value can be challenging for business owners, and it's where many owners find their Exit Plans stalling. This eBook will show you how you can help them overcome this challenge by identifying Value Drivers they haven't installed and addressing the issues the lack of Value Drivers causes them.

In subsequent guides, you will examine the specifics of third-party sales; sales to insiders; protecting the business against unexpected death or incapacitation; and protecting wealth in ways that allow your clients to leave their businesses when they want, for the money they need, and to the person they choose.



EXIT PLANNING CHALLENGES: VALUE DRIVERS

"Value Drivers are so important to a business exit, but many owners struggle to find next-level management teams that can close the gap between the resources they have and the resources they need to exit on their terms. When it comes to installing this most important Value Driver, many business owners lean heavily on their advisors. With BEI's tools and strategies, advisors can help owners create alignment in what they have and what they need from next-level management to exit on their terms."
–Elizabeth Mower, President of BEI

Business owners will face many formidable challenges in their quest to leave their businesses on their terms, some apparent, but many subtle and unseen. Several challenges that many business owners fail to anticipate include:

THEIR OWN MISPERCEPTIONS. Successful business owners tend to believe that because they built a successful company, only they can maintain the company's success. They work themselves to the bone, only to find that even their best efforts were not enough to assure a successful business exit. This eBook explores these misperceptions and describes what you can do to help owners avoid them.

A LACK OF KNOWLEDGE. It's common for owners to struggle with the concept of removing themselves from their businesses, especially when they feel as though they must be the ones to install and maintain all Value Drivers. Even with their best efforts, most business owners simply don't have the means to take the business to the next level. You can fix this problem.

INADEQUATE TIME. Owners who don't install and maintain Value Drivers often spend more time spinning their wheels than growing business value, preventing them from exiting on their terms. We calculate that about 200,000 out of 7 million businesses can be transferred today while allowing their owners to achieve their goals and objectives. An average time span to plan and execute an exit strategy is 5–8 years, which, of course, doesn't start until you or a different advisor convince owners that they need to begin.

FEAR OF CHANGE. Many business owners dedicate their lives to their businesses, so changing who runs their businesses and how can be a terrifying proposition. Those owners often have good intentions in their fear: After all, they built their businesses successfully, so handing them over to someone who might destroy their lives' work can be difficult to stomach. But for owners who don't want to die at their desks, they must install Value Drivers, starting with next-level management. You can be the advisor to guide them toward that path.

EXIT PLANNING BENEFITS: VALUE DRIVERS

"When business owners understand how Value Drivers affect their companies' transferable value, they often become more open to the idea of installing them. Regardless of the Exit Path they choose, transferable value affects the success of the business exit. BEI Advisors have the tools, strategies, and networks to help their clients install Value Drivers efficiently and effectively, which benefits everyone in the Exit Planning Process."
–Elizabeth Mower, President of BEI

Like other challenges owners face in exiting their businesses on their terms, some of the benefits of installing Value Drivers are obvious, while others are hidden. The most obvious benefit to business owners is building business value and growth while doing less work, thanks to next-level management.

Some less obvious benefits of installing Value Drivers include:

CLEARS THE MISPERCEPTIONS. Some business owners don't understand how next-level management can close the gap between what they have and what they need, and worry that installing other Value Drivers will take too much of their time. However, proper planning often grows the business and makes it even sturdier, in terms of cash flow, performance, and salability.

KEEPS OWNERS IN CONTROL. Owners often install next-level management themselves, which means they get to pick managers who will honor their vision for the company while they grow its value. Owners still get to play an important role in the company while their next-level management bears the brunt of the work.

GIVES OWNERS OPTIONS. Installing Value Drivers helps grow the company and its value, which lets owners pursue whichever Exit Path they'd like more easily. Companies with higher value become more attractive to more buyers, giving owners the option to adjust their preferred Exit Path if necessary to achieve their goals.

YOU ARE NOT ALONE

BEI always encourages advisors skilled in Exit Planning to reach out to business owners and other advisors. BEI also encourages advisors to commit to Exit Planning for the sake of their clients and core practices. Exit Planning Advisors know how to best organize and streamline their Exit Planning processes. In fact, we've included input from several Members of The BEI Network of Exit Planning Professionals™ in this series. These professionals are from a variety of disciplines (e.g., investment banking, financial planning, insurance advising, law, accounting, business brokerage, and ESOP creation and maintenance). They have incorporated Exit Planning for business owners into their core services and have found that working with owners is the most satisfying part of their careers.

For years, owners had no one to turn to for advice about how to exit or prepare their companies for their exits because advisors simply did not know how to help. One of BEI's founding and continuing goals is to equip advisors to prepare both owners and businesses for an owner's exit.

After reading this eBook, we encourage you to contact us, either at 303-321-2242 or info@exitplanning.com, so that we can help you help your clients install Value Drivers.

THE ROAD AHEAD

Planning a business exit is a journey, and the destination determines the quality of the rest of your clients' lives. With your help, owners choose which path to take to reach their destinations. To best describe how you can help owners map the most successful exits possible, this series focuses on you and the key concepts you will use to plan the exit best suited to each client.

Additionally, by incorporating knowledge of the Exit Planning Process into their practices, advisors report the following benefits to their practices:

- They find more satisfaction in their practices because (a) they are no longer "order takers" or "first responders" performing tasks only upon client request, and (b) they take more pride and joy in addressing their clients' "big pictures."
- As advisors align their skill sets to address an owner's most important financial event, their client relationships deepen and become long-lasting.
- They forge better working and referral relationships with advisors in complementary professions.
- They can differentiate themselves and their firms from competitors who lack both Exit Planning training and access to a successful process.
- Exit Planning serves as an engine for growing their practices.

INSTALLING VALUE DRIVERS

Business owners often don't know about Value Drivers or underestimate how Value Drivers can affect their businesses' growth and value. By introducing Value Drivers to your clients and helping them understand their importance to a successful business exit, you can improve their chances of exiting their businesses on their terms. This eBook will help you determine what needs to change for each individual client, based on his or her exit goals, by presenting case studies and applicable ideas. BEI provides numerous tools, including The BEI Seven Step Exit Planning Process™, to help Exit Planning Advisors guide their clients toward successful exits. In conjunction with the other guides in this series, this guide describes the most important actions you and your clients can take to help them install Value Drivers in their businesses successfully.

VALUE DRIVERS: ACCELERATING BUSINESS GROWTH AND VALUE

The most significant factor that impacts your clients' ability to leave their companies on their terms is *transferable value*. Transferable value is what a company is worth to a buyer without the current owner's presence.

A common trap that business owners fall into is bearing all of the company's major burdens, which essentially requires the owner to stay with the business if that business is to succeed. While this may do wonders for an owner's ego, it minimizes the company's transferable value, which makes a business exit on the owner's terms nearly impossible.

We discussed how helping owners change their roles in their companies can solve this problem in our last eBook, but most owners will want to know which tangible actions they can take to change their roles in their businesses. The answer lies in Value Drivers. Let's look at a case study to find out what Value Drivers are, which Value Drivers you'll need to help your clients install, and how they apply to your clients' businesses.

CASE STUDY: SCHUMACHER STEEL

Carl Schumacher was frustrated, but the cause was not immediately apparent. He had started his precision metal fabrication business, Schumacher Steel, 20 years ago at age 36. Since then, Schumacher Steel had grown from two employees to 25 and had revenues of $5 million, resulting in a pre-tax income of $500,000.

For the past five years, however, growth had stagnated. He and Eric, his right-hand man and principal manager, had tried everything to increase revenues and the customer base. Carl wanted to exit in seven years, but his advisors showed him that Schumacher Steel needed to triple in value to yield enough cash to satisfy Carl's financial security goal.

Financial security wasn't Carl's only exit goal. Equally important was his ambition to create a world-class company, a difficult standard to attain in the best of conditions. Out of the thousands of companies in Schumacher Steel's niche, Carl considered only five of them to be world class. He wanted Schumacher Steel to be the sixth before he sold it.

Like many owners, Carl was a smart, hard-working, classic entrepreneur. He and Eric had been working together for years at top speed, but Schumacher Steel was running out of steam, and Carl was running out of time.

Flash forward seven years: Carl has sold Schumacher Steel to a world-class company. He received $36 million in cash for the company, and $3 million for the two buildings and property used by Schumacher Steel.

The story of what Carl and his company did over those seven years is the subject of this eBook.

A BEI OBSERVATION

When you and your clients have reached this point in the Exit Planning Process, you'll have an accurate understanding of the value of your clients' existing resources and the amount of resources they need to accomplish their goals. For most owners, there's a formidable gap between the two, and their finish line remains a distant, glimmering mirage. To reach their finish line on time, you must help them accelerate (perhaps dramatically) the growth of their businesses' value and cash flow. It is possible to do so, but it rarely occurs by advising your clients to do business as usual.

PRIVATE EQUITY, INVESTMENT BANKERS, AND VALUE DRIVERS

Buyers—specifically, private equity groups—are the arbiters of value. Your clients may want to transfer their businesses to insiders or sell to a strategic buyer, but private equity groups (generally, financial buyers) remain the gold standard because, unlike insiders, private equity groups buy companies based on their experience, competition with other experienced buyers, and a thorough examination of a potential acquisition.

Private equity groups are sophisticated buyers whose existence relies on consistently making the right decisions about the growth potential of companies. In short, they know which qualities to look for in acquisition candidates. This eBook incorporates interviews with partners in several private equity firms, reflecting their expertise, experience, and insights. Even if your clients' companies seem too small to attract the notice of a private equity group or large buyer, remember that every buyer wants the same qualities in a business that professional buyers require.

In the world of investment bankers and private equity, there are certain business characteristics that sophisticated buyers require and investment bankers use to value businesses. We refer to those characteristics as Value Drivers. The strength of a company's Value Drivers determines the value of the company, primarily.

It's one thing to understand what Value Drivers are. It's another to incorporate them into your clients' businesses. That's why, throughout this eBook, we'll explain how Carl implemented each Value Driver and how you might help your clients install Value Drivers in their companies.

TRANSFERABLE VALUE

Transferable value is what a business is worth to a buyer without the owner's presence.

Let's begin by defining the type of value these Value Drivers are designed to create.

Recall a point that we made in our last eBook: Owners must change their relationships to their businesses if they are to flourish. Going a step farther, business owners whose businesses depend primarily on them for cash flow face a nearly impossible task when trying to exit, because without the owner, the business will face massive disruptions to cash flow. Since cash flow often determines company value, if the business relies on the owner for its cash flow, the owner cannot leave without harming the company's cash flow and, vicariously, the company's value. It can be a vicious cycle unless you can help owners increase their companies' transferable value.

- No matter which Exit Path your clients choose, transferable value is the common denominator of a successful exit.
- Insiders won't be willing pledge personal assets to acquire a company if they can't run the business without the owner.
- Passing a business to children is a recipe for disaster if the business can't continue successfully without the owner.
- Third-party buyers will refuse to buy businesses that rely on the owner for cash flow, because once the owner leaves, the buyer has lost the one asset that made buying the business worthwhile.
- Finally, it's likely that a business owner's immediate family relies on his or her performance in the company as their source of income. If the owner were to die and thus lose any income from the company, the family may face insurmountable burdens if the company cannot continue without the owner.

It bears repeating: Transferable value is the prime determinant of a successful exit.

VALUE DRIVERS

A company with strong Value Drivers can demand (and receive) a higher multiple on the same amount of EBITDA than can a company with average Value Drivers.

Strong Value Drivers are what make a company a desirable acquisition to buyers. When a company has well-functioning Value Drivers, buyers will pay top dollar for that company, because Value Drivers inherently contribute to increased cash flow.

To help guide you toward the kinds of Value Drivers your clients should aim to install in their companies, we've compiled a list of the nine most important Value Drivers. As you read through this list, remember that it is not exhaustive. Depending on who your clients are and which types of businesses they run, there may be other Value Drivers that create and increase transferable value. However, these Value Drivers are nearly universal.

9 PRIMARY VALUE DRIVERS

1: Next-Level Management
2: Operating Systems That Improve the Sustainability of Cash Flows
3: Diversified Customer Base
4: Proven Growth Strategy
5: Recurring Revenue That Is Sustainable and Resistant to Commoditization
6: Good and Improving Cash Flow
7: Demonstrated Scalability
8: Competitive Advantage
9: Financial Foresight and Controls

Next-level management is the most important of the nine Value Drivers. The rest are in the order that BEI's consultant Advisors have chosen as the most likely to affect business value.

TIMING THE INSTALLATION OF VALUE DRIVERS

The sooner owners begin to install or improve their companies' Value Drivers, the more their companies benefit. It's important for you, as your clients' most trusted advisor, to encourage your clients to install Value Drivers as soon as possible. One of the more common objections you'll likely face is when owners tell you they'll start installing Value Drivers (i.e., building transferable value) when they're ready to exit. But if your clients wait to begin building transferable value until they are emotionally prepared to leave the business, there are several problems.

First, they will still have to do all the same work necessary to build value whether they're emotionally ready to exit or not. The only difference is that if your clients wait until they are emotionally ready to exit to install Value Drivers, there's a high probability that they will have lost the passion and drive they had before they were ready to leave. Once entrepreneurs lose their drive, the energy and growth of their businesses suffer. Acting to push value upward is vital and, since owners must do it anyway, why not start today?

Second, if your clients wait to build transferable value until they are emotionally prepared to leave the business, they will have forfeited years of increased cash flow.

Third, by waiting, owners also forfeit a more pleasing ownership experience, because the heart of value building is making the owner replaceable while increasing cash flow. As you help owners install Value Drivers, the first tasks you'll likely help your clients do will be assigning duties that they find uninteresting or unpleasant to others.

Finally, when owners wait to build transferable value until they feel ready to leave the business, they limit their Exit Path options and increase the difficulty of the obstacles they'll encounter. Allotting extra time to allow owners to pursue alternative growth strategies (e.g., replacing non-performing management) is crucial, and without that extra time, they can trap themselves.

Insufficient transferable value is the principal cause of failure in Exit Planning, so the time to act is now, when your clients have time to create additional value. Don't let a lack of time or knowledge curtail your ability to do all that is necessary for your clients.

As you'll see in the "Three Tasks for Owners" section later in this eBook, one way of helping your clients overcome their limitations is to look outside the company for resources such as a business consultant. As an advisor to business owners, if installing any of these Value Drivers is already a part of your expertise, then you can help your clients build transferable value almost immediately. For Value Drivers that are outside of your realm, you can and should consult with other advisors and consider making them a part of your Exit Planning Advisor Team to assure that your clients have the best chance to install those Value Drivers.

Now, let's delve into each Value Driver in terms of what each Value Driver means, how it applied to Schumacher Steel, and how it can apply to your clients' companies.

VALUE DRIVER 1: NEXT-LEVEL MANAGEMENT

Next-level management is the mother of all Value Drivers. It is the most critical Value Driver because in the end, management oversees the installation and growth of all other Value Drivers. Next-level management supports and strengthens all other Value Drivers.

As an advisor, it's important that you help your business-owning clients do "what private-equity firms have figured out how to do: Attract and keep the world's best managers, focus them extraordinarily well, provide strong incentives, free them from distractions, give them all the help they can use and let them do what they can do." [1] This strategy creates outsized returns for private equity groups and can likely do the same for your clients' businesses.

As the name implies, next-level managers usually work in companies that are larger than your clients' companies. Next-level managers will know how to grow the company at least to the level of the larger companies they've worked for. These managers have worked with customers, vendors, advisors, consultants, and others in the market at levels to which your clients aspire to grow their companies. They understand Peter Drucker's concept of delivering value to their ideal customers: how to market, organize, and focus on the wants and needs of the consumers your clients want as customers. [2]

This isn't to say that your clients' existing managers can't grow the company to the level needed to bridge any Asset Gaps your clients might have. Whether current managers can do that is a determination you must help your clients make, using either your own expertise or the expertise provided by your Advisor Team.

Existing managers certainly can drive growth at the pace necessary if your clients' companies are currently growing at a pace that will bridge any existing Asset Gaps. If growth isn't on track to achieve your clients' goals, then their existing managers, with additional training (perhaps working with outside consultants and coaches), may be able to improve to the degree necessary to achieve the results your clients require.

[1] Geoffrey Calvin and Ram Charan, "Private Equity, Private Lives," *Fortune Magazine*, November 11, 2006, http://archive.fortune.com/magazines/fortune/fortune_archive/2006/11/27/8394344/index.htm
[2] Peter Drucker, *The Essential Drucker* (New York: HarperCollins, 2001), 145–48.

CASE STUDY: SCHUMACHER STEEL AND NEXT-LEVEL MANAGEMENT

Recall that Carl Schumacher had worked with his right-hand man, Eric, for many years. Like many owners, Carl appreciated Eric's loyalty and contributions to help grow the company to its current level. But he also knew that if Schumacher Steel was to grow at the rate necessary to achieve his financial goals and mature into the world-class company he envisioned, it needed an injection of new talent.

It's important to avoid minimizing the difficulty of making the decision to replace existing management. Owners usually know when it's the right decision, such as when doing so allows the business to grow at the accelerated pace necessary to achieve their business and personal goals, but that knowledge butts up against loyalty, friendship, and the obligation they feel toward long-time managers. In that clash, we have two suggestions and observations.

First, replacing part or all of a company's management team is normal for rapidly growing companies. Next-level management largely causes that growth. Eventually, the first set of next-level managers may also be replaced.

Second, hiring next-level management does not mean that your clients must cast out current management with six weeks of severance pay. Members of your clients' current management team may still be valuable to the company, albeit in different roles. Often, they can remain employed and perform well and responsibly, but in a sphere more appropriate to their experience level. For example, Eric—the manager of operations who performed well when the company had 25 employees and $5 million in revenue—may do just as well managing a division of the growing company with a similar number of employees.

Remember that your clients must understand that their roles in their companies need to change, perhaps dramatically, to assure a successful exit. To do so, your clients may need to shift their time and efforts to a narrower but still important role—such as providing strategic vision, product development, or developing a new marketing channel—to assure that their companies flourish. Once your clients understand this idea, it makes it easier for them to ask their current managers to do the same. After all, if your clients' management teams mirror your clients' level of experience and capability, then your clients are asking nothing more of their managers than what they would expect themselves to do to grow the business' value. As Peter Drucker reminds us, failure to change will stunt the growth of any enterprise.[3] *This applies to your clients' current management as well as themselves.*

In his search for next-level management, Carl decided to engage an international executive search firm. Within six months, it found a seemingly ideal candidate to lead Schumacher Steel's management team: Wilhelm Brandt, from Bremen, Germany, had helped his publicly owned employer greatly expand its precision metal business. The details of how he did it are not relevant here, but Wilhelm had been recently named the Leading Young Executive in an industry magazine.

[3] Drucker, *The Essential Drucker*, 156.

Wilhelm was willing to move to the United States and eager to tackle the challenge of growing Carl's company to world-class status, but Schumacher Steel couldn't afford to pay him the salary he commanded. This challenge provided a great example of Peter Drucker's maxim, "Build a top-level management team before [your company] reaches the point where it must have one." [4]

To remedy this issue, Carl's Exit Planning Advisor Team developed a plan to transfer significant ownership to Wilhelm if the company's performance achieved the lofty benchmarks necessary for it to fulfill not only Carl's personal goals but also world-class status. Wilhelm accepted Carl's offer, moved to the United States, completed a six-month trial period, and became the president of Schumacher Steel.

Carl was prepared to transfer almost half of his company to get and keep Wilhelm. He was also willing to take a lesser role in the development of Schumacher Steel and place Wilhelm at the helm once Wilhelm demonstrated his abilities. Carl's Advisor Team thought this was an astounding offer. At the time, Carl's Exit Planning Advisor didn't know who—Carl or Wilhelm—was the "greater visionary," but he soon learned. Wilhelm eventually became a 49% owner because due to his management and an uptick in the economy, Schumacher Steel's growth exploded.

Like most owners, Carl and the company's existing management didn't know how to achieve this growth. But Carl did know what he needed to do to grow the company: In this case, the what was to hire next-level management that knew how to grow the company. Once Carl saw that Wilhelm knew both what to do and how to do it, he stepped back from everyday involvement in the business and had time to work on strategic initiatives with Wilhelm.

Most importantly, and from the very beginning, Carl articulated a mission and vision for his company: become a world-class company. Developing and staying true to a vision and mission for the company is your clients' responsibility, but you must use your own expertise and that of the members of your Advisor Team to help clients find and pursue that vision. It is one feature of ownership that cannot be successfully delegated. As the owner, Carl provided the leadership necessary to make sure that his company achieved its mission and his goals.

A BEI OBSERVATION

Exit Planning Advisors often introduce owners to management consultants who can assess a current management team. They have a stable of outside talent on call to resolve issues that existing management or advisors cannot.

[4] Drucker, *The Essential Drucker*, 152.

YOUR CLIENTS' COMPANIES AND NEXT-LEVEL MANAGEMENT

Unlike Carl, your clients may not need to hire next-level managers to achieve their financial independence and other goals. If you've helped them complete a Gap Analysis, you and your clients will know the size of their Gaps, and the following suggestions will help you determine the caliber of management your clients will need to bridge those Gaps.

THREE TASKS FOR OWNERS AND HOW YOU CAN HELP

To help their companies move forward in developing and retaining next-level management, owners have three tasks.

TASK 1. As Carl demonstrated, the first and most important ownership task is to *attract and retain next-level management*. This may involve training and coaching existing management to the level needed, adding next-level management, or replacing or transferring underperforming management. As an advisor, you can network with business consultants on your Advisor Team or help address these issues yourself if your expertise allows.

TASK 2. Owners must engage management consultants and outside resources to spur growth; and retain consultants to assess, train, and coach existing management. Again, networking and tapping into available expertise—whether your own or of an advisor on your Advisor Team—is a crucial action you can take to assist your clients in this endeavor.

TASK 3. Owners must provide leadership and motivate top management to achieve the goals they've described in their growth plans. Strong incentives for management are one of the key components private equity firms create for newly acquired companies. *When designing incentive plans, be mindful of the need for your clients to retain management beyond their departure as active owners.*

There are two parts to this final task. First, when you help business owners create and provide financial incentives for managers that are designed to grow cash flow or business value, those managers become more motivated to help your clients achieve their exit goals. Second, these incentives can also motivate management to remain after your clients exit, which is important because management must stay in the business if it is to continue to thrive. If your clients' companies fail to thrive after they leave, their values-based goals—which often dictate whether owners are ultimately satisfied with their post-exit lives—are in danger. It's also unlikely that your clients will receive the balance of the purchase price they were expecting after they sold the company if their managers aren't properly incentivized.

INCENTIVE AS MOTIVATION

Perhaps the most common tool used to motivate management is a Non-Qualified Deferred Compensation Plan (NQDC Plan). For our purposes here, the NQDC Plan includes two elements: a benefit formula and a vesting schedule.

The benefit formula typically contains a performance benchmark that motivates participating key employees (i.e., next-level managers) to increase the profitability or cash flow goals of the company. The employees usually receive a cash award—half of it paid in cash each year if cash flow or profitability reaches or exceeds the pre-determined benchmark. The remaining half of the award is deferred and subject to vesting. Unless the business or key employee reaches the benchmark, the key employee receives no benefit. These plans are designed to encourage management teams to achieve the growth goals necessary for your clients to reach their financial security goals.

The vesting schedule is similar in concept to the vesting schedules used in many qualified retirement plans, such as 401(k) or defined benefit plans. Like many qualified plans, key employees are vested in the benefit over several years. If those employees leave before becoming fully vested, they forfeit part or all of the accrued benefit. Vesting encourages employees to stay with the company long term.

VALUE DRIVER 2: OPERATING SYSTEMS THAT IMPROVE THE SUSTAINABILITY OF CASH FLOWS

Establishing and documenting standard business procedures and systems demonstrate to buyers that your clients' businesses can maintain profitability both after the sale and after your clients have exited. Properly established and practiced systems create cash flow and increase its sustainability. As an advisor, having tools and systems to document your clients' business procedures goes a long way in assuring that they can show potential buyers what those procedures are and that those procedures work.

Patrick O'Keefe, a principal at Excellere Partners (a private equity group with a focus on investing in emerging growth companies) notes, "While all of the Value Drivers are components of a 'good' business, we look for companies that offer a compelling customer value proposition (what makes customers buy from that company) and a management team with a vision for the future of the business. **We partner with these management teams to drive growth in the business by building upon the existing customer value proposition and implementing repeatable and standardized processes that enable a company to scale without significant additional investment or overreliance on any one or group of individuals." (Emphasis added.)**

In short, savvy buyers—without exception—look to this Value Driver. If it is absent or weak, buyers move on.

CASE STUDY: SCHUMACHER STEEL'S OPERATING SYSTEMS

Recall that Carl Schumacher took the first step toward installing Value Drivers by hiring a next-level manager in Wilhelm Brandt. Because Wilhelm had worked as a leader in a world-class company, he had experience with the processes and systems used by world-class companies. His former employer put great emphasis on quality control, since it was a precondition to obtaining large contracts from major purchasers. If Schumacher Steel was going to compete on that field—it needed to if it wanted to become world class—it would need to become ISO 9001:2015 compliant (ISO 9001:2015 "sets out the criteria for a quality management system and can be used by any organization, large or small, regardless of its field of activity." In fact, ISO 9001:2015 is implemented by "over one million companies and organizations in over 170 countries."). [5]

To that end, Wilhelm began the credentialing process that addressed several quality management aspects. It was expensive and time consuming, but it constructed a quality-focused system. This gave prospective worldwide customers confidence in Schumacher Steel's products. Even more importantly, this focus on quality required Schumacher Steel to create world-class product offerings, putting Schumacher Steel on the road to achieving Carl's goal.

OPERATING SYSTEMS FOR YOUR CLIENTS' COMPANIES

Business consultant Scott Barth notes, "Companies can benefit greatly from creating and documenting systems and processes in all aspects of a business. These increase efficiency and effectiveness, ensure consistency of execution or delivery, and often generate dramatically improved results and potentially create sustainable competitive advantage." We cannot understate the importance of this Value Driver: Creating and documenting systems and processes is crucial to building your clients' business value to the point at which they can leave their businesses on their terms without fear that they will fall apart without them.

[5] "ISO 9001:2015," Popular Standards, International Organization for Standardization, accessed July 3, 2018, https://www.iso.org/iso-9001-quality-management.html.

VALUE DRIVER 3: DIVERSIFIED CUSTOMER BASE

Buyers typically look for a customer base in which no single client accounts for more than 10% of total sales. A diversified customer base insulates companies from the loss of a major customer. For example, if you are working with a client whose three top customers generate 40% of all sales, a buyer would be concerned if one or more of them left upon learning that your client sold the company. To a lesser extent, this may also be a concern to key employee, co-owner, or family buyers if the biggest customers are loyal to the business owner rather than to the business itself or other employees. Thus, customer concentration is a risk factor to avoid, regardless of the Exit Path your clients choose.

CASE STUDY: SCHUMACHER STEEL'S CUSTOMER BASE

To grow quickly, Schumacher Steel needed to identify, access, and sell new product lines to new and larger markets. In doing so, it naturally reduced customer concentration. Schumacher Steel's new management team—hired by Wilhelm—had experience operating in larger markets. That experience is one of the benefits of hiring next-level management. They already know the market and the customers.

YOUR CLIENTS' CUSTOMER BASE

While it may be difficult for your clients to consider new and/or profitable markets for their products and services, if you have clients who rely on only a handful of customers, it's a topic you must broach. As we've shown, incorporating new products and services is both important and easier to do when your clients have a next-level management team.

VALUE DRIVER 4: PROVEN GROWTH STRATEGY

Even if your clients expect to retire tomorrow, it makes sense for them to have a written plan describing future growth, and how they will achieve that growth in the context of industry dynamics and demand for their company's products. This growth plan may include developing new product lines or augmenting existing ones, market plans, growth through the acquisition of other companies, expansion into new territories, or increasing manufacturing capacity. A detailed and properly communicated growth plan helps attract buyers, especially if your clients' previous plans have allowed them to successfully attain their goals.

The effectiveness of this Value Driver is supported by research: Nearly 75% of established companies that have a business plan in place expected to grow more than 10% in 2014, compared to only 17% of companies that didn't have a business plan.[6] Also, a study by Dr. Gail Matthews confirmed that creating a plan with *written goals, accountability, and public commitment* resulted in a 50%+ increase in goal accomplishment.[7]

Combining next-level management with a written growth plan is a powerful one-two punch. Top management, with input from your business-owning clients, will create the plan for how goals will be accomplished and assign responsibility and deadlines.

CASE STUDY: SCHUMACHER STEEL'S GROWTH STRATEGY

Wilhelm immediately began drafting Schumacher Steel's first written plan to grow the company to world-class status, and to a value more than sufficient to achieve Carl's goals, within seven years. It became the blueprint for future growth by stating who was going to do what and by when.

YOUR CLIENTS' GROWTH STRATEGY

If your clients have not created a written plan, you must help them evaluate the resources within their companies to create a plan that, at a minimum, bridges the existing value/cash flow gap. This is an area where collaborating with members of your Advisor Team, or even bringing experts from the outside onto your Advisor Team, may be essential.

[6] Isaac M. O'Bannon, "The Secret to Small Business Success: Planning and Financial Management," *CPA Practice Advisor*, April 4, 2014, www.cpapracticeadvisor.com/news/11372784/the-secret-to-small-business-success-planning-and-financial-management.

[7] Dr. Gail Matthews, "Goals Research Summary," Goal Band, accessed July 3, 2018, www.goalband.co.uk/the-research.html.

VALUE DRIVER 5: RECURRING REVENUE THAT IS SUSTAINABLE AND RESISTANT TO COMMODITIZATION

You may want to view this as two Value Drivers:

1. Recurring, sustainable revenue.
2. Having products or services resistant to commoditization.

The reason that revenue is a Value Driver is evident: If you were a buyer, you'd much prefer to buy a business that makes money hand over fist than one that struggles to eke out a profit. The question you should ask your clients is, is there a way for their companies to create one or more recurring revenue streams? Whether your clients can think of ways to create recurring, commoditization-resistant revenue or not, getting them thinking about this question opens a door for you to help them, either with your own expertise or through your Advisor Team.

Because the nature of Carl's business implies recurring revenue, it may be more helpful to apply a different scenario in which this Value Driver was implemented. Business consultant and BEI Advisor Scott Barth believes that this Value Driver contains two important subsets.

First, sustainable recurring revenue is a highly valued driver for any buyer. For example, Barth encouraged a client from a business analytics company to create annual maintenance contracts for its customers. In doing so, it added more than 15% in recurring revenue to its top line.

Second, pricing margins resistant to commoditization are another significant opportunity for business owners. There are several strategies Barth uses, including continuous innovation; segmenting; disciplined ranking of A, B, C, D customer types; value-added services; bundling; unbundling; helping customers quantify the value of a company's solutions; and compensating sales on profit margins vs. sales revenue.

YOUR CLIENTS' REVENUE

The first step in installing this Value Driver is to find out whether your clients' companies have recurring revenue streams to begin with. Another question to ask your clients about their companies is whether their products and services are viewed as commodities by customers. It's difficult to create any useful product or service that can't be quickly imitated and commoditized by competitors, so continuous innovation in addition to the other strategies mentioned above is crucial.

VALUE DRIVER 6: GOOD AND IMPROVING CASH FLOW

Ultimately, all Value Drivers contribute to stable and predictable cash flow. You can help your clients increase their companies' cash flow today by focusing on ways for their management teams to operate their businesses more efficiently: increasing productivity and decreasing costs. However, this alone may not create sufficient growth to allow your clients to achieve their objectives on time. Additionally, this Value Driver depends on the effective operation of other Value Drivers.

CASE STUDY: SCHUMACHER STEEL'S CASH FLOW

Wilhelm's experience in working with next-level customers provided Schumacher Steel with access to new, world-class customers with far greater capacity to grow Schumacher Steel's revenues. To service these new customers, Wilhelm hired a next-level sales manager to hire next-level sales people. As you can see, next-level management is the foundation of successfully implementing this Value Driver. Further, to increase manufacturing efficiencies and reduce operating expenses, Schumacher Steel became ISO 9001:2015 compliant.

YOUR CLIENTS' CASH FLOW

Growth throughout the entire infrastructure of your clients' companies is pivotal to growing cash flow. For example, growth in the number of customers your clients serve requires growth in customer service. When the quality of your clients' customers increases, or when your clients add or change product and service offerings, the entire organization must grow in lockstep. This means more—or better—management, more training, and more accountability. Fortunately for Schumacher Steel, Wilhelm had substantial experience in finding, hiring, and managing junior management. As an Exit Planning Advisor, you can search for, find, and introduce your clients to the people and programs necessary to make the improvements a reality.

VALUE DRIVER 7: DEMONSTRATED SCALABILITY

Under the right circumstances, increased revenue can lead to increased profit margins for your clients. Consider a gaming app on a phone. There's a fixed cost to design and test the app, but additional sales don't necessarily increase those costs. While scalability may be a bit more difficult if you're representing the owner of a hardware store, it's not impossible: If your hardware store owner enjoys high profitability and strong revenue growth, it's likely that the company has many of these Value Drivers in place, including a competitive advantage. If these Value Drivers can be replicated, your client can scale the business by establishing new stores in different locations using the same Value Driver model, similar to the model Apple uses with its Apple Stores.

CASE STUDY: SCHUMACHER STEEL AND SCALABILITY

Schumacher Steel created scalability by systematizing its quality management, operational, and manufacturing processes. Additional production was easily ramped up with minimal expense.

YOUR CLIENTS AND SCALABILITY

Scalability should be a major focus for your clients. It is perhaps the quickest way to grow cash flow, because scalability is based on something the company is already doing. Recall Patrick O'Keefe's observation: Buyers demand scalability because a much larger company is not going to buy a company unless it believes it can grow revenue "by building upon the existing customer value proposition and implementing repeatable and standardized processes that enable a company to scale without significant additional investment…"

VALUE DRIVER 8: COMPETITIVE ADVANTAGE

To paraphrase Michael Porter of Harvard Business School, competitive advantage is the product or service that a company offers either better or more cheaply over time than does its competitors. The competitive advantage your clients provide is the reason their customers buy from them instead of from their competitors.

Warren Buffett takes competitive advantage so seriously that in his 2009 letter to Berkshire Hathaway's shareholders, he wrote that he focuses (in good times and in bad) on four goals, the second of which is "widening the 'moats' around our operating businesses that give them durable and competitive advantage." [8] How do you help your clients identify any competitive advantages their companies might have? It isn't easy, especially since your clients may have a competitive advantage that they don't even know they have. A good way to determine whether there is a competitive advantage at all is to compare your clients' profit margins and growth rate to their competitors'. If they are considerably higher for your clients, it's a good bet that they have a competitive advantage. If so, you and your Advisor Team must help them determine what it is and protect it.

Kevin Short, an investment banker, tells the following story about a company that attracted a buyer who paid a handsome purchase price—even in a commoditized industry—based on the company's competitive advantage.

I recall meeting with the owners of a North American manufacturer of circuit boards. Its annual profit was around $20 million, and it managed to manufacture its product in the United States, both characteristics especially valuable to a European or Asian buyer.

The company's expenses were similar to its competitors in the industry, but it had instilled, and stuck to, a discipline to replace less profitable sales with more profitable ones. It turned away existing or potential business that did not meet a set minimum gross profit margin. In two years, they replaced $100 million worth of business.

This company had differentiated itself from its competitors based on a policy choice its management team had made about a tradeoff between sales volume and profitability. Management made a conscious decision to serve only its most profitable customers and was willing to turn away less profitable business. We sold this company to a large, multi-national company who sent the members of this management team around the world to its other divisions to implement the same disciplined sales-replacement strategy.

[8] Warren Buffett, "2009 Letter to Shareholders," Feb. 27, 2009, accessed July 3, 2018, http://www.berkshirehathaway.com/letters/2008ltr.pdf

CASE STUDY: SCHUMACHER STEEL'S COMPETITIVE ADVANTAGE

As Schumacher Steel moved up in its market, it too jettisoned a lot of smaller, less profitable customers. Its success in doing so would one day attract potential buyers who faced the same issue but were less successful in resolving it.

In addition, as Schumacher Steel began its rapid expansion, management also realized that the short supply of skilled metal workers would constrict growth. To overcome the shortage, Schumacher Steel unintentionally created a competitive advantage. The company opened a vocational training center to train metal workers. The center qualified for government funding/tax credits. The training center was not a profit center, but it was located at Schumacher Steel. This proved to be a tremendous competitive advantage as the business grew, and as the local and national shortage of skilled metal workers became acute. Increases in the shortage of skilled workers increased the size of Schumacher Steel's competitive advantage. The government paid Schumacher Steel to train dozens of metal workers, and Schumacher Steel hired the cream of each year's crop while its competitors searched desperately for qualified workers. For the first time in a long time, Carl enjoyed seeing his tax dollars at work.

YOUR CLIENTS' COMPETITIVE ADVANTAGE

It's possible that your clients have a competitive advantage and know what it is. However, if they don't, they're likely competing on price alone, which means that they're susceptible to commoditization. In either case, it's worth spending time on this Value Driver with your clients, their management teams, and your Advisor Team. If the company has a competitive advantage, you'll want to help your clients protect it and promote it.

VALUE DRIVER 9: FINANCIAL FORESIGHT AND CONTROLS

Like recurring revenue, this Value Driver also has two aspects. The first relates to financial controls or reporting. Many companies lack reliable financial reporting to such an extent that buyers can't determine what the company has or track the source of its revenues. Usually, this problem is correctable, but it takes time to do so. More importantly, sloppy financial reporting can indicate to buyers that there's an underlying problem, the most benign of which is that owners and management lack a clear understanding of their own company's financial performance.

The second aspect is less apparent but more important. If your clients want their companies to grow substantially and quickly, their companies "must be fed." As you help your clients create a growth plan for their businesses, you must also help them project the cash flow cost of implementing the plan. Generally speaking, giving yourself and your clients a full year allows you, your clients, and your Advisor Team the time necessary to arrange financing.

CASE STUDY: SCHUMACHER STEEL'S FINANCIAL FORESIGHT AND CONTROLS

When Schumacher Steel's growth and cash flow were stagnant, financial foresight was hardly necessary. The company had no debt, and since it wasn't growing, there was no need for additional financial resources. That changed when Carl hired Wilhelm.

First, Wilhelm helped Carl realize that the current financial systems for the company were somewhat antiquated and completely inadequate. Becoming a world-class company meant implementing next-level financial controls and reporting.

Second, in Schumacher Steel's growth plan, Wilhelm and his team projected that the company required an initial infusion of $2 million to acquire state-of-the-art machinery, undertake new marketing initiatives, fund the additional operational overhead, and build up materials inventory. The growth that Carl desired needed to be fed.

Third, Wilhelm identified three likely financing sources: equipment manufacturers, banks, and Carl. The first two required reviewed financial statements, and Carl required an accurate forecast of uses and sources of cash flow, and a tight financial budget. Carl replaced his accountant with a CPA firm with significant experience working with fast-growing, mid-market clients.

YOUR CLIENTS' FINANCIAL FORESIGHT AND CONTROLS

You must assure that your clients have a firm grip on their companies' financial condition. This is a critical responsibility because your clients are the ones signing off on all of the loans and other obligations of the company. Thus, helping your clients forecast the financial demands that their growth plans will create, with the help of a CFO or CPA if necessary, is important. If growth needs to accelerate substantially and quickly to meet your clients' goals, it may take more than the cash flow their companies produce to support it. Bank or other financing should be secured before your clients find themselves in the middle of expansion and short on cash.

CONCLUSION

Growing and creating transferable value requires your clients to change their roles and install Value Drivers. Growing transferable value to the level needed to attain your clients' goals likely requires skills and experience beyond what your clients are capable of. Most owners need to look to others—next-level management and advisors like you—who have that experience and skill to achieve their goals.

It bears repeating: Next-level management is the most important Value Driver your clients can install. Next-level management enhances, and often creates, other Value Drivers. The capabilities of the management team determine the success of your clients' exits. In Carl's case, the success of his exit was directly tied to Wilhelm (his next-level manager), the junior management Wilhelm hired and trained, and the consultants Wilhelm recruited to create or enhance his company's systems and processes. The key to the successful growth of Schumacher Steel's transferable value was the strength of its management team.

As you guide your clients to hire the best management, don't be shy about calling in other experts to help your Advisor Team with specific projects. These experts should be able to tell your clients what to do to strengthen their companies and should be available to help implement their suggestions.

Finally, you and your clients have everything to gain by acting now to grow the transferable value of their companies.

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