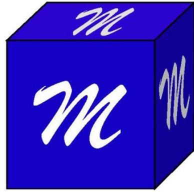

Middle Market Methods™ 2023: 1st Quarter

What is Value-Creation?

By

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Introduction

"We hold these truths to be self-evident . . . ." Thanks to history lessons in grade school, most of us may recognize this quote as lifted from the Declaration of Independence. Moreover, we are acculturated to know—or think we know—what it means. For better or worse, many words and phrases in the American lexicon enjoy analogous status.

In private equity circles, "value-creation" is a phrase which may be regarded as self-evident. However, Sir Arthur Conan Doyle reminds us through his novel character, Sherlock Holmes, that "there is nothing more deceptive than an obvious fact." Indeed, during a recent value-creation conversation with an equity sponsor client, I was asked for my definition of value-creation. Having read my book on the subject, he withdrew the question before I could answer and offered to just look it up. This left me curious about what definition I had penned several years prior. News flash! I had not defined value-creation. To my presumed reading audience of equity sponsors, the term was self-evident. However, my client reacquainted me with an aphorism: assume nothing!

I should know better. For over twenty years in what I call my second career, I have been a discrete interpreter/translator between portfolio company leadership teams and private equity deal teams. Both constituencies are sometimes unaware of discrepancies between their respective vernaculars. Investors steward the capital structure of the portfolio company business model. Operators steward the supply and value-chains which provide a return on invested capital. Alignment between and among those two parties is not self-evident. As leaders and change-agents, we have a duty to anchor all internal and external stakeholders of the business model in both (i) the necessity of value-creation as essential to business model vitality AND (ii) our respective accountabilities in creating value.

Keywords and their definitions matter to all business model stakeholders.

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Professional investors may read this article and think such points are obvious. However, I can speak from personal experience from both investor and operator roles that self-evident contextual understanding is problematic. Consequently, I am challenging all of us to engage in self-reflection for how we more effectively communicate with those who are NOT professional investors, BUT on whom we rely to create value.

Historical Perspective

My advent in private equity value-creation was concurrent with financial engineering yielding to operationally oriented value-creation. My initial curiosity was captivated by the post-close earnings J-curve (i.e., a common performance slump). I absorbed the conventional wisdom explanations, but the Six Sigma nerd in me wanted root cause verification. I relied on the Ishikawa diagram, a/k/a fishbone diagram, as a point of reference for its categorical utility. (See Figure 1.) Like a two-year-old, I kept asking "Why?" until something highly plausible was discovered. "Deal fatigue" was a material variable because all parties benefited by a post-close reprieve to decompress. Even so, three prime J-curve suspects emerged and remain ubiquitous relative to the lower middle market.

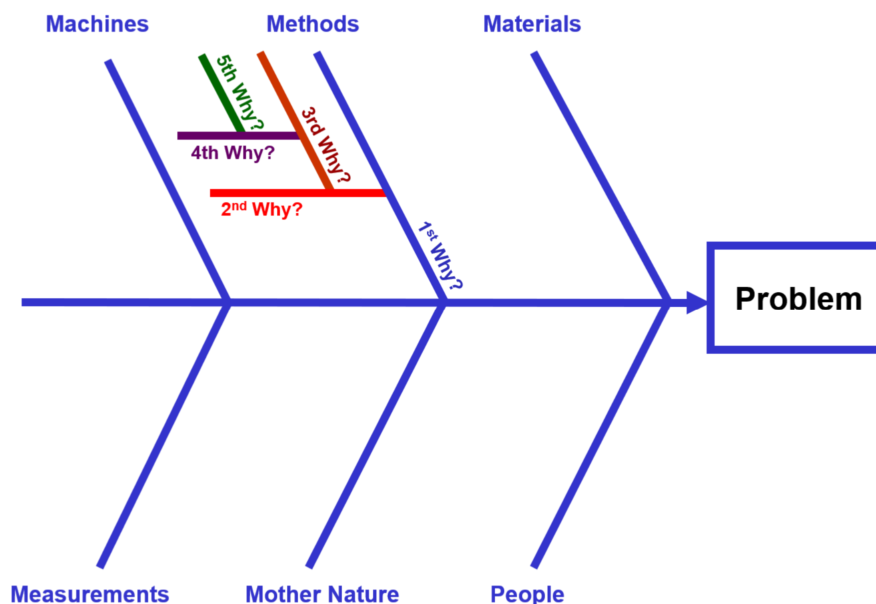

Figure 1: Fishbone Diagram

An intermediary is normally engaged to author the deal "book"—not the sellers who are busy running the business. Indeed, the logic makes practical sense that authorship and

promotion were delegated to an expert while the sellers wielded their core competencies to mind the store. Interestingly, the sellers may have described the business model in different terms, i.e., their dialect—not the language of professional investors. Another variable was understanding the sponsor's investment thesis. There tend to be two: a general one for the firm which doubles as a marketing channel elevator speech and a specific one relative to the individual prospect. The details of the latter evolve during letter of intent diligence but the buyer does not necessarily disclose everything learned prior to consummating the transaction.

The biggest of the three variables turned out to be unequivocal portfolio company leadership team ownership of the investment thesis during the hold period. This predominant point includes (i) the alignment of priorities between investors and operators, (ii) the resident technical skills to resolve the priorities, and/or (iii) the bandwidth to expeditiously execute atop daily accountabilities. To be clear, sellers rolling over capital into a minority stake is not a rock-solid hedge on this phenomenon.

The evolution of value-creation is anchored in deliberate, proactive priorities to create something customers want.

Collectively, this epiphany was the genesis of the M3 toolbox of growing pain solutions—plus a complementary network of value-creation practitioners whose expertise covers those things outside of M3's core competency strike zone. As Robert Earle Keene sings in one of his timeless tunes, "The road goes on forever and the party never ends!"

Enterprise Value

Value-creation is a perpetual process, but what is its objective? We should first consult our inner Simon Sinek and "start with why." The answer is enterprise value—what the market thinks a business is worth. Investopedia offers a simple equation as a point of reference for publicly traded companies:

$$EV = MC + TD - C$$

- EV: enterprise value
- MC: market capitalization (traded stock price times the number of outstanding shares)
- TD: sum of short-term and long-term liabilities
- C: cash and cash equivalents (perhaps excluding marketable securities)

The “market” is theoretically more objective than the individual because abundant information may at least partially diffuse inherent emotional bias. Allure is in the eyes of the beholder. Exhibit A for this phenomenon is the analogous original cost of celebrity palatial estates versus their selling price upon the decision to jettison the ballast.

A business model’s enterprise value is predominantly determined by its ability to generate earnings. Three general attributes loom large. One is resistance to degradation, i.e., defying atrophy. Another is sustainability to avert entropy, i.e., robust reliability over a protracted timeline. The third is trajectory, i.e., real growth relative to inflation and the industry vertical idiosyncrasies. Collectively, these communicate to the market not only a quantity of earnings, but also a quality of earnings. This is the de facto rationalization for the quality of earnings (“QoE”) diligence under the letter of intent.

Teams knowing why their organization must create value is the essential first step.

A reliable amount of earnings over time conveniently lends itself to an internal rate of return calculation. Reliable earnings make a company more valuable than its book value (i.e., net assets less liabilities). The language of public company valuations is the P/E multiple, the ratio of traded price of a share of stock divided by its earnings per share. The language of private markets is the EBITDA multiple, the value of cash flows. In a leveraged capital structure, EBITDA portends the ability to service debt.

Again, this is a remedial stroll for professional investors, but perhaps Greek to those creating the value. Exhibit B is the founder/owner of a small business who has never disclosed any company performance information to the employees. Now envision the town hall announcing the sale of the company to an equity sponsor. How often is the term “EBITDA” eschewed for lack of understanding? This is the buyer’s dilemma—not the portfolio company employees’ problem.

Value Creation: Two Perspectives

Assuming enterprise value to be the value-creation objective, the next question is “How is enterprise value created?” There are two perspectives from which this answer should be probed: customers and vendors. Let us tackle the customer perspective first. The rationale is simple: unless and until the customer perceives value, all vestiges of value-creations are more likely vulnerable to herd mentality than differentiation.

A company's unique value proposition explains why customers voluntarily exchange their cash for the purchase goods and services from vendors. Customers tend to be happy if the perceived utility of possession is worth at least as much as the cash surrendered for dominion of the purchase.

Customer decision drivers are rooted in four general categories: price, quality, timeliness, and service. Customers may want to start with price, but M3 strongly advises against this before probing the other three variables. The customers with whom we like to build our businesses understand that cost—not price—is the more appropriate focus. Poor quality, unreliable delivery, and deficient service increase effective cost, i.e., increase the "economic" price.

The value perceived by our customers reflects some blend of tangible and intangible characteristics. For example, the widgets which customers purchase from a vendor may be a subset of the cost of goods sold for what they offer their customers, e.g., a chip on a circuit board. To make economic profit, the customer must sell their wares for more than the materials, labor, and allocable overhead expenses necessary to create the widget. The COVID pandemic reminded customers about the intangible merits of having the item in their possession ahead of need, as is the case for "safety stock," to preclude supply chain disruption. Thus, there is an additional carrying cost of raw materials on hand when needed that must be reflected in the price. Conflict occurs when the customer will not voluntarily indulge that portion of expense in the purchase price. This conundrum presents a nice pivot to the vendor's perspective on value-creation.

Customers are the arbiters of value-creation; vendors must adjust to their specifications.

Whereas customers establish the price ceiling on vendor goods, the vendors must figure out how to manage cost within that limitation to earn "enough" profit. "Enough" is an important criterion because the vendor must at least break even to exist. However, vendor profitability must be sufficient to create a competitive return on investment to facilitate the attraction of both investor capital and serviceable debt in the capital structure. This algorithm gets interesting for vendors. The sales effort should leave no money on the table with the rational exception of sharpening one's pencil in exchange for larger orders. This is plausible because (i) acquisition cost for additional customer share of wallet is lower than "start from scratch" alternative sales, (ii) production scheduling may consume idle capacity, and (iii) sourcing leverage improves in the supply chain by bulk purchasing. M3 would be remiss in not highlighting the integrity of cost accounting as a vital ingredient in modeling the impact of price concessions relative to material variables like asset utilization and overhead absorption. Indeed, one of the best

practices M3 observed at trade shows was a vendor's financial planning and analysis person dynamically modeling such trade-offs to counter getting hotboxed by a shrewd purchasing agent.

Cost Drill-Down

Vendors have more "control" over cost than any other value-creation variable. The mortal enemy of cost is waste. Waste is rampant but wears many disguises. Let us examine three aliases, the first of which is process. Process regards the value-chain, or workflow, germane to creating a merchantable item. This may not be as simple as it sounds. An articulation of tasks takes on the attributes of quantity, chronology, and velocity. From advent to conclusion, there may be stage bottlenecks. Several questions must be asked in relief of these impediments. Among them are whether a task (i) is necessary, (ii) might benefit from different sequencing, (iii) should be augmented by incremental capacity, (iv) should be cushioned by "safety stock" to preclude downstream disruption, and/or (v) should be out-sourced to a vendor for whom the task is a comparative core competency with a favorable cost structure.

Labor is a second possible source of waste. Leaders often lament labor costs, but perhaps in overly simplistic terms. The rhetorical argument leaders should adopt is not what labor costs, per se, but rather what labor produces, i.e., productivity. This is a mouthful and includes both quality and quantity attributes. There are many possibilities for "excessive" labor cost. One traces back to the process argument in the previous paragraph. To wit, is a bad process wasting labor? Another is the instability of the labor force. Turnover may be much more expensive than we think. Beyond the obvious, the associated phenomena include the efficiency curve from onboarding new hires toward competency, through proficiency, and hopefully to sustainable excellence—and, of course, retention! The choreography of seasoned labor within lean processes correlates highly with productivity.

Vendors have many exploitable cost levers which may be unwittingly overlooked.

A final high-level variable is automation. Assuming the ideal process is implemented and the labor efficiency horizon has plateaued, the only remaining option may be automation. Indeed, this entails the disintermediation of labor. However, this does not necessarily mean the reduction of employees relative to the business model. The same amount of labor may be capable of stewarding larger quantities of production because they are productively symbiotic with automation.

The Concise Definition of Value-Creation

Readers may have pondered why value-creation has yet to be defined. This crescendo was deliberate. The resonance of the definition improves in context. Value must be created for customers before we derive value for ourselves. Value-creation is an evolutionary journey—not an accidental destination. Value-creation is an output, i.e., a dependent variable of many independent variables. ***Value-creation results from activities by which profitable revenue grows faster than the expense to produce it.*** Moreover, profit quality looms large, as well and the robustness of the business model delivering those profits.

Incremental revenue may emanate from multiple sources: (i) more of the same in existing or new markets, and/or (ii) new things to existing and/or new markets. Product innovation may be part of the profitable earnings. Cost reduction innovation is relevant to the entire value chain. Irrespective of the combination, the quest should focus on something differentiable which is validated by customers relative to their purchasing decision options.

Sustainable value-creation enhances enterprise value.

Differentiation should not be assumed. It should be verified. Sadly, a material portion of lower middle market businesses may not ask their customers (by a methodology which minimizes bias) what their customers value and what they do not value. M3 regularly asks clients to recite their unique value-proposition. My first observation is that the response is often word salad—a possible symptom that insufficient effort has been invested in honing this tool for marketing and sales endeavors. Subsequently, M3 routinely challenges the (purported) unique value-proposition with, “How do you know this to be true?” This is commonly one of those “moments of truth” whereby the leader realizes this may be his/her opinion—not something anchored in customer feedback.

A vendor may elect to reduce prices to capture market share from competitors, however, productivity facilitates doing this without margin degradation. The big take-away is that profitable sales result from providing something desired by the market via continuously refined productive processes.

Acknowledging a rhetorical paradox is necessary. EBITDA can retire debt and thus increase enterprise value absent revenue growth or productivity increases. Consequently, a static business model may be an annuity—albeit a less valuable one than a dynamic model depicted in the opening paragraph of this section. Borrowing from an Earnest Hemmingway novel, the enterprise value bell may toll for a lethargic business model by “punishing” the EBITDA exit multiple.

Value-Destruction

The value-creation discussion is incomplete unless value-destruction is acknowledged. The harmful shortcut answer is transforming all protagonistic axioms into antagonistic ones—but this is a deceptive oversimplification. There are numerous value-destroying carcinogens. Losing customer focus is atop the list. There is only one prophylactic: a routine cadence of voice of the customer feedback. We should be the first to know when our customers are unhappy. This at least gives us a head start on corrective and preventative action before competitors may successfully exploit our vulnerabilities.

There is a universal enabler of value-creation: culture. The entire business model is defined by the people who produce merchantable goods and services. The corporate esprit de corps—or lack thereof—is as self-evident as an insect resting on the tip of one's nose. We should not expect miracles from a workforce which (i) does not like what they are doing, (ii) does not like the team with whom they are doing it, and/or (iii) does not feel that their input matters. Revolutions have occurred in countries over analogous irritants.

BEWARE: Value may be destroyed more quickly than it may be created!

Especially in stressful times, leaders should routinely communicate market dynamics and company adjustments. In the absences of proactive messaging, leaders are vulnerable to misinformation and disinformation filling the void. Exhibit C is falsely connecting dots between increased loading dock traffic and company profitability (i.e., the grapevine rationalizes imminent wage increases). However, this "reasoning" may ignore actual margin erosion from increased raw materials and price concessions to keep a customer. In reality the scenario may be capturing share of wallet instead of outright losing a major customer which would catalyze layoffs. Facts and transparency provide good currency in employee relations.

During the COVID disruption, M3 anecdotally observed that business culture often became a casualty of survival. Moreover, M3 has noted scant evidence of cultural rejuvenation as the pandemic subsided. A recent Korn Ferry's "Briefings" acknowledged the conundrum and argued the need to "re-culture." M3 concurs. Culture matters more when one's ox is groaning in the ditch than when snorting triumphantly from the hilltop. Might cultural lethargy be one of the material variables for the sluggish post-COVID rebound in the labor participation rate? The U.S. Bureau of Labor Statistics reported that the civilian labor participation rate as of March 2023 was 62.6 percent, still below the February 2020 COVID plunge from 63.3 percent which bottomed out at 60.1 percent in April 2020.

Conclusion

This article endeavored to answer the “What?” question—a definition of value-creation. We started with a “Why?” because value-creation defines enterprise value. We next focused on “How?,” the relationship between profitable revenue growth and productivity which determine the quantity and quality of earnings. This is essentially the two hands clapping in that one without the other makes no discernable noise. By inference, “When?” is in perpetuity.

Portfolio company leaders are eternally obliged to explain these principles in understandable terms to their stakeholders—beginning with the teammates who create value. Professional investors should not assume that any of this is self-evident. Indeed, private equity professionals should recognize their obligation to explain salient principles in terms that resonate with those creating the value.

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Middle Market Methods™

Our firm offers a value-creation toolbox of growth, productivity, and cultural solutions to portfolio companies of private equity firms. The premise is that best practice adoption correlates with a smoother investment hold period, resulting in higher exit multiples. Consequently, deal team time is liberated from operational surprises to invest in new transactions.