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Boost your business's value

What to do—and what not to do—when you want to be worth a fortune

October 2012

A RoseRyan roundtable with:

Adrian Bray, founding partner, Assay

James Chapman, partner, Foley & Lardner LLP

Jim Goldhawk, senior consultant, RoseRyan

Tony Yeh, managing director, Strategic Advisory and Research Services, SVB Analytics

In an unpredictable economy, entrepreneurs have to be smarter than ever about how they build their businesses if they want to get maximum value from M&A deals or the public market. RoseRyan pulled together a roundtable of sharp Silicon Valley thinkers in key fields—accounting, investment analysis, business strategy, and law—and asked them what companies need to do now and as they grow to ensure all that hard work pays off. This report shares the highlights of that conversation.

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Some companies can score a high valuation in any economy. Our panel looks hard at some of their secrets.

If you survey the signposts, 2012 should have been a banner year for mergers and acquisitions. Corporate buyers were sitting on trillions of dollars in cash. Debt markets loosened up, giving private equity firms room to deal again. The economy improved, if more modestly than everyone would like. The European financial crisis led buyers worldwide to look to the U.S. for opportunities. Sovereign wealth funds and large corporations stockpiled masses of capital. And yet, M&A deal flow this year has been more a steady drip than a flood.

The reason? Lack of confidence. That was the conclusion of some of Silicon Valley's sharpest minds in finance, investment analysis, business strategy, and law, whom RoseRyan brought together in a roundtable conversation. We asked the group what companies could do to boost their valuations in such skeptical times (and by extension, anytime).

The short answer: plenty. Here are our experts' thoughts on talent, culture, product positioning, customer mix, business infrastructure, and more.

RoseRyan: If you're building a company, what are the factors you can start looking at within your business to bank against uncertainty?
Chapman: Right now, every entrepreneur's task is to build the best business they can under the circumstances and, for the most part, not spend a whole lot of time thinking about the macroeconomic situation. You can't control it; you can't even influence it. But there are things you can do to continue to improve your business and position for when we get a real turnaround.

Bray: The biggest danger to a lot of entrepreneurs is blind faith. I came across a wonderful company, but they are now two years out-of-date. Their technology is interesting, but the big players are already there. They were just too slow and they were blindly going along on the assumption that it would still work. You've got to go out and sell your technology.

Goldhawk: You need to focus on business planning—it's a useful tool to help guide rigorous strategic thinking. Also, defensible projections are necessary for investor pitches.

RoseRyan: What are some of the key components of valuation?
Yeh: The key is to get away from commoditization. Look at a firm like Dropbox, which lets you store your files online and access them anywhere. Then you have Microsoft coming out with SkyDrive—and there are other similar products—and something that was unique, first of its kind, quickly becomes commoditized. If you're

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Tony Yeh, managing director, Strategic Advisory and Research Services, SVB Analytics going to build, look at your business and figure out what part of it is a commodity and what part of it is proprietary. If it's proprietary, the second question you have to ask is, how high are your walls—your barriers to entry? If your walls are pretty low, guess what? The big guys are going to come after you. You may think you have a crack team of 14 people. Google can throw hundreds of people at the problem, and they can hire away your employees.

On one hand, if you have a good set of patents that protect your technology, and the key people who built it are actually the founders, your walls are going to be pretty darn high. On the other, if you're using programming talent from India or China, the idea or technology can usually be duplicated. If it's an extension of existing technology, I don't think the advantage will persist.

Bray: You actually have to be pretty ruthless in attracting the right talent and not accepting mediocre talent. As the market heats up, we'll see an inflow of people who are less qualified. If you're a growing company and you need people, you might be willing to accept the "wannabes." But to be on the leading edge, you've got to have the top people. And it's not just the talent you bring in, it's also the founding group—they've got to know when to get out the way of the commercial stuff, because sometimes they're really good product people but not necessarily as great at the commercial side.

Chapman: That's right, the team and the talent are one of the big drivers of value.

Yeh: At SVB, based on our research, we're starting to find that if you just look at the financial metrics, that doesn't tell the entire story. When we ask why certain firms are very successful while other firms in the same product area seem like they're half a year ahead but just don't make it, the financials don't explain that. So we've started to shift to more qualitative measures, like looking at the backgrounds of the entrepreneurs. Is this their first company? Is this their 20th company? What kind of successes have they had in the past? Did this team work together before? That's very important. A lot of times when you're developing new products, what breaks apart an initially very good team is a lack of trust. You have to look at all these soft factors.

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Goldhawk: When you're valuing a deal on the accounting side, after the actual close—during the "purchase price allocation," as it is known—accounting doesn't like to put a lot of value on the workforce. But it does like to put a value on what that workforce has already created. We're still allocating the value of intangible assets, but such qualitative measures might not necessarily follow directly from what the valuation experts are computing.

Bray: The challenge with a lot of strategic investment in the markets is that they're looking at the opportunity. What is the growth going to be? It's always six to 12 months out. That's why you have some sharp market corrections. If you look at the value of the business versus the balance sheet, it's roughly 80 percent on intangible assets. So it's an interesting dichotomy.

Goldhawk: Part of that disconnect can be the difference between historical-cost balance sheets and balance sheets at fair market value. You can fix historical cost to a particular date, but fair value generally is going to be more subjective. Other than that, I agree the change in value is reflected in the intangibles, including goodwill—the perceived value of the business.

Yeh: A really simple example is Apple's products. What is an iPod? It's an MP3 player. You go to Asia, and 8-gigabyte MP3 players are under about 20 bucks now. So how is it that Apple can sell an 8-gig MP3 player for over 100 dollars when Asian manufacturers can make money selling it for 20? The difference is the brand. You're not going to book that—it's not on the books.

Bray: Exactly, and that's why brand is near the top. Just pure brand alone—forget the scale—can easily double the multiple, whether the company is private or public.

RoseRyan: We've looked at employees and other internal factors, so let's look at some of the other aspects of valuation, like customers.

Chapman: If you're a company looking for venture capital, customer traction is critical and has been for a while. At the early stage, investors want market validation that there is someone out there who will buy the company's product. Then, if you have a diverse customer base, in terms of both the nature of the customers and the geography, that gives you more validation and reduces the risk for investors. By reducing the risks for investors, the company is making itself more attractive and valuable.

In the acquisition context, the customer base is also important, for a couple of reasons. First, customer concentration is really problematic. If you have two customers and they constitute 70 percent of your business, that's a problem because one could get bought or go bankrupt. If you're a company in that zone, you need to get out of there as fast as you can and diversify your customer base, even if it means a drop in revenue. The second reason is that when a large company is looking to buy a smaller company, it's going to analyze the customer base to determine what else can be sold to those customers. So a bigger, more diverse, higher-quality customer base really adds value in acquisition.

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>
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Yeh: The interesting thing in the social media market is, even if they're not paying, the very fact that you can attract a large number of users to your product line could be enough to make a firm very valuable, depending on the stage of the company. It's been proven that if that user base is big enough, you can always convert a portion of it into paying customers. Instagram is a classic example—no revenue, but it got a billion-dollar valuation.

RoseRyan: What are some of the other things that could make a non-revenue company valuable?
Chapman: The technology is a critical driver of value, including technology that is still in development or has been incorporated into a product or service. For example, in the life sciences industry, a company doing clinical trials for a new pharmaceutical, working through the FDA process, may have tremendous value even if it's at a pre-revenue stage. Other industries share this dynamic. A cleantech company that develops a scientific breakthrough in energy storage will have tremendous value—that could be the holy grail of clean technology.

Bray: And if you've got this breakthrough, an acquiring company may say, "It's going to cost half a billion to make that, but we will offer a billion, or $750 million, to make sure the deal goes through and to keep other buyers from the table." As the markets heat up, I think we're going to start seeing more of that.

RoseRyan: Let's move on to risk management. What aspects of that are going to boost your valuation?
Chapman: Essentially, risk management is the concept of looking at all the things that can go wrong and working to mitigate and/or manage those to the extent possible. From a legal standpoint, the better you manage the risk or mitigate potential risk—other things being equal—the more attractive an acquisition candidate you are, and the more attractive a candidate you are for financing.

Goldhawk: And this is very challenging for small companies.

Chapman: It's because in a small company, there's always a shortage of resources. The biggest challenge an entrepreneur faces is, "How do I allocate scarce resources among the many competing demands? Do I file patents and protect the company's intellectual property or do I hire more engineers or salespeople?"

Goldhawk: One of the areas that's frequently underinvested in is record keeping, and that can have a huge impact. Sometimes we find that there aren't well-documented contracts for arrangements with customers, vendors, or employees. It could be that some of your IP is being developed by an engineering vendor. If the underlying contracts aren't around, rights and obligations can become murky. Also, it's likely that any specialized GAAP hasn't been applied. As the number of arrangements grows, problems deepen pretty quickly.

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Yeh: We see this within SVB Analytics. Our valuation teams do a lot of 409As, and in order to do that we're talking to management. But we find, inordinately, that the entrepreneurs are so focused on product infrastructure, they tend to underinvest in the business infrastructure.

You go to any business school, and in Entrepreneurship 101 they hammer it into you that a product is not a business. Obviously, a lot of entrepreneurs didn't go to business school. So they're focused on the product infrastructure and they're really, really underspending on the business infrastructure, the contracts, the financial agreements. That's not what excites them, but underspending there is a huge risk because later on, when you go through the audits, when you're putting together your term sheets and prospective investors do their due diligence, there are a lot of gaps. You can't prove what you're saying exists.

Chapman: Some of the things that I typically see are cutting corners on legal compliance and a lack of investment in IP protection and building an IP portfolio.

Bray: That lack of investment can actually stop growth. We're hearing a lot of commentary at the moment that companies are not growing because either they've not cleaned up their business infrastructure or they've held back from investing in the infrastructure.

RoseRyan: What other things are undervalued?
Bray: The one that I think is most undervalued—because it's the most intangible and seen as the least manageable—is culture. If you start creating a toxic environment, that's a risk element—you're actually not managing the business.

Yeh: You have to honor your commitments. From a valuation standpoint, one of the key commitments to honor is your forecast. What is very disheartening for people who are doing the valuation, and more importantly for investors, is to give a forecast and then consistently underperform your forecast. That's really bad. You can talk pie in the sky, but make sure when you actually give the financial forecast, it's pretty close to what you can deliver. Better yet, be pretty sure you can beat it. When you give a forecast, you're more or less committed to it. A lot of times entrepreneurs don't understand that.

Chapman: CEOs and CFOs at publicly traded companies have learned that lesson the hard way. They know that if they don't hit a forecast, they get punished immediately and severely with a decrease in stock price.

Bray: It's actually a 20 percent penalty on the benchmark. The other penalty comes in if you're not meeting your numbers in comparison to companies that the market has deemed to be your peers. This whole thing of expectation setting and commitment is absolutely huge. It's another intangible, and it's very emotional. This is why—even with all the math—the markets are emotional, both public and private.

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— Adrian Bray

RoseRyan: So, is there a real formula that you can use to determine valuation? Is there some way you can develop a formula for your company?
Bray: Valuation is profit or revenue times a multiple. That's the agreed-upon formula. The challenge lies in all the definitions of profit. Certainly with your pre-revenue and the multiple, there is absolutely a formula in the markets. Each fund manager guards the secret sauce of their formulas because a fraction of a point is worth a lot of money to them. Ultimately, it all comes down to math. There's a lot of debate on what the

variables are, whether they're from an accounting calculation or whether they're from a strategic investment calculation.

Yeh: Everything breaks down to two pieces: the revenue or the sales figure—that's science. You know whether you produce or you don't. There's nothing to argue about there. Then there's the multiple, which is the value realization. What is somebody going to pay for that dollar produced? Is it 10 times, 20 times, 30 times, 100 times? That's where the art comes in.

RoseRyan: When you're looking at the multiple and you want to obviously raise it, are there any aspects of it that are more or less in a company's control?

Yeh: One of the things that investors will pay for is what I call "organic growth"—when you have a product that's so cool people buy it even if the economy is in the tank. A firm that produces products like that is the golden child of the VC industry. The other thing is how you're achieving your growth. Anybody can build up their growth by spending more than a dollar for a dollar of revenue. Look at Amazon back in '98, '99. They were giving away product, right? But they built the business up to a point at which they turned that off; they then had momentum.

So the issue going to the multiple is, if you're paying X for this type of revenue, how is that revenue being achieved? Is it through ramp or is it through momentum? If it's momentum, that's great because your spending actually may be flat or going down, but sales are exploding. Ramp requires that in order to maintain this growth rate, you've got to spend at least a dollar, maybe more than a dollar, to get the customers through the door. So even though you have two companies with the same growth rate, the one with momentum is going to be valued higher than the one depending on ramp.

Chapman: That's because their customer acquisition cost is going to be much less.

Bray: You can actually manage your multiple. The problem is most business schools don't teach you how to do that because it's actually not an MBA you need, it's a master's in finance. There is a balance to how you build the capacity of your business and how quickly you fill that capacity. But it's very, very hard to drive a multiple if you're in a commoditized market. So again, all investors are asking is, "Where's the growth?"

Chapman: Other factors, such as the particular market, play a role. For example, if you're in a large, growing market, your potential valuation is going to be higher. If you're in a large, declining market, or one of little or no growth, your valuation is going to be less because the opportunity is much less.

Yeh: That's a really good point. We shouldn't just hand-wave over this. If there's no growth or if your product is commoditized, then the fight is about getting your costs down, because the market is going to dictate what you can charge. On the other hand, if you're in a high-growth market, or you have a proprietary product, what you really want to do is to create walls and prevent other people from coming in. Google is a very good example. It wasn't the first in search, but it had a product that was a world-beater, and it just built up those walls through AdSense and other ways of locking in its clients.

Chapman: Oracle is another really good example. The switching costs for an enterprise software system are so high and so painful that once you're in with a customer, you're not going to get kicked out unless you do everything in your power to screw it up. When Tony's speaking about walls, that's what he's talking about. Those barriers to entry into your market or into your customer—the better you can build those, the more valuable you're going to be, the more long-term player you're going to be, the more you're going to grow.

RoseRyan: Are there any points in the growth cycle that are more precarious than others in terms of potentially seeing your value go down the tubes?

Chapman: Commoditization is one point. That's a danger for every company. Products can be commoditized so much faster than ever before—and that pace is accelerating. So you always have to avoid that, which means you need to be constantly innovating. The "valley of death" is another. This is the point after the first round of funding, usually the Series A round, when many companies can't get investment for the next round of funding. This is usually because the company didn't reach a milestone needed to convince investors that the company can be successful.

Bray: Actually, there are several periods. One is in the emerging growth period where they can't quite get customers' attention. They've got some customers, but they just can't get it going. Ultimately, that dings the valuation because investors are going, "Hmmm...they're too slow to market; they're too slow to get that product out."

Chapman: A company must get beyond the early adopters, and that's a key point.

Bray: The second period that we find is actually after some major success. After that success—and it can be a funding round, it can be a liquidity event, it can be rapid growth—the management team is unable to cope with the size of the business. That could mean everything from having a hard time running the business to not having enough drive toward the future of the business.

Yeh: It's a vision thing, isn't it? You have a great product and you're going to build a business. Once this product goes out, what's next? When you're early on, you have to show that this product works. Once you show that it works, you have to show what follows from that. If it's a platform play that you're trying to develop, then what other things can you sell or get other people to partner with you on? At the end of the day, regardless of whether you're early stage, midstage, growth stage, or late stage, where a lot of managers trip up is they have a great idea, they create a product from that, and that's it. It's like the Macarena, you know? What's next?

"Commoditization is a danger for every company, which means you need to be constantly innovating."

— *James Chapman*

RoseRyan: If there was one thing you could say to CEOs who are interested in or worried about their valuation, whether or not they have an exit strategy on the horizon, what would you tell them?

Chapman: I would tell them that every entrepreneur needs to take a regular period of time to step out of the business. Instead of working *in* the business, they need to work *on* the business—and in working *on* the business, they need to think about two major things. One is these various elements of value that we talked about, whether they be talent, customer traction, technology, or market opportunity. The other is they need to be thinking about their exit strategy very early on and design their company to build the value that maximizes that opportunity.

Bray: One thing is that the multiple is manageable; it just takes a very different approach to running your P&L. The second thing is we're in a particular period of the market cycle, and what I know is going to happen that will absolutely affect valuations is that there's going to be a flood of businesses that all put themselves up for sale as they see the market going into strong recovery and potentially into boom. That will actually drive the prices down because there will be a lot of businesses available.

Goldhawk: This discussion has clarified for me that while the finance side of the shop doesn't necessarily add directly to the valuation, it's key in defending the valuation. We talked earlier about companies tending to underinvest in business infrastructure—you have to be aware of that and you have to bring it to the table.

Chapman: Lawyers are in a similar position. Another way of saying it is, you're no longer overhead, you're an investment, right? You're an investment in the exit. If you start to look at it that way, the whole mindset changes.

Bray: Underinvesting in business infrastructure can actually damage the valuation, not just compromise your ability to defend it. If you've skimped on your business infrastructure, on your allocation of resources all the way through, then when there's a liquidity event or something else, there's a sting in the tail: the amount of management time and the cost to fix the business infrastructure can kill a deal.

Yeh: I agree that it behooves you from time to time to step away from your business. I would say, take a look at how the financial market is looking at your niche. Is it viewed as a niche that's growing? That's question number one. The second question is, will the market view you as the entity to extract value from that niche? That involves a lot of soul-searching because sometimes entrepreneurs, if they are true to themselves, will find that maybe they've got a me-too product, as opposed to being a unique player within that space.

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So that leads to the second part. You may think you have the greatest product in the world, but your customer will be the final arbiter of whether that product is great or not. One of the easiest walls to build around your product is actually going to your customers and asking them, "What is unique about my product?" Hopefully it's not, "You're cheap," because then you're competing on price. Hopefully, it's "We like the way it allows us to live our life," or something along those lines. That's what you want to focus on, because that is what you will be able to monetize, either now or at some point in the future.

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Adrian Bray is a founding partner of Assay, an international advisory firm specializing in increasing multiples beyond the benchmark by blending traditional investment banking with proprietary business processes. He has worked with businesses in all major industries, and has founded, built, and led his own businesses. Adrian also is a founding partner in Assay's sister business, Shirlaws, an international business consulting and coaching firm. Learn more about Assay at assayadvisory.com and assayip.com.

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