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Enterprise Value and Operational Excellence: A Reasonable Starting Point

A 'reliable, continuous and actionable measure of enterprise value' requires a generally accepted measure of both financial performance and operational excellence.

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Overview

The ‘fundamental responsibility’ of the CEO is to build enterprise value. To accomplish this, a CEO must have a ‘reliable, continuous and actionable measure of enterprise value.’ The public company CEO has such a measure, the publicly quoted stock price; the private company CEO does not. The lack of such a measure for 99% of the businesses in the US economy has created significant inefficiency in the capital markets.

Financial performance is a necessary part of determining enterprise value. However, a moment’s reflection reveals that past or current financial performance is useful in determining enterprise value only to the extent that it helps to predict future financial performance, because it is only the latter that determines enterprise value. When we consider things in this manner, it becomes clear that effectively measuring enterprise value requires data and information on both financial performance, and the ability of the enterprise to maintain or improve upon that performance in the future, that is, upon its operational capability. The lack of a ‘reliable measure’ of enterprise value is caused by an inability to measure ‘operational excellence’ with the same speed and confidence with which ‘profitability’ is measured.

Objectives

The first objective of this white paper is to present a reasonable and useful market-tested ‘framework’ to quantify operational excellence and its linkages to enterprise value. Then to show that it can act as a ‘generally accepted’ starting point upon which further efforts can build, thereby helping address the fundamental challenge of investing capital into privately held enterprises.

The second objective is to introduce the ‘CoreValue Rating’ as a ‘reliable quantifiable measure of operational excellence.’ Then to identify and define related vocabulary that can help clarify communication between professionals, business owners, CEOs and management teams as they discuss enterprise value and its operational linkages.

Summary

The Problem	There is no reliable, continuous and actionable measure of enterprise value, because there is no generally accepted measure of operational excellence.
Why it Matters	The impact can be seen in the excessive reliance on financial results that encourages public company short-termism, the high failure rate to transfer private companies, and the resulting economic dislocation and loss of jobs.
Solution	Businesses need both: (1) a reliable quantitative measure of past operational results, which exist today thanks to GAAP [1], and (2) a reliable quantitative measure of operational strength and capability.

Even though the problem is large, the solution is conceptually simple. Just as GAAP largely solved the problem of 'measuring financial performance' accurately, what is needed today is an equivalent generally accepted approach to 'measuring operational excellence'.

The Problem: Is easy to understand

"There is no reliable, continuous and actionable measure of enterprise value, because there is no generally accepted measure of operational excellence."

The marketplace has only half the information required to measure enterprise value effectively. Financial results, though measured accurately, only provide half the story. They measure past operational results, while enterprise value depends on future operational results. Thus, a reliable and useful measure of 'enterprise value' requires a second measure, the ability to deliver future profitability.

Enterprise value requires both that past 'profits' remain 'sustainable' into the future and that the profit potential be 'transferable' to a new owner. Thus, the equation for enterprise value: Enterprise Value = Profit that is both Sustainable and Transferable.

Value Equation: $EV = P\,(S*T)$

If you think of a business as an engine, the output of the engine, its 'operational performance,' is measured by its financial results. The key measure is Profit (P). Thanks to GAAP, and a regulated industry of accountants, we can confidently rely on the financial reporting of the business. The marketplace has a clear and reliable view of the past. However, the value of the engine – its enterprise value – is based on ability of that engine to generate future profit for present and future owners, thus the need for more information, and the second half of the equation.

'Operational Excellence' is understood as the foundation of a valuable business. For the public company there is an army of analysts, an entire industry, formed to examine and review details underlying operations and the market they serve. These analysts report continuously to the owners and the public providing an assessment of the future of the company. The CEO of a public company is both blessed and cursed with this system. They are blessed as it provides the benefit of a continuous measure of enterprise value and access to capital. But they are cursed, as the analyst has no generally agreed to framework of operational strengths and weaknesses with which to communicate. The lack of framework opens the door to a continuous stream of information flowing to the public that has little or no context, unlike the financial information, which is grounded in GAAP and a framework of financial statements. The system functions imperfectly, but it does at least function.

For the private company however there is neither an industry of analysts nor a framework. Today there is no standard method by which a private company CEO or owner can know their enterprise value on a daily, monthly or even quarterly basis. There are numerous approaches for understanding value based on financial results, but they all suffer the same challenge of being backward looking, based on past results. Thus, the lack of an effective measure of 'Operational Excellence' creates an even more acute problem in the private company market. The measure of success for the CEO and the owners is enterprise value, and yet, there is no effective way to measure it.

Today the only generally accepted solution for understanding operational excellence in a private business is due diligence. When a private business has a bona fide offer, the buying party undertakes due diligence looking deeply into the business on the operational side. This process can take weeks to months, and the quality of the effort is based solely on the individual doing the work. There are no standards with which to review the business, but there is a process, and in this process lay the seeds to a solution. The due diligence process is normally undertaken only once in the owners tenure, and on it rides the success of the CEO's efforts and the value of the business.

For the private company CEO it is a bit like playing an entire football game where the rules are not fully understood, by either team, and the scoreboard is hidden. You only learn the results after the game is over and the score unveiled. Private business CEOs and owners, and we might argue all CEOs and owners, suffer from a lack of a rule book on Operational Excellence, and a reliable 'scoreboard' on Enterprise Value.

Why it Matters: Inefficient capital markets impact everyone

> ***"The impact can be seen in the excessive reliance on financial results that encourages public company short-termism, and the high failure rate to transfer private companies, and the resulting economic dislocation and loss of jobs."***

For public companies the lack of quantifiable operational measures manifests itself in a marketplace relying heavily on short-term, mostly quarterly, financial results; and "As a result, companies are less able to invest and build value for the long term ..." The problem was well described recently in the Harvard Business Review:

> Since the 2008 financial crisis and the onset of the Great Recession, a growing chorus of voices has urged the United States and other economies to move away from their focus on 'quarterly capitalism' and toward a true long-term mind-set. This topic is routinely on the meeting agendas of the OECD, the World Economic Forum, the G30, and other international bodies. A host of solutions have been offered – from "shared value" to "sustainable capitalism" – that spell our in detail the societal benefits of such a shift in the way corporate executives lead and invest. Yet despite this proliferation of thoughtful frameworks, the shadow of short-termism has continued to advance – and the situation may actually be getting worse. As a result, companies are less able to invest and build value for the long term, undermining broad economic growth and lowering returns on investment for savers.
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> ***The Big Idea: Focusing Capital on the Long Term***
> *Harvard Business Review*
> *January-February 2014*

Thoughtful evaluations and frameworks are helpful, but words without numbers that tie directly to business performance are not concrete enough to enable the needed change. Without a new set of operational metrics based upon a quantitative framework there is little hope of real change.

For private companies it is much worse as there are no analysts working to help understand and report on the links between past financial results and enterprise value. They have access to accountants, consultants and advisors, all skilled at their professions, but all working in semi-isolation to solve the enterprise value puzzle. As previously discussed in a whitepaper, titled "**Transferable Enterprise Value**; The Importance of Quantifying Intangible Value Drivers in Small to Medium Size Enterprises (SMEs)," [2] the number of private businesses that do not or cannot sell or transfer is quite staggering.

SME Ownership Demographics and Transfer Issues

Exact figures vary, but ownership of privately held SMEs is concentrated in the hands of a generation approaching retirement. In 2010, 70% of U.S. firms with paid employees were owned by baby boomers. In 2020, the youngest baby boomers will turn 55 and more than half will be 65 or over. It is projected that in 2020 70% of U.S. firms with paid employees will be in the hands of owners 55 years or older.

Private Business Ownership

Despite being close to retirement, many of these owner/operators do not have a plan for the transfer of ownership. A 2008 survey reports that 96% of Baby Boomer business owners agreed that having an exit and succession strategy is important for their future as well as the future of their business, yet 87% did not have a documented exit plan. This lack of planning further complicates ownership transfer. It is estimated that at any one time 20% of businesses are for sale. It is also estimated of those businesses put on the market with less than $50m in revenue, 80% do not sell; of those businesses over $50m in revenue, 65% do not sell.

Transferable Enterprise Value; The Importance of Quantifying Intangible Value Drivers in Small to Medium Size Enterprises (SMEs) (2)
CoreValue Software, January 2013

The impact of this lack of transferability on our economy is now starting to be felt, and this inability to transfer enterprises to new owners is rooted in the same fundamental problem: the inability to communicate the future prospects of the business.

As stated above, private companies, like public companies, do have access to an industry of accountants versed in GAAP and therefor fully capable of producing audited financial statements that assure accurate reporting of past operational results. This is critical information for any transfer, but it only documents past events. Buyers, investors and capital providers are looking to the future for their return. They need to understand the risk of the investment. They need to be assured that the business will deliver the future operational results needed to provide a return on their capital. Without some kind of reliable operational measures and metrics this becomes a difficult task.

The degree of difficulty in assessing operations is made even harder as there are no benchmarks, no data points, and no ability to easily compare businesses with their peers. This creates a situation in which legions of investment banking and other professionals are working hard to understand businesses and communicate what they have learned, but in the absence of a common language, the consequence is frustration and waste at many levels, and ultimately market inefficiency that threatens our economy.

Solution: Following the financial roadmap

> ***"Businesses need both: (1) a reliable quantitative measure of past operational results, which exist today thanks to GAAP, and (2) a reliable quantitative measure of operational strength and capability."***

The challenge is easy to understand. If Profit (P) is the first half of the Value Equation, and Sustainability and Transferability (S*T) the second half of the equation, then we must measure (S*T), the business' ability to reliably generate future profitability.

The US economy has faced this problem before, and it sounds incredible now, but before GAAP, before the 1930's, there was no reliable measure of profit. The markets, investors and capital providers all faced significant challenges making sense of and investing in a business without reliable financial statements. The Market Crash of 1929 changed all that:

> Following the stock market crash of 1929, an American Institute of Accountants' (AIA) special committee, in correspondence with the New York Stock Exchange, recommends five "broad principles of accounting which have won fairly general acceptance" and introduces the phrase "[the financial statements] fairly present, in accordance with accepted principles of accounting consistently maintained" in the auditor's report. These five broad principles, along with a sixth, are approved by the AIA membership. The purpose is to improve accounting practice.
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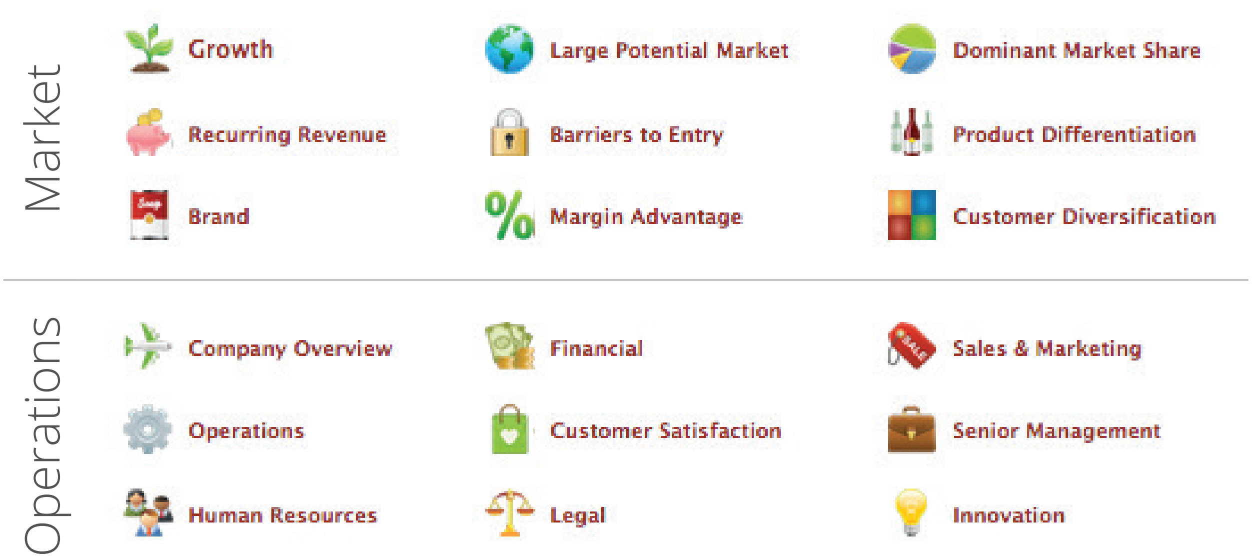
> Within quite wide limits, it is relatively unimportant to the investor what precise rules or conventions are adopted by a corporation in reporting its earnings if he knows what method is being followed and is assured that it is followed consistently from year to year. (3)

The financial world created a roadmap for accessing reliable information. To solve the second half of the equation we must follow that same path. The marketplace needs a structured approach for communicating operational realities that includes a generally accepted set of standards, a framework and a shared vocabulary. It is important to note that, "Within quite wide limits, it is relatively unimportant to the investor what precise rules or conventions are adopted ... if he knows what method is being followed and is assured that it is followed consistently from year to year." Thus the need today is not perfection, but for a 'generally accepted' set of standards and framework – a starting point, a foundation upon which the market can build.

The financial world was looking for a way to reliably measure financial results. To be useful for the 'Value' equation that means finding a reliable measure of 'Profit'. That single number, reliably produced, enables all to know and understand how much the business produced over the past period. On the operating side we need the twin of 'Profit', the single measure that sums up the ability of the business to produce future profit. That single number is the 'CoreValue' of the business, a measure of operating excellence.

Financial reporting is based on GAAP. The standards create a foundation from which to build reliability. The standards do not directly quantify, they enable the reliable quantification of past financial results. In a similar fashion on the operating side of the equation a set of 'Private Business Standards' is needed to enable reliable quantification. Like GAAP they are not meant to quantify directly, they simply enable the creation of a framework from which to quantify.

A set of 'Private Business Standards' (PBS) [4] was pioneered over a decade ago to create such a foundation. It was based on the attributes of a well-run private business irrespective of industry. It was a body of research that included literature reviews, reviews of due diligence practices, processes and systems, as well as work with industry experts and academics. Out of those Standards emerged a framework of '18 Value Drivers' that enabled the measurement of operational excellence. Excellence defined as the ability of the business to deliver future profit at or above the past rate, without the existing owners.



The framework of '18 Value Drivers' covers all aspects of the operational side of the business. Half the value drivers are 'Market' based, that is value drivers external to the business. The second half are 'Operations' based, that is value drivers internal to the business. The combination of internal and external drivers provides a complete view of the environment in which the business and its people operate. This framework has been repeatedly tested for completeness in the market over the last decade by thousands of CEOs, owners, professionals and academics, and has been widely accepted.

Using this framework the 'CoreValue' of the business can be reliably measured. This quantifiable measure is the CoreValue Rating (CV), that is the CoreValue Rating equals Sustainability and Transferability. (S*T) A strong and reliable business has a high score, a weak and unreliable business a lower score. The CoreValue rating is easily understood and communicated as it is a single number like profit, and because it is based on a structure similar to finance, it is reliable.

CoreValue: CV = S*T

We can now solve the equation for enterprise value reliably, and it becomes even more useful as both the financial and the operational structures enable continuous measurement and depth. Profit is the tip of the financial information iceberg. Underlying that single number is the backup and information contained in the income statement and related documentation. CoreValue is also the tip of an information iceberg. Underlying that single number is the complete backup and information contained in the Market and Operation Drivers. The ability to drill down on either side of the equation makes it actionable.

The 'fundamental responsibility' of the CEO is to build enterprise value. To accomplish this a CEO must have a 'reliable, continuous and actionable measure of enterprise value,' which in turn requires generally accepted measures of both financial performance and operational excellence. With GAAP and PBS the markets have the foundation. With the three financial statements and the 18 value drivers the markets have the frameworks. Individuals in the markets will be able to communicate effectively, and with just two measures, Profit and CoreValue, there will be a 'reliable, continuous and actionable measure of enterprise value' by which to judge business success.

The Road Ahead: A reasonable starting point

For centuries sea captains navigated using only the sun and the stars. They explored the oceans, found new worlds, transported people and delivered cargo, all the time knowing they did not in fact know their true location. They traveled the oceans knowing just latitude, but not longitude. Their professional responsibility was to deliver the ship, crew, passengers and cargo safely to the next port of call, and they had only half the information to accurately navigate. It was a centuries old problem that vexed the maritime world until, 'a practical solution came from a simple carpenter, John Harrison, who solved one of the most difficult problems of his time by creating an accurate chronometer'. The ability to keep time accurately enabled mariners to measure longitude, and once they had the second measure, the world changed.

Knowing both longitude and latitude, navigation became more precise, making ocean voyages safer, trading routes shorter and charts more accurate. Navigation continues to evolve with the latest GPS technology making life simpler, safer and better, and all made possible by the availability of the two sides of the navigation equation.

For decades business leaders managed by the financials, opening new markets and building companies, all the time fully aware there was a disconnect between the financial results and their ability to communicate the value of operational decisions. Their fiduciary responsibility was building enterprise value for the benefit of all stakeholders, and they only had half the information. Today we have the opportunity to access both halves of the value equation. We have the opportunity to bring greater information and precision to business leaders and the marketplace.

The benefit of having both financial and operational measures is clear. It is easy to imagine the evolution of management as markets adopt the second half of the equation. It is easy to imagine how technology and research can increase our understanding. So how do we move forward? A reasonable starting place is to first acknowledge the need for and logic of the enterprise value equation. Then to follow the financial roadmap by creating a Blue Ribbon Group to review the existing Private Business Standards and the 18 Value Driver framework for completeness.

End Notes

(1) "The term generally accepted accounting principles (GAAP) has a specific meaning for accountants and auditors. The American Institute of Certified Public Accountants (AICPA) Code of Professional Conduct prohibits members from expressing an opinion or stating affirmatively that financial statements or other financial data "present fairly...in conformity with generally accepted accounting principles," if such information contains any departures from accounting principles promulgated by a body designated by the AICPA Council to establish such principles." Federal Accounting Standards Advisory Board

(2) Transferable Enterprise Value: The Importance of Quantifying Intangible Value Drivers in Small to Medium Size Enterprises (SMEs); Ralph Bradburd, PhD, David A. Wells Professor of Political Economy, Williams College; Chuck Richards, CEO Chairman's View, Inc. January 2013

(3) The CPA Journal Online; The Evolution of U.S. GAAP: The Political Forces Behind Professional Standards, January 2005, Stephen A. Zeff

(4) Private Business Standards; copyright Chairman's View, Inc., 2009

(5) Longitude: The True Story of a Lone Genius Who Solved the Greatest Scientific Problem of His Time, Dava Sobel, Walker & Company, 2007

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