GET READY FOR RISKS

Shannon Pratt's Business Valuation Update
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The year 1999 will be an interesting one for valuators. As we all know, the Chinese consider the saying "may you live in interesting times" to be a curse, and we may just be confronted with more than a fair share of "interesting times".....

A few issues ago, in Shannon Pratt's Business Valuation Update, I wrote about consulting with managements to increase shareholder value. Such advice would be incomplete, even irresponsible, if the negative side of the matter were overlooked: the risks businesses may have to face.

First, there is the impact of the consolidation of industry stimulated by the euro. While the year-end transition went quite smoothly, there are bound to be problems in further integrating eleven diverse economies along the way. Second, we have to cope with the aftermath of the Asian Flu, the so-called Asian Contagion, which means not only reduced purchasing power for Western goods and commodities in the Far East, leading to lower commodity prices worldwide, but also to the East's desperate attempts to survive by any means, particularly by undercutting Western producers.

There is the factor of Russia, whose economy was strangled last August - even financial wiz and stock market idol George Soros lost $2 billion there last summer. More disquieting, the former Soviet Republics may just hold the States and the rest of the Western world to ransom, like "bucks for bombs", perhaps even "bucks or bombs".... And, although there are few economic links, the Russian shock waves reached as far as Latin America.

Add to this the Year 2000 situation, which finally seems to be getting sufficient attention from the powers that be, including various governments trying to shed their long-practiced pachyderm behaviour pattern. Not even the most diligent adjusters to the "double zero" can be aware of all the surprises in store for us, but the innumerable hours spent working on the problem, taking time away from gainful undertakings, will certainly have an impact on the profitability of any business.

A combination of all those factors may pull the United States to-wards a recession. Although today's auspices are excellent, the world's most powerful nation may eventually be drawn towards the same fate already experienced by a large chunk of the globe. Even if this does not occur, eight years of an upswing make for a pretty long cycle, and external events can be expected to have an impact on the country's economy and hence company values.

For the next months, in preparing a valuation, not only should professionals include a scenario in their Financial Projections in which revenues and profits remain stagnant in 1999, but also pay attention to the "life boats" a company needs to preserve cash flow during a slow-down; those lower the risks and the Capitalization Rate. Without life boats, once a proprietor finds himself in a downturn spiral, it will be rather hard to get out.

As shown in the recessions of the early 80's and early 90's, the key to survival of an owner-operated business is adequate cash flow. A little stash of cash wouldn't do any harm either and might open the door to unforeseen opportunities. Without those two basic ingredients, many companies end up having very little value when a recession rolls around.

Some factors the valuator should consider:

Bank Relationships

Companies dealing with a local "country bank" may find that a year from now, that neighbourly financial institution may no longer be around. As the smaller banks have been notoriously lagging in preparing for the Millennium Bug, many will likely have been acquired by "United Behemoth Bancorp". Suddenly, local business owners may find themselves no longer dealing with Bill or Joe, whom they've known for years, but with a manager reporting to a distant city, with very little leeway to make decisions on his own. It will not be easy to build a close relationship with such a manager, resulting in having to pay a risk premium.

Most banks know that if their clients do not prosper, neither will they; therefore, unless there are major personality differences, they are usually quite willing to collaborate with management. However, this takes a bit of ground work, where a wise valuator can make himself indispensable - at least for the next few months. He must review the terms of any credit arrangements with the bank and confirm that the necessary security is in place so that help is available in times of stress. The valuator should also make certain that management regularly supplies adequate information to the bank, and that it is being properly acknowledged.

Pricing Policy

During the 1990s, many companies have lost "pricing power", as tough import competition has prevented price increases. In a recession, even current levels may not be sustainable. There-fore, a valuator should discuss with management the history of what happened during the past two recessions, particularly in regard to selling prices.

He must verify that, if prices or sales volume decline, the gross profit will still be sufficient to cover fixed costs. If this is not the case, discussions must determine management's strategies. Inquire if they have considered eliminating some lines with weak margins to free up cash. After all, in spite of emotional family ties, Ford did discontinue building the Edsel.

Overhead

As part of the financial statement analysis, the valuator should divide all costs into fixed and variable portions. With a high level of fixed costs, in a recession, profits will fall much faster than revenues. The valuator should therefore look at all expenses that do not adjust to output and suggest to management means of reducing them. For instance, if you have excess space, lease it; even if you get less than cost, it is still better than nothing. Outsourcing may be another approach.

Staffing

A phrase frequently repeated by management is that "people are our most important asset". And yet, when there are financial problems, an immediate reaction is to let employees go, temporarily or permanently. This not only can prove expensive, with severance pay and possible law suits, but it also effectively reduces a firm's "institutional memory" and has an impact on the corporate spirit - it can hardly be called Corporate Culture when looking at small and mid-sized firms.

Replacing such staffers by part time or contract workers, whose remuneration is based on output rather than time, may deal with some of the financial worries. However, it may also create an atmosphere of lingering uncertainty and mistrust, which can manifest itself in various ways. The pros and cons of such steps must therefore be carefully weighed and long-term effects considered. Geography is also important, as practices and reactions will differ in the sunbelt, in California or in Michigan.

I recently attended a seminar by a New York Stock Exchange listed company, the sixth largest of its kind in the US that specializes in acquiring service functions of companies and outsourcing the activity to them. The Executive Vice President stated that because of their volume and expertise, they could usually save a company up to 30% of previous costs.

Capital Expenditures

Many companies have been improving efficiency by substantial capital expenditures that allow significant increases in output from the existing labour force. However, the return on such expenditures often takes time to reach a satisfactory level. When a recession is possible, a valuator must be concerned that all planned capital expenditures produce quick returns in excess of their cost of capital.

The valuator should raise the question if plant expansions scheduled for 1999 could be temporarily put on hold and replaced by a second or third shift. To the extent that capital expenditures are essential, leasing instead of buying may minimize the short-term cash impact.

Inventories

While some industries moved to "just-in-time" deliveries, others remained with the more traditional approach, and there-fore may have excess inventories. The valuator should ask to what extent suppliers are willing to switch to smaller and more frequent deliveries to reduce the stock on hand.

The cost of carrying inventories is substantial, up to 20% a year, and slow moving or obsolete items can tie up a lot of cash. When valuing a company, I have often discovered that the most obvious solutions do not present themselves to the people who live with the situation day in, day out. When I point this out, as tactfully as possible, clients are at first perturbed, but a day or so later, they sheepishly agree that I've got something, and that for one brief moment in time, I know perhaps more about their company than they do. In the worst case scenario, at least I know to ask the questions they haven't asked themselves in years.

So, suggest that management sell off slow moving items at a discount, perhaps even get rid of older product lines whose gross profits are not sufficient to cover both their share of fixed costs and give adequate return on the capital invested.

Receivables

Every firm tries to maximize its "free" supplier credit, but customer credit limits are another very important "life boat". Establishing appropriate levels, and not increasing them unless payments are consistently up-to-date, is an important step management can take to conserve cash. A credit check on both, new customers, and on existing purchasers at least once a year, is essential. Those are quick, inexpensive and can prevent long overdue amounts raising doubts in your banker.

Traditionally, invoicing takes place at the end of the month; this is inefficient and can result in bloated receivables. Modern accounting systems can easily issue an invoice that is faxed to the customer at the same time the goods are shipped. This approach, coupled with monthly faxed statements and re-gular telephone calls to slow payers can free up significant amounts.

Collection Procedures

A valuator should examine credit and collection policies and make sure they are appropriate. The time it takes to get paid says something about management's abilities and priorities, which may have considerable impact on the bank manager. Cash receipts can often be improved by basing the sales force's earnings on gross profits, and disbursing commissions only after payment is made in full.

Factoring

The sale of Accounts Receivable is a trade financing approach well accepted in some industries and totally foreign to others. Most of the large factors have the systems and resources to accelerate collections, reduce the time devoted to credit management and achieve fewer bad debts, thereby improving their customers' cash flow.

Payables and Suppliers

Trade credit is an important source of funds for small businesses. Just as banking relationships must be polished before a possible recession to give reasonable assurances that adequate funds are available when required, so must supplier arrangements. As cash flow is more important than profits, better terms, rather than the lowest price, should be considered in the choice of vendor.

In valuing any business relying on one or two major suppliers, it is essential to determine the actual degree of dependence. Are alternatives available, and what impact would such a switch have on the business? If the firm is a major customer, substantial discounts for prompt payment may be available, or billing may be deferred for some shipments.

Administration

Inefficient administration can result in significant cash erosion, leading to a higher Capitalization Rate. Get friendly with the book keeper, get to know how he does things.

Sales & Marketing

Most sales organizations are oriented towards volume; sales-people want to meet, better still, beat their quotas by maximizing the orders, irrespective of profitability. As mentioned previously, basing commissions on gross profits and deferring payment until all the cash has been received can have a significant, favourable impact on cash flow. In a recession, some companies go further and reduce or eliminate commissions on low profit lines, shifting support and selling efforts to the more profitable ones.

Many of those twelve items were standard operating procedures when I started my accounting training in the late 1950s. In the heady enthusiasm of the last eight years, many valuators ignored problems below the surface of the companies they were appraising, and paid little attention to the details of operations beyond those reflected in the Financial Statements. In our view, in the testing times ahead, the due diligence approach set out here will be important to understand the risks in small or medium size businesses.

