

PART I

CORNERSTONES

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CHAPTER 1

Why a New Approach Is Needed

At the conclusion of a valuation engagement, the professional should have value-enhancing insights into the client's business that the client does not have. This is true even in projects in the rapidly growing niche, valuation for financial reporting. If the analyst does not have such insights, then he or she did not do the job right. That is a strong statement, I know. But I am with Dizzy Dean, the supremely self-confident pitcher from the 1930s, who liked to say "If you can do it, it ain't braggin'."

The valuation field is growing fast. The general absence of barriers to entry in our arena, however, invites opportunists, charlatans, incompetents, low-ballers, and rip-off artists to eviscerate pricing and destroy the opportunities that serious practitioners can have to create value for clients. At Beckmill Research, LLC, we are about value creation. That comes from my experience before I became a valuation guy. I had held various jobs as a financial professional, but the game-changer—life-changer, really—was the half-decade I spent as a Ph.D. student in strategic management in the mid-1980s. As the word 'strategic' suggests, it is management for the long term as seen from the top of the organization. The focus is on the creation and retention of value. We—my wife, Dorothy, and I—launched our firm in 1991 as a strategy boutique. I "discovered" valuation in 1993. As I dove into the field devouring books and every other piece of information I could find, I was struck by the huge disparity in rates of return among firms of different size in the Ibbotson dataset. Frustrated by the insufficiency of tools from finance and accounting to explain such disparities, I began experimenting, first with tools from strategy. I found that they had considerable utility. I then added other tools from industrial organization and organization theory, two other disciplines I had encountered in my Ph.D. coursework.

At a valuation seminar sponsored by the American Society of Appraisers (ASA) in 1995, one of the instructors introduced Porter's five-forces framework. My jaw dropped, and I almost fell out of my chair. I had the empirical confirmation that I needed that I was on the right track.

4 Why a New Approach Is Needed

Not surprisingly, we see the world differently from most of our colleagues. For starters, we do not believe that valuation has much to do with accounting. Now, before all my accounting colleagues take aim at me, please hold your fire and allow me to explain. For starters, I am a Certified Public Accountant (CPA) and a Certified Management Accountant, as well as a former controller and chief financial officer (CFO). But, if accounting knowledge were essential in this line of work, we would see CPAs on what remains of Wall Street and working for buy-side institutions. Few are there. Labor markets are telling us something.

Don't misunderstand. I'm glad I know, understand, and can do accounting. I'm a better valuation professional because of that knowledge and experience. But I suffer from no delusions that valuation should be seen through the lens of accounting. It shouldn't, and here's why: Valuation is about the future, and accounting is about the past.¹ It's that simple.

Like most who have worked in this emerging field for a while, I didn't start out here. Near the end of cramming four years of undergraduate education into 14, I had 54 on-campus job interviews, got 53 rejection letters (including eight in one day, which surely must be a record), and received one job offer. That lifeline was to become an internal auditor at Union Pacific Corporation (UP).

Next to what I do now, that job was the most fun I ever had professionally. The staff at "Uncle Pete," as we called it, was run in the mid-1970s by former members of the "traveling audit staff" at General Electric. My two years there were a career-changing experience that stands me in good stead to this day.

For one thing, the idea of paying our way was hammered into us. We were obsessed with finding ways to reduce costs, eliminate inefficiencies, and help processes work better in our operational audits of various functions within the far-flung UP empire. The late Charlie Billingsley, then the general auditor for UP, oversaw the staff. It was a preschooler, barely five years old when I joined it. We spent only a quarter of our time on financial audits; that was to keep the fees of the outside auditors down. The other nine months of the year, we did operational auditing, long before such audits became all the rage in U.S. industry.

We had audit programs, of course, but Charlie liked to say: "At the end of the day we have a three-word audit program around here: 'Do something smart.'" That is because operational audits, like business valuations, are very much about "facts and circumstances."

¹ Section 3.03, Revenue Ruling 59-60: "Valuation of securities is, in essence, *a prophecy as to the future* [italics added] and must be based on facts available at the required date of appraisal."

As I did when I started out in 1975, today I still go where the facts and the circumstances lead me. If that makes the client happy, terrific. If it makes the client unhappy, well, I'm sorry. We want clients to be happy but their happiness is not part of our engagement letter. It doesn't change anything we do. In the inimitable characterization by the late Senator Paul Tsongas, valuation professionals cannot be "pander bears." Those who are—and there are many of them these days—mislead and disrespect clients. In the process, they undermine the hard work and credibility of the rest of us.

Valuation as Craft²

We often hear colleagues bantering back and forth over the question, "Is valuation an art or a science?" Some claim to know the answer. Others take an unambiguous position straddling the fence, muttering that it is some of each. We believe that, like adherents to traditional microeconomics, what they are debating is about the pinhead-dancing of angels.

Valuation is craft. It is not science because it lacks precision and certainty. It is not art because it has utility and economic dimensions. The word "craft" summons images of objects made by hand—by masons, carpenters, weavers, silversmiths, sculptors, and potters. But such one-off work products also come from surgeons, writers, dentists, basic researchers—and valuation professionals. In a craft, neophytes serve apprenticeships under the supervision of a journeyman (or journeywoman). She or he is experienced in the craft and is older, wiser, and more knowledgeable. In a craft, experience dominates because only through experience can one acquire the necessary knowledge of nuance and technique that enables the delivery of a top-flight product.

When craftspeople talk with clients, we speak as weavers, masons, silversmiths, carpenters . . . or analysts. When we speak to one another, however, we speak as craftspeople. We understand the use of every tool in our toolbox. That understanding, combined with our experience, gives dignity to our work product.

Each craftsman creates a body of work that grows, evolves, and improves with experience. Each creation is unique. Each is personal. Each is a stand-alone statement by and about the craftswoman. Improvement comes only from repeated ventures into the craft, pushing the envelope, extending knowledge, expanding reach, and explaining meaning. Craft that does not explain has not meaning and is not craft.

None of these aesthetics, sensory experiences, or nuances afflict charlatans masquerading as craftsmen. They think only of power, prestige, and

² This section draws from my article of the same title, which appeared in the Winter 2008 issue of *Business Valuation Review*.

6 Why a New Approach Is Needed

money. We think only of preserving and enhancing our craft. If we do right by our craft, money and the rest of it takes care of itself.

Done right, every valuation—like every surgery, every piece of hand-made furniture, every rock wall, and every silver-and-turquoise belt buckle—is different, not at the margin but in substance. There *is* a process, of course, and we must respect and follow it wherever it leads us, regardless of how the client feels; if she feels strongly enough, she can fire us. So be it. But, that is why “facts and circumstances” are so important in our craft. It is also why one-size-fits-all doesn’t work any better in valuation than it does in haberdashery.

The State of Our Craft

Academic scholars are craftspeople, too. Every paper, whether published or not, gives them new knowledge, new understanding, and insights that they didn’t have before. Some business professionals disparage the primacy, at least at larger institutions, of research. Before I spent five years in a doctoral program, I did, too. I learned there, though, that research keeps professors, especially the tenured ones, current in their knowledge. I have seen faculty members at colleges without a research emphasis, and what they know—and what they teach, of course—is often out of date. But 19-year-olds will never know until it’s too late.

Besides keeping professors’ knowledge current, I believe there is an even stronger argument for a research component: Those in the business of disseminating knowledge should also be about the business of creating some. Similarly, those of us in the business of assessing value should be about the business of knowing how to create it. And if we know how to create it, then opportunities present themselves to do great work helping clients increase the value of their life’s work.

The literature of business valuation today is resoundingly mute on the issue of value creation. The major reference books—by Shannon Pratt; George Hawkins and Michael Paschall; Chris Mercer; McKinsey’s Tim Koller and his colleagues; and by those who contributed chapters to Jim Hitchner’s edited volume³—all come from serious professionals with financial backgrounds. Such backgrounds can be limiting; I know because I started out that way. In none of these books, for instance, is there any discussion about value-creating mechanisms, their durability, and the ability of current or would-be competitors to replicate or imitate them. There is nothing about how to analyze and assess such mechanisms. Most important, they are silent on the issue of how to create value.

³ Pratt, *Valuing a Business*; Hawkins and Paschall, *Business Valuation Guide*; Mercer and Harms, *Business Valuation*; Koller, et al., *Valuation*; Hitchner, *Financial Valuation*.

Cause and Effect: What *and* Why 7

I'm reminded of the famous words of Supreme Court Justice Potter Stewart in a 1964 pornography case:

I shall not today attempt further to define the kinds of material I understand to be embraced within that shorthand description [of pornography]; and perhaps I could never succeed in intelligibly doing so. But I know it when I see it.⁴

Business valuation is more than numbers. It is about cause-and-effect relationships and how or if a firm creates value. We need an approach to valuation and a framework that enables us to identify causal relationships and that takes us to how value is created, how to assess the durability of value-creating mechanisms, and how to make replication and imitation by competitors more difficult and impossible if possible. This book advances such an approach and such a framework.

Cause and Effect: What *and* Why

The data archives and ratio analysis tell us what. The published research tells us where. But neither tells us *why*. The view taken here is that *why matters*. In our experience, it is all too common in a valuation report to read a paragraph like this:

The Company's inventory turnover, which is Cost of Goods Sold divided by average inventory, is $\frac{1}{2}$ the industry average. That means that the Company is not selling what it has on hand as fast as the rest of the industry is. Days' sales outstanding is. . . .

We have only one question: **Why** is inventory turn half the industry average? The expanding literature of valuation teems with "tools of the what," especially ratio analysis. Unfortunately, it offers few tools that help us get at "the why." Yet if a valuation professional cannot explain why a certain metric is notably above or notably below where competitors' performance is, then the probability is overwhelming that the analyst does not understand the business that she or he purports to value. And without that understanding, the valuation will be on point only by chance.

To be sure, a blind hog can find an acorn every now and then. But it is not something I'd want to bet the farm on every day of the week.

Explaining why not only enhances the quality of the analysis, it also increases the credibility of the analyst. Put yourself in the role of a judge and

⁴ *Jacobellis v. Ohio*, 378 U.S. 184 (1964).

8 Why a New Approach Is Needed

ask yourself who you would think is more credible: a professional who can explain why or one who cannot. It never ceases to amaze us that so few valuation reports really explain the why. They don't explain why because their authors don't know why, yet understanding why is the key to sound valuation practice as well as to unlocking business wealth.

Multidisciplinary Tools for Analyzing Value Creation

Many of our valuation colleagues—hardworking, honest, well-intended people, all—have one “deep” specialty. It might be accounting or finance. Or it could be expertise in a domain—for example, healthcare. We believe that valuation, especially of closely held companies for whose securities there are no active markets, is difficult and complicated. It is also multifaceted. Therefore, we cannot get by with knowing a little about a lot or a lot about a little. To serve clients and do right by our profession, we must know a lot . . . about a lot.

As a craft, our work is multifaceted. The absence of active securities markets requires us to be able to look at a situation from different angles, with different perspectives, and through different lenses. In our shop, we have an arsenal of tools that we use in almost every valuation. These tools—mental, but no less cutting edge than a surgeon's scalpel—come from a panoply of disciplines that we have learned to use over the years.

First and foremost is **strategic management**. Before “discovering” business valuation in 1993, I spent a half-decade as a Ph.D. student in strategy. Almost from the beginning of my valuation journey, I saw overlap in the basic questions underpinning these two fields:

- **Strategy.** Why do some companies perform much better than others for long periods of time?
- **Valuation.** Why is this company worth what I say it is worth?

It is all about why. I knew that finance and accounting knowledge was not going to be enough. I also saw that some key ideas from strategic management could be deployed in valuation. Strategy-based notions such as distinctive advantage, strategic intent, and generic competitive strategies had roles to play in business valuation. We elaborate at length on these in Chapter 2.

The second field on which we rely for understanding and explaining value creation is a branch of economics, **industrial organization** (IO). IO itself has two subfields: antitrust and industry studies. We focus on the tools of industry studies. In IO, the unit of analysis (i.e., what the analyst examines) is *not* the individual company. It is the domain: the group of firms in the valuation entity's competitive arena. The 1974 Ph.D. of strategy guru

Multidisciplinary Tools for Analyzing Value Creation 9

Michael Porter was in IO. It was thus no accident that he rose to prominence through his “five-forces framework” (which we have expanded to six).⁵ Chapter 3 is about IO’s applications to valuation.

The third field from which we draw our perspective about creating value is **organization theory** (OT). OT deals with the multidimensional relationship between organizational structure and company performance. It also considers external influences (macroenvironment and domain) on the available choices for structuring and designing an organization. Phrases such as “span of control,” “boundary scanning,” and “policies and procedures” are prominent in the OT lexicon. Prominent OT scholars include Barney and Ouchi, Daft, and Galbraith.⁶ We devote Chapter 4 to a discussion of the use of OT tools in business valuation.

The fourth piece of our multidisciplinary puzzle is **evolutionary economics**. The connection between evolution and economics originated with UCLA’s Armen Alchian.⁷ Building on Alchian and on the behavioral theory of firms,⁸ *An Evolutionary Theory of Economic Change* brought evolutionary economics to the fore.⁹ The gist of this book is the importance of “routines” in determining firms’ behaviors and decision making, the economic analog of genes embedded in firms’ behaviors, the effects of technological innovation on economic growth, and the selection processes by which firms grow and survive . . . or don’t grow and don’t survive.

Somewhat parallel to the work of Alchian was Edith Penrose’s seminal contribution, *A Theory of the Growth of the Firm*.¹⁰ Penrose was the first to identify the constraints imposed by managerial knowledge and a firm’s resources on its ability to grow. Her work laid the foundation for what became, 25 years later, the *resource-based view of the firm* (RBV).¹¹

The RBV posits that firms have unique resource endowments, which are due in no small part to the uniqueness of the people working inside companies, and that those resource endowments ultimately become embedded in routines and thus are nonportable from one firm to another. In part, this explains why imitation can never explain superior performance. It also explains why firms that try to purloin the capabilities of competitors by hiring their key people invariably come up short. The only way to appropriate

⁵ Porter, *Competitive Strategy*. See also Porter, “Competitive Forces”. An update of this article appeared in 2008.

⁶ See, for instance, Williamson, *The Mechanisms of Governance*; Barney and Ouchi, *Organizational Economics*; Daft, *Organization Theory and Design*; Galbraith, *The Customer-Centric Organization*.

⁷ Alchian, “Uncertainty, Evolution, and Economic Theory,”

⁸ Cyert and March, *A Behavioral Theory*.

⁹ Nelson and Winter, *An Evolutionary Theory*.

¹⁰ Penrose, *Growth of the Firm*.

¹¹ Wernerfelt, “The Resource-Based View.”

10 Why a New Approach Is Needed

those capabilities is to buy the entire rival. Even then, it probably won't work, however, because most acquirers cannot leave well enough alone and insist on meddling and changing the prize they bought. That is a major reason why over three-quarters of acquisitions fail to earn back their cost of capital: Firms overpay and then cannot deliver. Evolutionary economics is the subject of Chapter 5.

Given my criticism of traditional microeconomics, readers will not be surprised that I have a different perspective: **Austrian economics**. It has two central tenets: (1) value is subjective and (2) human action is purposeful. But for Hitler's rampage against Jews, it is likely that the legislatures and central banks of the free world would have seen economics from an Austrian perspective for the last 70 years. The key debate in economics in the 1930s was, after all, between John Maynard Keynes and Friedrich von Hayek. But Jewish economists, including Hayek, Ludwig von Mises, Ludwig Lachmann, and Fritz Machlup, had to flee Vienna to evade the coming Nazi murder machine. The resulting geographic dispersion of these scholars snuffed out the synergy of intellectual firepower that occurs when brilliant people gather daily to argue, theorize, criticize, and innovate. We elaborate on these and other aspects of the Austrian School in Chapter 6.

Our focus on these five disciplines does *not* mean that they are the only ones that matter. Certainly an in-depth knowledge of finance—the capital asset pricing model (CAPM) and hedging—is essential. A good grasp of marketing, anthropology, and operations management is likewise helpful. Each has its own vernacular, which valuation professionals should be able to speak. But we zero in on these five other fields because they comprise the cornerstones of the new approach to valuation that is the subject of this chapter and of this book.

Parameters of Valuation

The value of an equity interest depends on a company's expected free cash flow, expected growth in discretionary cash, and the risk of the business in which the interest is held. Expressed in terms of these three variables, the relationship is:

$$V \propto \text{EFCF}, \text{EG}, 1/\text{R} \quad (1.1)$$

where:

- V = value
- α = "varies with"
- EFCF = expected free cash flow
- EG = expected growth in free cash flow
- R = risk

What We Know about Risk 11

This equation means that as expected growth or free cash flow increases, value should also increase. However, value varies *inversely* with risk (i.e., as risk increases, value decreases). We see it every day in bond markets: Interest rates [risk] rise (fall), bond prices [value] fall (rise). We know from statistics that there are outliers in any large distribution, but the exceptions serve to prove the rule.

In our experience working for and with owners of smaller businesses for the last 30 years, we have yet to meet one who has been advised to increase the value of his business by reducing its risk. They have all heard that they should grow the business, though growth seems to focus on the top line only. They have all heard that, to increase the value of their business, they should “increase profit.” However, few of them have understood why there is a substantial difference between “net income” and “free cash flow” in growing businesses. In fact, many owners judge the health of their business by how much cash they have in the bank.

Rapid growth is risky. It has impoverished—and sometimes bankrupted—many more businesses than it has ever enriched. We subscribe to the adage, “If you’re going to grow the business, you’d better grow the people *and* the infrastructure *first*.” Otherwise, a \$20 million business ends up perched on a \$2 million infrastructure while it’s run by people with \$2 million skill sets. The data from Morningstar and Duff & Phelps persuade us that reducing risk is a gigantic slice of the valuation pie for most owners and chief executive officers (CEOs) of nonpublic businesses.

What We Know about Risk

From the data sets of Morningstar and Duff & Phelps, we know that, on balance, smaller companies are far riskier than larger ones. What those data do not tell us, however, is *why*. Are smaller enterprises riskier because they’re smaller, or smaller because they’re riskier? We subscribe to the former because most firms become less risky as they grow larger.

What those data sets do not tell us, however, is where the risk of smaller companies comes from. For that, we turn to the literature of strategic management. From 1991 through 2007, nine papers published in top-tier “A” journals found that, on average, variation in rate of return was 2.9 times as great at the company level as it was at the domain (i.e., industry) level. Let’s think through the implications of those findings for valuation professionals.

- Companies *within* a domain are more different than domains themselves. That notion of “competitive heterogeneity” flies in the face of traditional microeconomic models, which ignore innovation, exclude the effects of entrepreneurship, disregard differentiation, are silent

12 Why a New Approach Is Needed

about causality, assert that the actions of no competitor affect the actions or profitability of any other, and assume that a domain's output is a commodity where the only question is price. Such assumptions make for elegant mathematics, but little else.

- Domain definition is essential because it provides the constraints that enable the facts and circumstances of a given valuation situation to be analyzed in context.
- The research findings also suggest that the variation which has enabled humans to evolve and survive for millions of years is found in economics, too. Imitation is not the way to fame and fortune. Superior performance comes from doing differently.
- Competitors have different beliefs about what is important, different views about how things work, different resources, and different ways of doing things (called "routines") that lead to different levels of performance.
- These differences highlight disparities in the value of assets because of disparities in how companies deploy them and the rates of return the assets would bring. The farther one goes down the balance sheet, the more disparate these views become.

Components of Risk

From the capital asset pricing model, we know that risk comes in two flavors: systematic and unsystematic. Systematic risk is "market risk," also known as undiversifiable risk. Using modern portfolio theory, finance scholars assume away the problem of unsystematic risk by positing that rational investors hold fully diversified portfolios. That is sound investment counsel, of course, but it is a nonstarter for most owners of closely held businesses. To paraphrase the late football coach Vince Lombardi, for them, "Unsystematic risk isn't everything. It's the only thing." But exactly what do we mean by *unsystematic risk*?

Let's begin with the standard build-up method for estimating the cost of capital for a nonpublic business:

$$E(R_a) = R_f + (R_m - R_f) + U_a \quad (1.2)$$

where:

- $E(R_a)$ = required rate of return on security a
- R_f = risk-free rate of return (typically the yield to maturity on a Treasury security, short-, medium, or long-term, depending on facts and circumstances)
- R_m = market rate of return for large-cap stocks
- U_a = unsystematic risk associated with security a

A Framework for Unsystematic Risk 13

As we have previously noted, longitudinal data from Morningstar and from Duff & Phelps confirm that size (however measured) and rate of return are negatively correlated. However, both data sets take us only as far as the size premium. Therefore, let's list the components of nonsize unsystematic risk:

- **Macroenvironment.** Six forces.
- **Competitive domain** (industry or strategic group). Six forces.
- **Company.** Firm-level risk is a function of alignment and of the durability of value-creating mechanisms.

Expressed mathematically, then, unsystematic risk looks like this:

$$U_a = RP_{\text{size}} + RP_{\text{mac}} + RP_{\text{dom}} + RP_{\text{co}} \quad (1.3)$$

where:

- U_a = total unsystematic risk for firm a
- RP_{size} = risk premium for size
- RP_{mac} = macroenvironmental risk in the industry/strategic group
- RP_{dom} = domain (i.e., industry or strategic group) risk
- RP_{co} = company-specific risk

Now, expanding equation 1.2, we get:

$$E(R_a) = R_f + (R_m - R_f) + RP_{\text{size}} + RP_{\text{mac}} + RP_{\text{dom}} + RP_{\text{co}}$$

And, since $(R_m - R_f)$ = the equity risk premium (ERP), the equation simplifies to:

$$E(R_a) = R_f + ERP + RP_{\text{size}} + RP_{\text{mac}} + RP_{\text{dom}} + RP_{\text{co}} \quad (1.4)$$

Solid data are available for the first three terms but not for the rest. It is these latter factors that complicate the analysis and valuation of smaller companies. That is why an analytical framework is so important. Done right, the process endows us with insights and a comprehensive understanding of the business(es) of the subject company. One cannot understand a smaller firm's business—*really* understand it—without an in-depth grasp of its unsystematic risk.

A Framework for Unsystematic Risk

Small and medium-sized enterprises (SMEs) are the sweet spot in the market for valuation services. Finance scholars assume away unsystematic risk,

14 Why a New Approach Is Needed

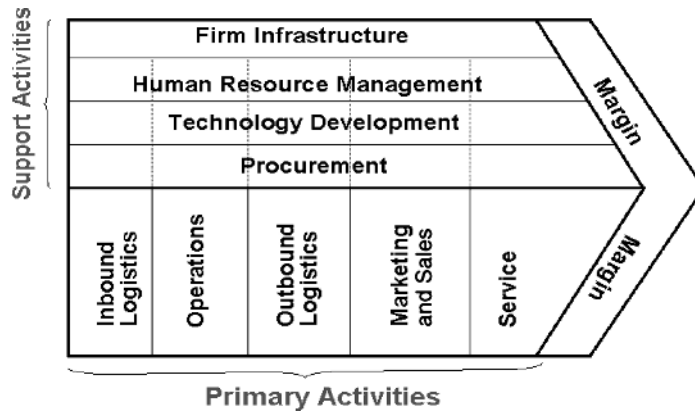


Exhibit 1.1 Value Chain

yet these are the companies that have most of it. There are few data for non-size components—macroenvironment, domain, and company. Morningstar/Ibbotson publishes industry risk premiums, but these are of little use to most professionals, as we shall see in Chapter 9. Before we can gather data, create hypotheses, and test them, however, we need a framework to guide us toward that data. We wrestled with the problem for a dozen years, beginning with Porter’s value chain (see Exhibit 1.1).¹²

SME clients found it convoluted, unintuitive, and hard to use. We next tried McKinsey’s “7-S Framework” (see Exhibit 1.2).¹³

This had the appeal of being alliterative, which McKinsey did intentionally to make for ease of recall. But it ignored such organizational facets as

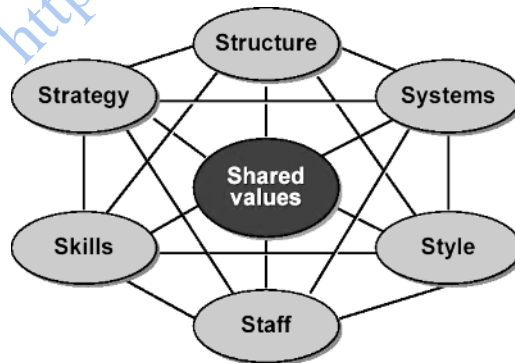


Exhibit 1.2 McKinsey's 7-S Framework

¹² See Porter, *Competitive Advantage*, 37.

¹³ See Peters and Waterman Jr., *In Search of Excellence*, 10.

A Framework for Unsystematic Risk 15

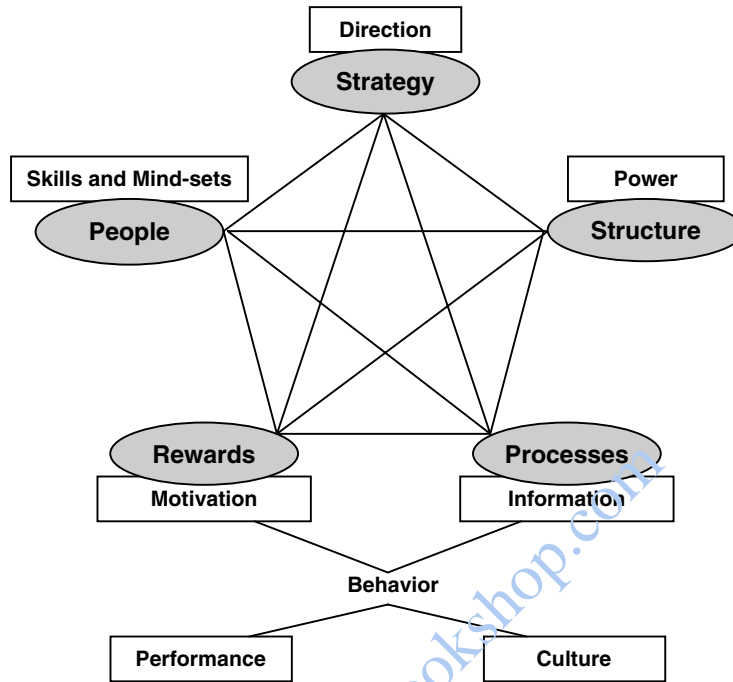


Exhibit 1.3 Star Model

culture. And all the interacting variables, as represented by the lines in 7-S lines, made it visibly “busy,” both for SME clients and for us.

We next tried something from Jay Galbraith. His field is OT, and that is evident in his model (see Exhibit 1.3).¹⁴

Truth be told, we liked the star model. But we believed that culture should be an integral part of any model, not an afterthought, as the exhibit seems to suggest. We also had the problem with all three models—Porter’s, McKinsey’s, and Galbraith’s—of how to make it work inside a graphic representation of the other two nonsize components of unsystematic risk, macro-environment, and domain.

Borrowing from strategic management, industrial organization, OT, evolutionary economics, and Austrian economics, we created a trilevel unsystematic risk framework (see Exhibit 1.4).

The framework resonated with clients when we first used it in 2005. For valuation professionals, it is easy to remember (two hexagons + SPARC) and easy to work with. In our shop, we also use it as a kind of mental filing cabinet as we gather information, do research, conduct

¹⁴ Galbraith, *Designing Organizations*, 15.

16 Why a New Approach Is Needed

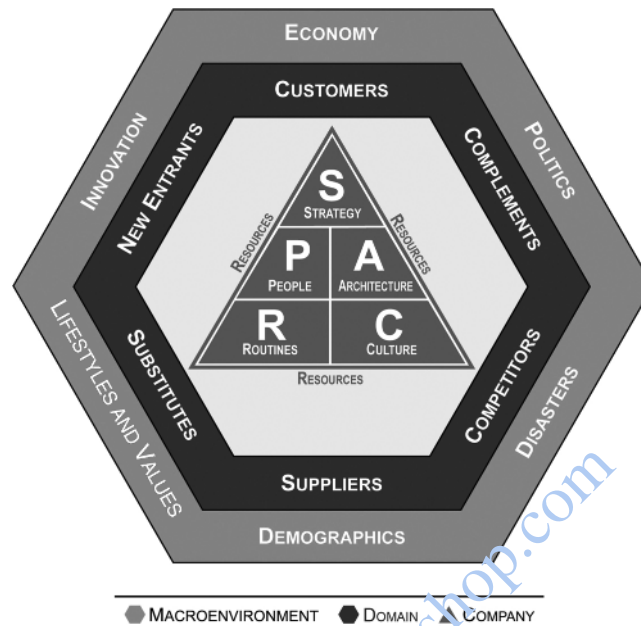


Exhibit 1.4 Trilevel Unsystematic Risk Framework

interviews, and work through the analysis and performance metrics in valuing a client company.

Most important from our standpoint, we now have a framework that enables valuation professionals to explain **why**. At the company level, there are five components. SPARC has been back-tested in more than 400 valuations and advisory engagements over the last 17 years. In every case, its elements—strategy, people, architecture, routines, culture—explained, sometimes in combination with one another, the aberrant metrics at the company level.

Unlocking Business Wealth

Using the framework and tools in this book, valuation professionals will have opportunities for add-on consulting work. In our shop, for instance, we often combine “calculations engagements” with a value-enhancement phase. Most often this combination occurs in the initial stages of exit planning, buy-ins by one or more new internal owners, or an overarching desire by an owner or chief executive to enhance business value. No valuation report is necessary at that point. Besides getting a range of value of the business, the client also gets a “value map” that points the way to increasing the value of the business as it goes through the fix-up stage prior to being put on the market or sold to known buyers.

SPARC is the linchpin of the add-on deliverable. Understanding the why is the essence of SPARC. And once we have our arms around the why, we can, with additional research *and* an in-depth understanding of the routines and capabilities of the client company, make detailed recommendations under the SPARC aegis to reduce risk, boost cash flow, and increase the expected rate of growth in free cash flow. This process adds real value for clients.

To be sure, it does not happen overnight. Lead time of 18 to 36 months provides the kind of window necessary to do the work to get the value up, identify and contact potential buyers, and conduct the auction that fetches top dollar for the seller. It is a natural extension of the work the valuation professional has already done for her to be the outside quarterback in the value-enhancement phase. Besides leading to a far bigger payday for the client, the work—which can be done on a contingency basis, but with a hefty retainer—is lucrative for the professional. Routing it through a separate entity where one does not run afoul of provisions that restrict or prohibit contingency pricing, especially for CPAs, can be useful, as can teaming up with a boutique investment banking firm. In contingency-fee engagements, however, one must be careful to avoid holding oneself out as, for instance, a CPA or as having any other credential whose sponsoring organization takes a dim view of “success fees.”

Summary

In this chapter we made the case for a new approach to business valuation, one that uncovers cause-and-effect relationships to enable professionals to explain *why*. If we cannot explain the *why* causing the *what*, then presenting only the naked *what* makes us like the emperor and his new suit of clothes. We also argued that tools for analyzing the creation of value come from at least five nontraditional disciplines. We provided a brief overview of the “risk archives” from Morningstar and Duff & Phelps, which led into an extensive discussion of risk. We presented the graphic of a trilevel framework for analyzing and understanding unsystematic risk; it is the key to understanding SMEs and why the valuation is what it is. We also noted that such understanding will lead to opportunities for professionals to provide add-on consulting services and offered some caveats about doing that.

Additional Reading

- Kerr, Steven. “On the Folly of Rewarding A, While Hoping for B.” *Academy of Management Journal* 18, No. 4 (Fall 1975): 769–783.
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