

Marketplace Today

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Value Engineering

Numerous studies indicate that businesses, on average, change hands every 7-10 years. Practical experience and observation of many businesses over the years suggest another simple fact: *most businesses change hands when the owners least expect it?*

The reasons for unplanned change of control transactions are simple: owners die unexpectedly, become involved in divorces, simply grow tired or have a change of attitude, or receive an unexpected "offer they cannot refuse".

These two facts: 1) businesses do change hands periodically, and 2) a surprising number of the transactions, are relatively unplanned; lead to an inescapable object lesson for every business owner. The time to be concerned about the value of any business is now!

The board of directors, shareholders, and management need to focus on value from a longer-term perspective; call it: Value Engineering.

Value Engineering can be defined as the development of business strategies and tactics to maximize the value of business interests using the tools and knowledge gained in the valuation process. Value Engineering should be contrasted clearly with the traditional concept of "window dressing" a business immediately prior to sale. Window dressing involves tinkering with the balance sheet of a business in the short run; painting and fixing those things that make a first impression on potential buyers.

Value Engineering is a long-term, ongoing philosophy of operations designed to enhance and preserve value. Although it takes time and effort, the result will almost always be an easier sale at a better price *when* the shareholders are ready to sell or *when* the unexpected happens. "Timing is everything".

The techniques of Value Engineering are straightforward. Improve the fundamentals of the balance sheet and the income statement, and therefore, improve the basis for any potential sale.

In addition, Value Engineering continually builds on the important nonfinancial areas of a business that can directly influence value. Management depth should be created to minimize dependency on a key person.

Information systems should be built that gives the potential buyer (and current shareholders, managers and board members) confidence in the entity's financial and operational performance and trends. A solid business plan should be in place as a guide for future operations. Ownership should be simplified – that is, get the company's shares into the hands of those who share a common philosophy about the future of the organization.

The financial areas requiring work are more readily apparent. Improve the quality and quantity of earnings while building and maintaining a strong balance sheet to support future growth. The income statement can be improved in a variety of ways, including, potentially, raising prices if the competitive situation allows, reducing costs and improving operating efficiency. A business can continually work to improve margins overall, and to shift the mix of business toward more profitable lines.

Value Engineering includes the focus on improving the quality of a company's products or services, as well as service level with which those products or services are delivered. The Japanese word "Kaizen" means ongoing improvement, involving everyone in the business, including both management and workers. Value Engineering is not a Japanese concept, but there are similarities. Kaizen is a process-oriented way of thinking to develop strategies that assure continuing improvement at all levels in an organization. The messages of Kaizen and Value Engineering are clear: *not a day should go by without improvement somewhere in every company.*

For a conceptual overview of the basics of Value Engineering, there are two basic accounting and valuation equations:

$$\text{Earnings (E)} = \text{Total Revenues (TR)} - \text{Total Costs (TC)}$$

And

$$\text{Value (V)} = \text{Earnings (E)} \times \text{Multiple (M)}$$

If other things remain the same, the equations show that corporate Value is maximized when Earnings are optimal. If Earnings are optimal, Value is enhanced by those factors that increase the Multiple to be applied to Earnings.

It is easy to overlook the critical drivers of Earnings and Value amid the day-to-day pressures of running a company. This lack of focus results in lower values upon the ultimate sale of a business, which often occur as a result of unplanned events.

Given the first equation, basic math suggests that there are three ways to increase earnings: 1) increase revenues while holding costs constant; 2) decrease costs while holding revenues constant; and, 3) for even greater impact, increase revenues and decrease costs at the same time. All too often, companies sacrifice their cost structures for the sake of growth, and never realize the value-building goal of achieving and maintaining adequate profit margins.

The first part of Value Engineering focuses on taking those business actions that place revenues and costs and, therefore, Earnings into proper relationship with each other. In other words, Value Engineering seeks to maximize (or optimize) Earnings (E). This focus is not a one-time thing but a consistent, daily, weekly, monthly emphasis on building revenues and managing costs. Earnings can be measures in relationship to a company's own history, to its budget or business plan, to similar companies, and to its own unique potential. All these perspectives are helpful for the value engineer.

There is always a more efficient, effective, and profitable way to do what a business is currently doing. Often the consistent focus on improvement will lead to new and related opportunities to exploit a company's products, markets or other resources.

The second part of Value Engineering focuses on those factors that influence the Multiple (M) applied to Earnings (E). Many factors affecting the Multiple come under management's control. Other, such as required rates of return in alternative investments or external market conditions, do not.

From a Value Engineering standpoint, management should focus on "controllable" elements, including a company's profit margins, its historical growth record and outlook, the "quality" or replicability of the earnings stream (including concentrations of customers or suppliers), the quality and condition of the balance sheet, management capabilities (including "key person" characteristics and realistic succession plans), and other factors.

In general, valuation Multiples applied to privately held businesses are function of the specific *risks* applicable to the earnings stream (in relationship to alternative investment) and the outlook for continuing *growth* in earnings. Value is maximized over time by reducing risks and increasing growth. As with the continual focus on increasing Earnings noted above, Value Engineering involves a consistent focus on reducing the risks associated with a company's earnings while optimizing its growth potential.

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