The Fallacy of Safe Harbors

MANAGING FOR VALUE IN THE PRIVATE FIRM

BY PETER J. LEITNER, CMA, CFM

A PRIVATE FIRM once prospered by churning out steady revenues and profits, gliding along like a schooner with fair wind in its sails. True, it passed first through a treacherous start-up, with survival far from certain, but thereafter it found smooth sailing, perhaps enduring for several generations.

So it was in the last half of the 20th Century when being closely held was a rational business model. It still is, but only if management sees profound changes in the global economy approaching like a perfect storm and adjusts course accordingly.

The coming storm, and the way to survive it, was succinctly expressed at the 2006 World Economic Forum in Davos, Switzerland, by former U.S. Treasury Secretary Lawrence Summers. As reported in the January 31 edition of *The Financial Times*, Summers said:

> *"The resurgence of China and India and the impact of disruptive new technologies are revolutionizing the global economy so that we now live in a mark-to-market world, where everything is tested against market forces every day."*

The term *mark-to-market* means knowing your firm's value and making decisions that maximize it. Unfortunately, most people in private firms care not a whit about value until it's time to sell the company, but then it's too late. According to a Waterford Advisors LLC survey of financial executives in January, only 60% of private-company CFOs, controllers, and other financial executives have at least some idea of their firm's value. Of those, nearly two-thirds said it was based on "…management estimates or wishful thinking."

This may have worked in the past, when private firms could prosper even if run like ships moored in a safe harbor. But unprecedented competition and world-flattening technology, fueled by abundant liquidity, give private firms no choice: They must manage for value. This means making decisions with the express goal of creating corporate value and measuring performance by the change in value from one period to the next.

Think of a safe harbor as a metaphor for how many private firms exist. They are cash generators with modest competition, and many apparently have little incentive to reinvest profits for the long run.

SAFE HARBORS AND THE PRIVATE FIRM

Privacy has its privileges. Closely held firms avoid scrutiny by competitors and can invest in R&D and other initiatives with the advantage of quietly burying their failures. They can also tolerate losses in income while repositioning the firm for more favorable markets. In essence, being private grants an option to take the long view. Unfortunately, most private firms don't exercise this option and instead, because of two blind spots, consistently lag the market.

First, without publicly traded shares, private firms usually have no clue about whether their value rises or falls each year. They also forgo an excellent leading indicator that can signal a change in a firm's prospects. Finally, they do without the market's feedback loop that evaluates corporate decisions and events, such as a change in management, a new product launch, or a merger announcement from which savvy leaders sharpen their decision-making skills. Not knowing your firm's value is like sailing a ship without navigation equipment or a recent weather forecast.

The second blind spot is the absence of market discipline that accompanies investor, regulator, and competitor scrutiny. Certainly no one enjoys having critics peering over the shoulder, but the leaders of today's most successful firms accept this challenge and outperform their peers.

Yet most private firms don't operate this way, and their performance—despite generating considerable wealth for their stockholders—grossly lags their potential. As evidence, consider the growth of the private-equity industry whose players acquire private firms and later sell them profitably. They couldn't have added value if they weren't improving the operations, capitalization, and governance of the firms they acquire. After all, private-equity firms wouldn't buy them if they didn't see untapped value.

But as in most things, there are exceptions that merit consideration. The first is the private firm that is managed for the long run and focuses on shareholder value creation. Since their leaders think and act as if they might sell the company at any time, they address management succession, develop nonfamily employees, and empower independent board members whose talents and opinions complement those of the management team. The second exception is those companies that are funded by reputable private-equity firms that infuse market discipline and coach company management to be better leaders. When invested properly, private equity turbocharges performance and value creation.

Many private firms, however, are market laggards that are easily identified by risk aversion, narrow capital structure, and a shallow bench of talent.

Table 1: Private Firm Risk Aversion

FIRM LIFE CYCLE	STATUS OF OPERATIONS	RISK AVERSION	OWNERS ARE THINKING
Start-Up	Chaos	Low	Be Bold, Yet Conservative
Growth	Steady State	Medium	Wealth Tastes ***Good***
Mature	Loosening	High	Wealth Tastes ***Great***
Decline	Disintegrating	Highest	***We're Outta Here***

Aversion to Risk

Risk aversion reflects a desire to maintain the status quo, which often means underinvesting in R&D and marketing while increasing dividends. And while the Greek chorus of financial cognoscenti praises the return of cash to stockholders, it fails to see how shortsighted this can be. Risk aversion stems largely from liquidity preference, meaning the trade-off an individual makes between having very liquid but low-yielding assets—like cash—or very illiquid assets that earn higher returns.

Risk aversion rises as the company moves along the life-cycle curve, meaning the owners are willing to assume the most risk when the firm is in a start-up stage (or immediately following a management buyout). Once the firm enters the growth, mature, and decline stages, however, the owner's aversion to risk increases dramatically, as Table 1 shows.

At start-up, a firm's operations are in a state of chaos, and the owner's risk aversion is at its lowest. The mantra of most that eventually succeed is, "Be bold, yet conservative." But in the growth stage, which can last for years or decades, things begin to change.

With operations now in a steady state (at least compared to a start-up's chaos), there's less boldness and a greater desire to repeat whatever led to the initial success. This shift is often triggered by newfound wealth as well as the still fresh memories of struggles and perhaps near failure during start-up.

At maturity, when revenue grows at or slightly above the inflation rate, the situation grows even cloudier. Operations loosen up because of an underinvestment in infrastructure and people, and the owner may become distracted by nonbusiness matters. Risk aversion is high, and nearly all excess cash is swept out through dividends or used to employ family and friends.

Eventually, revenues decline, and the operation starts disintegrating: Product and service quality are horrible, employee turnover is the pits, and problems with regulators and other stakeholders are surpassed only by acrimony among whatever board members and other shareholders remain.

Narrow Capital Structures

Private firms too often rely on narrow capital structures that comprise retained earnings and perhaps temporary loans from insiders (which are usually recycled dividends) or a line of credit. This is a vestige of the start-up and growth phases when becoming debt free was the overriding goal.

Retained earnings are indeed beautiful. They demonstrate that the firm earned enough profit to erase cumulative losses, and they show that at least some profits were reinvested in the firm. But they're also the most expensive form of capital, so if retained earnings are the entire capitalization, then the firm's high hurdle rate for new corporate investments renders most infeasible. What it really needs is some long-term debt.

Yet, all too often, debt is a loan from the founder or officers, which may be helpful at critical moments but is counterproductive in the long run. First, the loans are often recycled dividends that should have been reinvested in the firm rather than distributed to shareholders. Second, even well-intentioned loans are hardly arm's length and thus don't include much market discipline. Finally, even wealthy owners may be unable to fund the entire amount needed, so they provide what they can but leave the firm still undercapitalized. A better alternative is a conventional loan from a financial institution.

But the only conventional loan many private firms have is a line of credit, a mortgage on real property, or both. Most troublesome are credit lines, which were designed to fund working capital like accounts receivable and inventory. All too often private firms use them to fund anything but, including payroll and acquisitions. This violates a cardinal rule of finance, leading to higher volatility in the firm and possibly insolvency.

The major reason private firms have narrow capital structures is the owner's desire to avoid equity dilution, loss of absolute control over the business, and questions from pesky investors and lenders. But there's a more insidious reason a private firm may not have outside investors and lenders: They won't tolerate a dividend addict, an owner who sweeps every available dollar out of the firm's cash account. While this is legal, and even a venerable capitalist tradition, it drains the lifeblood from

the firm, stunting its growth and jeopardizing its future.

A Shallow Bench of Talent

The final but equally troubling problem is a shallow bench of talent. Many companies have a surplus of docile employees, an absence of rising stars, and unqualified family members and friends in mission-critical roles. The firm is thus profoundly hollow, more like a large sole proprietorship than a going concern.

"So, what's the problem?" you might ask. Capitalism allows owners to choose their risks, financing options, and employees at will, and for the past 50 years or so they did so successfully. But a glance toward the horizon tells us those days are gone.

THE APPROACHING PERFECT STORM

Private firms face a perfect storm as three factors quickly converge: the tendency to avoid risk by hiding in ostensibly safe harbors, the near omnipresence of private-equity capital, and the rise of unprecedented global competition.

Private equity refers to investors who acquire all or part of a private firm whose value they increase by improving operations, tuning up capitalization, or both, before selling it for a profit. Today there's more than $1 trillion of private-equity capital under management worldwide, complete with industry best practices and a nearly 40-year track record of above-market returns. Hedge funds—which have another $1 trillion under management—recently started investing in private firms, too. So, while professional investors are turbocharging many of a firm's domestic competitors, global competition is roaring in from the other direction.

There are more ambitious and hungry entrepreneurs on Earth today than ever before, particularly in Asia (notably China and India) and Europe (especially former Eastern Bloc countries), who crave a share of the U.S. market. And they're getting it. This rise in global competition stems from three successive and interrelated waves that are converging into what some describe as an economic tsunami.

The first wave follows the fall of the Iron Curtain across Europe in 1989. Once moribund economies in Central and Eastern Europe sprang to life and stimulated growth across the continent and in parts of the Middle East. The Curtain's fall no doubt unleashed demand held latent by nearly a century of war and political repression.

The second wave is the nearly unbridled flow of funds across borders, which not only provides greater liquidity for investors and funding options for issuers, but it's transforming the globe into a "mark-to-market" economy. This began in the early 1990s, exemplified by the rise of economies like Hong Kong, Taiwan, Singapore, and South Korea, and it continues to accelerate.

The third wave is the rise and near ubiquity of the Internet. To paraphrase Tom Friedman from *The World is Flat*, the Net has flattened the world such that Earth's inhabitants are now more connected than ever before. But in so doing, it spawned new business models and culled others while accelerating cycle times and removing barriers that once allowed small private firms to operate blissfully, with little fear of global competition.

There's nowhere to hide, and, as any ship captain knows, a harbor can be the worst place for a ship in a storm. Indeed, the crew may be safe and dry, but the ship too often capsizes or washes ashore.

FACING DOWN THE STORM

When facing a perfect storm, what do you do? Without question, weigh anchor and head to sea, even if you're sailing directly into it. And apparently some senior financial executives are, as 16% plan to reinforce their capital with private equity or an IPO in the next two or three years, according to the Waterford study, while another 41% anticipate merging with one or more other firms. The largest group (44%), however, expects neither capital nor corporate transactions. Regardless of their course, they all should manage for value.

Managing for value means running a private firm *as if* its shares trade publicly or it has private-equity investors aboard. It means building layer upon layer of corporate value, year after year, so that it is maximized whenever the owner decides to sell, even unexpectedly. But there's a more pressing reason, too. With private-equity investors funding a firm's competitors, there's no choice but to operate like they do: mark-to-market and manage for value.

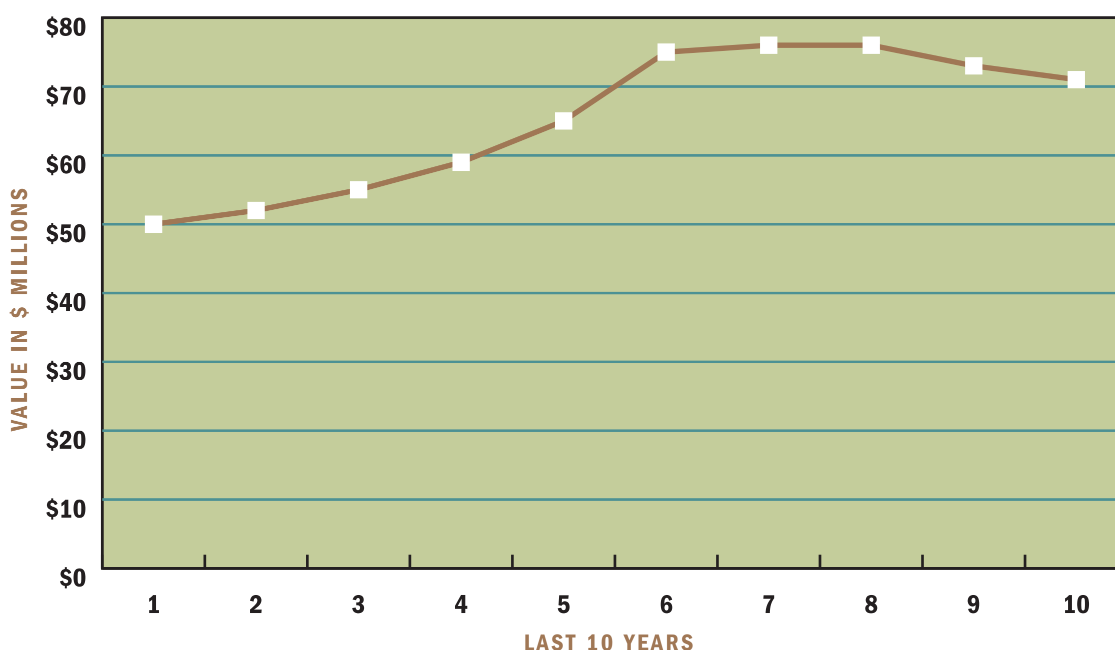
PREPARING FOR HEAVY WEATHER

Once a firm embraces managing for value, the next step is investing in areas that often are underappreciated. These include a business plan, people, and infrastructure, as well as innovation.

A Real Business Plan

A business plan is the living document that states what the firm does, how it is done, and for whom; its essential resources and budgets; its long- and near-term targets; and the real risks to achieving them. It should be developed and agreed to by management and the board and

Figure 1: Corporate Value of ABC, Inc.



then revisited quarterly or monthly so that course corrections can be made. It shouldn't lie dormant on shelves or exist solely in the CEO's mind.

People and Infrastructure

Investments in people and infrastructure go hand in hand because one often reinforces the other. They include formal recruitment, training, and retention programs that convince all employees, especially nonfamily members, that they have a career path with the firm. Moreover, infrastructure improvements ensure that people and systems are efficient, scalable, and flexible enough to handle unforeseeable opportunities and challenges.

Innovation

Finally, investments in innovation—that is, bona fide capital budgeting for promising new endeavors—ensure that the firm has a future beyond the next several years, even if current revenue and profits seem unshakable. Indeed, many a firm began its irreversible decline soon after management declared prosperity permanent.

In addition to investments that improve operations, managing for value requires an appreciation for optimizing the capital structure and corporate governance.

Tuned-Up Capital Structure

Capitalization should be restructured to reduce the cost of capital while retaining prudent flexibility. This lowers the hurdle rate for new products, joint ventures, acquisitions, and other growth initiatives that require capital investments.

Lowering the cost of capital usually involves adding one or more tiers of debt, like bonds, term loans, notes, or debentures that are issued to institutional lenders and investors. But you must balance additional interest and principal obligations with cash flow and ensure that an increase in financial leverage is compatible with the firm's operating leverage. If both are high, especially if cash flow is volatile, a catastrophe is likely.

When restructuring the capitalization, it's wise to match the lives of liabilities with the lives of the assets to be financed, which is the cardinal rule mentioned earlier. This means short-term financing of long-term assets is a no-no, as is using long-term financing, such as bonds or term debt, to buy short-term assets, like inventory. A mismatch, while tempting if rates are low enough, only leads to trouble.

Finally, the restructuring must complement the business plan to ensure that grand ideas to grow by acquisition, joint ventures, or organic means are properly funded. Too many undercapitalized firms fail to meet expectations, or simply fail, for this reason.

Tuned-Up Governance

A hot topic today, corporate governance is especially important to private firms because it's so often under-

appreciated. A strong board composed of seasoned and independent directors who speak their minds is a priceless asset. Yes, this may occasionally make the CEO uncomfortable, but it sends a favorable signal to investors and other stakeholders and results in better strategic decisions over the long run.

In this vein, I also advocate that private firms comply with the Sarbanes-Oxley Act (SOX). It's indeed a headache, especially for the CFO, and reaching compliance can be expensive, but there are very compelling reasons to do so.

First, should the company decide to seek private equity or an IPO, the investors or underwriters will expect it to become SOX compliant. If it's before the financing journey begins, the process will be faster and smoother, with lower issuance costs and a more favorable valuation.

Second, if a sale to a strategic buyer is likely, then you should assume that the potential acquirer is SOX compliant and will expect the target to comply within a year. If the target is already compliant, the buyer may be even more eager to do a deal, given the lower perceived risk.

Finally, private firms that sell products and services to or have alliances with larger public firms may soon discover that their customers or partners require SOX compliance from their vendors as part of their own compliance program.

According to a recent PricewaterhouseCoopers survey, 27% of private companies with revenue between $5 million and $150 million have already adopted best practices modeled on SOX, even though they're not required to do so by law, according to the January 30 edition of *Treasury & Risk Management Express*. Clearly, this sets a new standard of excellence in the market.

STAYING ON COURSE

Once a private firm optimizes its operations, capital structure, and governance, from which improved performance should soon follow, it faces the delicate task of staying on course. This is achieved by monitoring revenue, income, and free cash flow and by measuring the change in corporate value from one period to the next.

A firm's corporate value equals shareholder value (or the market value of shareholders' equity) plus debt, as eloquently described by Alfred Rappaport in *Creating Shareholder Value* and shown in the following equation:

Corporate Value = Shareholder Value + Debt

Most experts agree that measuring value equals the discounted future value of free cash flow plus residual value. This is most often estimated with discounted cash flow analysis, with due consideration given to other methods, such as comparable company analysis.

Only by measuring the change in corporate value from period to period can you know if it's increasing. This yields a telling picture of the firm, its prospects, and any changes that may be required, as Figure 1 suggests. In this hypothetical example, ABC, Inc.'s corporate value grew swimmingly, rising at an increasing rate, until five years ago when it peaked at about $75 million, flattened out, and then began to decline. Like most "successful" private firms, ABC could have chugged along like this for years, with revenue more or less keeping up with inflation while its corporate value eroded. But no longer—the competitive environment doesn't allow it.

Measuring performance, therefore, requires marking the firm to market. Annually is sufficient, though some firms going through a dramatic restructuring or other transformation should consider doing this analysis semiannually or quarterly and certainly before raising capital or pursuing an M&A transaction as either buyer or seller.

So that managing for value can be truly effective, the firm must link employee and management compensation to the change in corporate value. Instead of paying bonuses or options based on improvements in revenue, profits, or even free cash flow, tie them to changes in corporate value.

Regardless of how often corporate value is measured, independent and objective experts should do the measuring. Yes, many CFOs (and even a few CEOs) understand corporate valuation and may even have experience doing them. But anyone's judgment is seriously impaired if they aren't completely independent of the firm. This includes management as well as investment bankers, business brokers, and others who, while perhaps quite prescient, may have a serious conflict of interest.

MANAGE WHAT YOU MEASURE

The world economy and its rules are changing profoundly and quickly in ways no one yet fully understands. For most firms, this means the old advantages of being private are quickly becoming liabilities unless the firm is managed for value. But you can manage only what is measured; everything else is wishful thinking. ■

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