Creating a valuable business

Hundreds of everyday actions affect the performance of your business, whether you are negotiating a sale, recruiting a new employee or complaining to a supplier. Much of the working day is spent reacting to circumstances, making small decisions that have a limited, short-term impact.

In contrast, creating a valuable business is about taking strategic decisions that have a lasting effect. Unsurprisingly, this is easier said than done. But for many directors, particularly those who own a share of the business, it must be the ultimate aim.

This briefing outlines:

- How growth and security contribute to a valuable business.
- The major opportunities for creating and increasing value.
- How to protect the value of your business.

1 What is value?

1.1 A valuable business typically offers **growth**, **profitability** and **security**.

- Growth and security are covered in **2** and **3**.

  Banks are more likely to support a business with a positive cashflow.

1.2 Creating a valuable business generally requires a medium or **long-term strategy**.

- In the short term, creating value usually requires investment.
- Short-term methods of increasing cashflow and profitability can reduce your potential for creating value in the long term.
- Long-term strategies are usually riskier. Their eventual outcome is more uncertain.
- If you plan to sell your business, the value will be higher if you can show a strong track record over time.

1.3 Different **stakeholders** may have conflicting objectives.

- Some shareholders value a business that offers high, secure and gradually increasing dividends.
- Other shareholders may accept more risk for higher growth potential.
- Directors and employees may have their own agendas (eg generous contracts, career opportunities or job security).
- The local community may value a business that is environmentally responsible, or

contributes to the community in some way.

Ideally, your strategy will take all these interests into account.

1.4 Your strategy will have a better chance of being successful if it includes **measurable objectives**.

- These are likely to include ways of measuring the overall value of the business (see box).
- Set intermediate targets for what you aim to achieve in different areas of the business (see **4** to **7**).
- Include realistic timescales for the completion of these objectives.

2 Growth

2.1 Operating in an expanding **market** makes it easier to grow your business.

- If you are operating in a market that is stagnant, or in decline, you may want to exit the business or merge with competitors.
  Larger companies are usually in a better position to exploit mature markets.
- It is difficult for a small business to create market growth.

Measuring value

A A traditional **valuation method** is to multiply sustainable earnings by a factor reflecting your growth prospects.

- There are also valuation methods based on assets and discounted cashflow.
- Particular industries have rules of thumb for measuring value (or potential value).
  For example, the amount of floor space a retail business has.

B The cost of **recreating** a business from scratch often provides a good indication of the value you have built up.

- This is particularly appropriate for young, growing businesses that are investing heavily to build future profits.
- The figure will be misleadingly optimistic if the investment does not turn out to be as worthwhile as you had hoped.
  For example, companies that 'buy' market share will not create value unless they can retain customers and make them profitable.

2.2 Create a business which can be **scaled up**.

For example, you might aim to:

- Expand into other geographical areas.
- Acquire smaller competitors.
- Franchise the business.

2.3 A **narrowly focused** business, which pursues its goals relentlessly, is the most likely to create outstanding value.

- However, it is also the type of business most at risk of failing.
  Diversifying into related products or businesses that suit your strengths can reduce this risk.
- Outsourcing non-core activities can improve your business' focus. But you risk losing control of them.

2.4 Strategic **alliances** can be an important source of growth, particularly if you do not have the resources to exploit your opportunities fully. For example:

- Working with a major distributor may be more effective than developing your own sales channels.
  Tying in key partners in this way also reduces the risk of losing business to competitors.
- You might want to involve a partner in exploiting your intellectual property — or you might want to sell the rights.

The key to growth is marketing (see **4**).

3 Security

3.1 Businesses that are relatively **stable** are usually considered more valuable.

- A business with volatile profits is less valuable than one with fairly predictable year-on-year increases.

3.2 **Assets** can be a significant element of security.

- Intellectual property can be an important element of value.
  This is particularly true in the IT industry, where ownership rights to software and products are a major issue.
- Freehold or long leasehold property can provide capital growth as well as security.
- Your customer mailing list may have significant value.

3.3 The value of assets needs to be **protected**.

“Pay attention to contractual matters. Business owners often regret not looking at the details of the contract early on.”
Brian Hayden, Hayden Associates

- Maintaining assets helps generate value, while failing to do so can destroy it.
- Intellectual property should be patented, copyrighted or trademarked.
  Trade marks can be an important part of your branding (see **4.2**).

3.4 The smaller the percentage of your business' value represented by assets, the greater the **risk**.

- All the intangible value needs to be protected.
  For example, in a 'knowledge' business whose value largely reflects the skills of its employees, the business risks losing value to the employees (see **5.4**).
- Protect your customer database and other key records by creating back-up copies and keeping them off-site or in a fire safe.
- Back up data on your IT system.

3.5 The ability to **anticipate** change is an important way of protecting value.

- Set up systems to monitor the business climate.
  You need to be aware of forthcoming political, economic, social and technical changes (eg changing customer needs).
- Systems that allow you to anticipate problems and plan ahead will help you create a strong, consistent track record.

Tying in value

A You may be able to make some of the intangible value of your business more **concrete**.

- One way of achieving this is by building a strong order book.
  Differential pricing techniques can help create advance sales.

B Use **contracts** to protect value.

- Employees' contracts can protect confidential trade secrets, and limit their ability to set up in competition with you.
- You can use long-term contracts to guarantee the supply and price of crucial materials.

C **Relationships** can be more powerful than contracts.

- A good working relationship is a better way of controlling an employee than resorting to contractual obligations.
- Good customer relationships can have a more enduring effect than any sale contract.

4 Marketing

4.1 Aim for market **leadership**.

- Greater market share can create a virtuous circle, with increasing turnover providing economies of scale and high visibility, making it easier to win more customers.
  It also makes it easier to attract and retain employees.
- No matter how small, any business has the potential to differentiate itself from its competitors and become the market leader in a defined niche.

4.2 Create a **brand** which captures the essence of your business.

What does your product or service offer that sets it apart from those of your competitors? This is your unique selling proposition (USP), and is the basis of successful branding.

- A brand helps you maintain the important ingredients of your business as you grow.
- A brand helps you interest existing customers in new products.
- A powerful brand can be extended as you diversify (eg Virgin).

4.3 You may be able to grow by changing your **market positioning**. For example:

- A hotel might grow by moving upmarket, gradually improving its facilities, standards and prices.
- A specialist engineering business might grow by moving downmarket, developing cheaper, mass-market versions of its market-leading products.

4.4 Above-average profitability and growth usually attracts fierce **competition**.

- Protect your market with strong customer relationships.
- Protect any intellectual property that helps you ward off competition.
- Use market research to keep in touch with your customers' needs.
- Continue to innovate and avoid any kind of complacency.

5 People

5.1 Make your firm an **attractive** place to work.

- Provide good working conditions.
- Offer competitive remuneration.

5.2 Strengthen your **personnel resources** through recruitment and training.
For example:

- Experienced directors who make creating value a priority.
- Managers with transferable skills to manage growth.
- Employees who help you achieve market-leading standards.

5.3 Make sure employees **want** to increase the value of the business.

- Communicate your strategy and get employees to buy in to it.
- Use incentive pay to align remuneration with creating value.

5.4 Set up systems to minimise the risk of employees '**owning**' value.

- For example, sales people may own customer relationships, expert employees may own important company skills and managers may own their entire team.
- You may want to include clauses in your employment contracts to prevent former staff from competing with you.
- Systems that make sure knowledge is shared, encourage teamwork, and make employees easy to replace are vital.

5.5 **Retain** key employees.

- The individuals who have created a valuable business will themselves be an important part of that value.
- Provide opportunities for career progression within the company.
- Allow them an appropriate share of the value they create.

6 Operations

6.1 **Invest** in your operations.

- You may need to invest in research and development for new products.
  You may qualify for a research grant or tax credits. Contact your local Business Link or other business support organisation.
- Outdated facilities and technologies will harm productivity.
  This hidden negative value can suddenly become apparent when a competitor overtakes you.

6.2 **Streamline** operations and create standard policies and procedures.

- Simple, smooth-running processes are easier to use as you grow.
- Continually having to make one-off, ad-hoc decisions limits your ability to grow.
  Firms with a strong owner-manager are particularly susceptible to this limitation.

6.3 Build **management information systems** to monitor the business.

- Identify weaknesses and risks, and take steps to protect yourself from them.

7 Financing

7.1 Ensure that you have adequate financial **resources**.

- Make sure that working capital limitations do not restrict your growth.

7.2 Build your **financial status**.

- Use the right mix of debt and equity to make the business creditworthy.
- Behave in a creditworthy fashion.
  Pay lenders and other creditors on time.
- Make sure investors and lenders are kept informed, and are given advance warning of any likely disappointments or problems.

7.3 Protect yourself with the right **borrowings**.
For example:

- Set up borrowing facilities in case of need.
- Borrow at fixed rates.

7.4 Work to minimise **debt**.

- Ensure that as a long-term strategy you strive to keep your costs down.

Expert contributors

Thanks to **Brian Hayden** (Hayden Associates, 07785 532 266).

Published by BHP Information Solutions Ltd, Althorp House, 4-6 Althorp Road, London SW17 7ED
Tel: 020 8672 6844, www.bhpinfosolutions.co.uk