Measure Twice, Cut Once

CREATING AND MEASURING VALUE IN THE PRIVATE FIRM

BY PETER LEITNER, CMA, CFM

"Measure twice, cut once," the wise carpenter says to ensure the best decision involving precious resources. So, too, as business leaders grapple with allocating capital, developing talent, and nurturing ideas to ensure the firm's future.

At the heart is corporate value, an elusive concept to most. Yet there it is, central to the strategic and tactical decisions business leaders make every day, though many proceed without giving it much thought, or, worse, it's only an afterthought. Too often a valuation merely justifies a decision already made, like acquiring a competitor, or supports a point of view, such as a stock option plan. This is particularly true in private companies, which usually don't know if they're creating value at all.

But this is changing quickly. Private equity now funds the growth or ownership transfer in many closely held firms. Global competition across basic, high-tech, and service industries is pinching even the smallest companies in previously secure niches. And the reforms of recent years, like Sarbanes-Oxley, are shaking private firms, too, as their lenders, investors, directors, auditors, potential suitors, and even customers shield themselves by expecting more from all companies they encounter.

With the days in a safe harbor quickly vanishing, leaders of private firms must now focus on creating and managing for value. They need to capitalize on the inherent advantages of being private and, at the same time, make strategic and tactical decisions as if they were public firms. Leaders must execute business plans with discipline and muster the courage to change course when necessary, though many struggle with measuring their value and putting that information to good use.

That's where market-based valuations come in. They allow private firms to be valued as if they were public but without losing their privacy or gaining the associated burden. Multiple experts independently value the firm and then price it in a secure market where its leadership can see value emerge in real-time. This yields a flow of information that has long been an advantage of publicly traded firms.

To help you fully appreciate market-based valuations, I'll explain creating value and managing for it, the peril of hiding in safe harbors, and how markets convey value in general. Then we'll look at how a market-based valuation works and the benefits companies gain from them.

CREATING ENTERPRISE VALUE

A company's value rises and falls at the crossroad of its capitalization, the return it earns on its capital, and the market's perceptions about its future. A company creates value when it generates free cash flow, which is the actual cash that the company could return to investors after it pays all operating costs and expenses and makes all necessary investments in working capital and capital expenditures. A firm with zero free cash flow isn't creating value, only maintaining it, and a firm with negative free cash flow is in fact destroying value.

To grasp how much or how little value a firm is creating, you focus not only on the amount and timing of free cash flow but also on the risk an investor must bear. This includes the opportunity cost of forgoing the guaranteed return of U.S. Treasurys plus the risks associated with the firm's markets, competition, operations, technology, regulatory environment, and so forth. Expressed in percentage terms, it equals the return required to make the investment worthwhile as well as the company's cost of capital. Creating value, therefore, follows the trifecta of growth, consistency, and certainty in free cash flow.

Creating value requires free cash flow that grows in a consistent and predictable manner or on a trajectory with commensurately high returns.

Growth is perhaps the most obvious: Selling more products and services, cutting expenses, and liberating unproductive capital will boost free cash flow. But there are limits to this because the company must innovate to ensure its future. Then comes consistency, which satisfies investors' desire for no surprises. Consistency builds trust between the firm and the market and yields a valuation premium over competitors. Finally, there's predictability, which the market prizes above all.

Creating value, therefore, requires free cash flow that grows in a consistent and predictable manner or on a trajectory with commensurately high returns.

MANAGING FOR VALUE

Free cash flow isn't enough, however, because the market's perception of a company's prospects matters, too. Markets assign more value to companies whose expected future cash flow, discounted for investor risk, is greater than that of others. This begins to explain why an established and profitable company with $50 million in sales could be worth less than an emerging and unprofitable company with $5 million in sales or how two companies in different industries but with the exact same revenue, profits, and free cash flow may not be equally valuable. These aren't cases of market failure but, instead, the *failure to manage for value.*

Managing for value is decision making with the pur-

pose of creating value. Savvy publicly traded firms do this by paying less attention to quarterly earnings per share and more to connecting the dots between their decisions and the resulting change in value over time. In essence, they exploit the feedback loop in markets. Private firms can also manage for value, provided they use objective sources to regularly weigh the value created by their decisions and then learn from the process.

To manage for value, leaders first rigorously evaluate free cash flow and profits. The latter measure, long-known but often ignored, reveals deep truths about a firm's prospects because it measures economic vibrancy in a way that GAAP-based net income doesn't. High among these truths is the company's ability to pay the entire cost of its capital in a given period, and if it doesn't do this year after year, it's surely on a slippery slope that foretells a bad fall.

Managing for value is the modern-day successor to managing for cash flow, which came of age in the late 1970s with the realization that a profitable firm could run out of cash. Cash flow statements as we know them today weren't required, and the zest for cash came only when leveraged buyouts—acquisitions of firms using previously unheard of levels of debt—became the new thing in the early 1980s. Until then, managing for profit was considered good enough.

Managing for value, therefore, builds on the power of free cash flow by focusing on the decisions and actions that will cause the market to favorably adjust the value it assigns to a company over the long run. Regardless of where on the life-cycle curve the company plays, the goal is to add layer upon layer of enterprise value or to change direction—even sell the firm—when this is no longer possible.

THE PERIL OF HIDING IN SAFE HARBORS

Being private has its advantages. Chief among them is the luxury of a long-term perspective. Others include: Risky moves can fail quietly out of public view, losses can be incurred while trying new things, competitor scrutiny can be largely muted, and the huge expense and distraction of Securities & Exchange Commission (SEC) compliance is avoided.

But being private forgoes the valuation from a public listing, as well as the discipline that accompanies investor, regulator, and media scrutiny. This complicates managing for value enormously, though historically there are two exceptions for private firms.

The first exception is the closely held company that performs well year after year, thriving because its board, management, and employees *truly believe* they're building a business for the long term. Such a firm is apt to be family owned and has addressed management succession, developed nonfamily employees, and empowered independent board members. The second exception is when a reputable private equity firm acquires the company in a leveraged buyout. The company's performance soon sparkles because the investors infuse market discipline that can surpass even that of public firms.

Yet the vast majority of private companies are neither managed for the long run nor institutionally financed, so they enjoy a relatively independent existence while their value insidiously erodes like soil in a steady rain. This condition stems from their aversion to risk, their narrow capital structures, and their shallow benches of talent.

Private companies can become risk averse after they reach an acceptable level of success, as if the owners prefer a harbor mooring over sailing in open water. They underinvest in R&D, retain docile employees while blocking rising stars, and refuse to forgo profits while repositioning the company for more attractive markets. In some cases, the controlling management team merely has little interest in returning to a 60-hour workweek.

A private company's capital structure can be very narrow, comprising retained earnings, loans from the founder and officers, and perhaps a line of credit. This can be a vestige—if not a badge of courage—of the company's early and lean years and very often reflects the triple threat of equity dilution, loss of control, and pesky investors asking too many questions. Most troublesome is the Dividend Addict. This controlling shareholder starves the business to finance a personal lifestyle, behavior unthinkable with institutional investors or lenders. Ironically, firms with such a founder/CEO could generate free cash flow and profits, but, with nothing reinvested in the company, little value remains.

Arguably the worst form of squander is the failure to develop people so that the firm is little more than a sole proprietorship with many employees, not a going concern. It's profoundly hollow and will likely unravel if the founder becomes bored, falls ill, or dies.

HOW MARKETS CONVEY VALUE

For 50 years the cognoscenti in financial economics have debated market efficiency, which is the degree to which asset prices adjust to reflect new information. Consider the discovery of a large oil reserve in the North Sea, causing the oil barrel price to fall 5% in one day, or FDA

approval of a new drug immediately boosting a pharmaceutical firm's share price 10%. Both exemplify some form of market efficiency such that all agree markets are at least reasonably efficient and that information is their lifeblood.

Markets first formed for the convenience of buyers and sellers, but the information they generated was soon recognized as valuable in and of itself. This included differences in product quality among sellers and the creditworthiness of buyers, causing prices to adjust and giving rise to market efficiency. As the number of participants and both the volume and size of transactions increased, markets became more liquid, ensuring that buyers and sellers could find each other when a deal needed to be made.

The importance of information in markets holds true today, from commodities to securities to used personal items. eBay, for instance, revolutionized the garage sale by using new technology to provide information and transaction capability to what had been a highly inefficient market. The secret sauce for all markets is free-floating prices, the dissemination of information, and the ability to act on both. Competitive dynamics and the wisdom of crowds therefore yield market prices that most accurately reflect the value of the traded assets. But markets function only if there are unmet supply and demand, animal spirits (a term made famous by economist John Maynard Keynes that refers to the basic human emotions that drive markets—including greed and fear among others), and access to an arena where buyers and sellers can meet.

The secret sauce for all markets is free-floating prices, the dissemination of information, and the ability to act on both.

HOW MARKET-BASED VALUATIONS WORK

Market-based valuations harness the forces of price discovery to produce independent, objective, and robust assessments of fair market value. They allow multiple experts to competitively value a private firm as if pricing an initial public offering (IPO) of stock and then trading the shares during their first few hours on the market. Compared to others, market-based valuations use a hybrid of the open outcry and electronic market models.

Unlike in an IPO, however, the company isn't issuing shares or raising capital. It follows similar steps but without the public disclosure of sensitive information, the time-consuming and expensive process of preparation, or the ongoing burden of SEC compliance. This enables private firms to have the best of both worlds: They can manage for value, and thus maximize their value, without the hassles of going or staying public.

In addition to the company that decides to be valued, the primary participants in a market-based valuation are the sponsor, the analysts who value the firm, and the marketplace itself.

The company first selects a sponsor to guide it through the three-phase process of information gathering, analysis, and pricing. The sponsor is analogous to an IPO underwriter, insofar as it assumes responsibility for due diligence, preparing the deal book, and delivering the final valuation report to the company. It serves as the company's gateway to analysts and the market.

To start the process, the sponsor interviews senior management and tours the principal site of operations, all while gathering from the company the same kind of information that a potential investor or lender would require. This includes historical financial statements and tax returns, the current business plan, operating and capital budgets, board minutes and resolutions, biographies of management and directors, and so forth. For established companies, most if not all of this is readily available. The sponsor then compiles this information into a deal book and distributes it to the analysts.

The analysts who price the company come from the vast ranks of valuation experts around the globe. Each is screened, vetted, and agrees to the rules of the marketplace—including extensive confidentiality provisions—before it can participate. The analysts include investment bankers, financial advisors, corporate development officers, and appraisers. Many have operating experience in various industries, and all are seasoned analysts whose valuations preceded transactions based on their work. In investment parlance, they've eaten their own cooking.

Soon after they receive the deal book, the analysts participate in at least one conference call hosted by the sponsor. Then they independently complete their analyses and submit their written reports to the market, which redistributes them to all the other analysts so each one can cri-

tique the approaches, assumptions, and conclusions of the other experts.

At a predetermined date and time, the analysts log on to a private Web and telephony-based marketplace, where the initial valuations in their written reports have been posted electronically, to price the company. The virtual marketplace combines conference-call technology and a Web interface so the analysts can communicate directly and submit revised prices to the market. Management can log on, too, but only to observe, so they can't influence what takes place.

All market activity is led by a market maker, who represents the market and formally opens the pricing session by inviting each analyst to deliver a brief summary of his or her approach and conclusion. When the oral summaries are complete, the analysts direct questions to each other at will, most often about the methods, assumptions, and other factors used to arrive at their values. Civil but incisive questions can result in highly spirited debate as the analysts attack and defend the valuations.

The market maker moderates the pricing discussion and, if necessary, referees serious disagreements. As a neutral party in the process, the market maker neither supports nor defends a particular analyst or the company except to ensure that all the participants hear the relevant information.

During the pricing session the analysts may change their valuations by submitting new prices as often as they want via a secure Web interface. This factors new information into the valuation, including reactions to the written reports, criticized points of view, and insights gleaned from the buzz in the market. Both company management and the market maker can see all of the prices submitted by the analysts, as well as other useful information.

THE BENEFITS

Market-based valuations deliver significant benefits to private companies, including a robust data set; the objectivity, independence, and diversity of the analysts; the enhanced quality of their work; and unexpected insights about the company.

Robust Data

Having multiple analysts value a company in parallel dynamically generates a rich data set. Each submits an initial value in a formal written report and then unlimited revised values based on what they learn in the market. The mean and standard deviation of the most recent values are calculated continuously, allowing the market maker and observers to see in real-time how the final, central value emerges. Table 1 shows a company's value at the beginning and the end of a pricing session.

Table 1: Valuation of a Technology Firm

Analyst	Opening Value	Closing Value
1	$26,331,163	$26,900,000
2	$38,803,000	$30,000,000
3	$65,000,000	$40,000,000
4	$27,000,000	$30,000,000
5	$17,000,000	$29,000,000
Mean	$34,826,833	$31,180,000
Standard Deviation	$18,557,109	$ 5,090,383
S.D. as % Mean	53.3%	16.3%

Five analysts independently valued this technology firm, which was considering a strategic sale to a larger company. Their initial valuations ranged from $17 million to $65 million with an average—or opening—value of about $34.8 million. After rigorously debating each report and submitting revised values, the pricing session formally ended with a closing value of $31.2 million.

With a standard deviation of $18.6 million, the range of initial values reveals the core benefit of this robust approach. First, with independent analysts working in parallel, the spread of values from different experts is clearly visible, which isn't possible when relying on one source for a strategic valuation opinion. Second, the standard deviation quantifies the spread in dollar terms, thereby revealing the statistical error the company avoids by using a market-based valuation instead of relying on one source, such as an investment banker, appraiser, or the company's CFO. Some have equated this to an insurable risk that, if left unhedged, can lead to an expensive error. In this case the company valuation could have made an *$18.6 million* error, either by selling themselves cheaply or walking away from an otherwise reasonable offer from a strategic buyer.

Independence, Objectivity, Diversity

Independence and objectivity are like two sides of a coin: The former relates to the relationship between the analysts and the company (both real and perceived), while the latter pertains to the analyst's state of mind as a result of the relationship. Market-based valuations by their very nature permit analysts to be more independent and

objective than they otherwise might be because the company isn't their client. Therefore, the company has little influence on their thinking and behavior, while the analysts are motivated to provide the highest-quality and most accurate valuation possible.

Close behind is the diversity of views about a firm's value, not only from multiple analysts but also their orientation and experience. When all of these voices are blended, valuations are richly balanced. Consider the following types of analysts and what they offer:

- Investment bankers and financial advisors tend to have a keen sense for market values at a given time and what will fly on Wall Street, which is priceless when valuing a pending financing;
- Corporate development officers know what strategic acquirers look for and how they think, which illuminates a valuation for an alliance or merger; and
- Appraisers offer deep technical competence, often in tax and legal matters, adding specificity to understanding a complex situation.

Valuation Quality

The intense scrutiny of every analyst's work by his or her peers raises the quality of the work he/she produces. As one analyst said, "Nothing sharpens iron like iron." Since the market is transparent in real-time to analysts and company management alike, shoddy or incompetent work, or an unsubstantiated point of view, is quickly and mercilessly rejected. This prompts competent analysts to be well prepared and discourages all others from participating in the market.

Transparency also assures the company that the valuation is real. They receive the initial analyst reports and can watch the firm's value rise and fall during the pricing session, allowing them to begin connecting the dots between performance and changes in value. They also hear the debate among analysts, who pull no punches, so each analyst's final price, and thus the final mean price, is neither abstract nor muddied.

Unexpected Insights

The unexpected bonus of a market-based valuation is what company management learns from the frank, unscripted dialogue among competing analysts. They hear individual and consensus views about the firm's market, competition, operations, capitalization, management team, and prospects, which can change the way management thinks and acts. A board member of one technology firm said, "We saw ourselves in a different light and will change our story to the outside world accordingly." The COO of another firm mentioned, "We learned more about our company in 90 minutes than we have in the last 10 years."

MEASURE, AND THEN MEASURE AGAIN

While a carpenter measures twice and then cuts once to save raw material and time, a savvy business leader measures once, executes the plan, and then measures again to gauge how much enterprise value was created. In a public company, this occurs naturally. Its market capitalization is there for all to see at the start and end of its fiscal year, with the difference largely attributed to management.

Private companies can now do this as well with market-based valuations, which measure not once, twice, or thrice but however many times multiple experts consider new information about the firm before the market cuts the final value. This empowers their leaders when raising capital, doing mergers and acquisitions or alliance deals, or repositioning the firm for new and more attractive markets. After a valuation, the company has the knowledge of the value they created and of the repeatable steps they took to do so. ■

Peter Leitner, CMA, CFM, is the founder and CEO of Princeton-based Numeria Management LLC, which established the first market for valuing private firms. He's widely published on strategy and corporate finance topics and is a frequent public speaker. You can reach Peter at pleitner@numeria.us.