

Building Shareholder Value In Closely-Held Businesses

CEO Roundtable

June 16, 2005

Agenda

- Shareholder Value In Perspective
- Managing Value Drivers
- Case Study
- Recommendations
- Comments and Q&A

What Public Companies Focus On

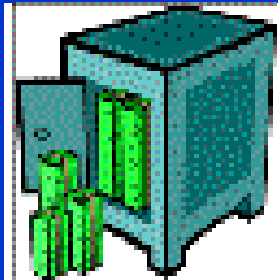
Increasing Shareholder Value!!



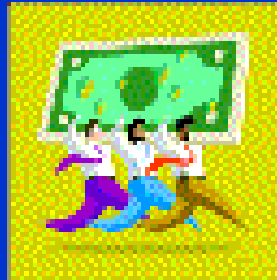
“The ultimate test of corporate strategy, the only reliable measure, is whether it creates economic value for shareholders.”

Creating Shareholder Value by Alfred Rappaport, 1998

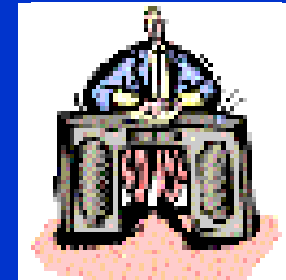
What Private Companies Focus On



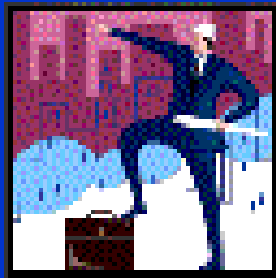
Creating Wealth



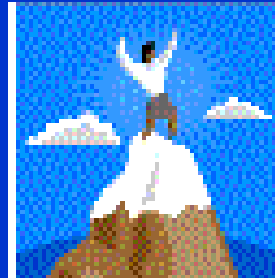
Maximizing Income



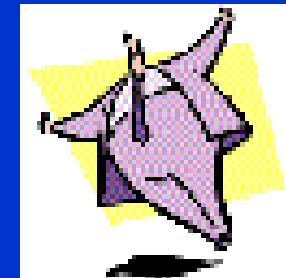
Being the Boss/Control



Building Something



Winning



Having Fun

Why the Difference?

*Private Company Perspective **

- Competing personal objectives
- Weak corporate governance
- Valuing a privately-held company is difficult and there is no frequent independent scorecard

* Excluding venture capital backed companies.

Upshot for Private Companies

- Understand how competing objectives distract or conflict with building shareholder value
- Implement strong corporate governance to monitor performance and provide direction
 - Independent boards and committees
 - Frequent reporting
- Establish process for valuing the company on an annual basis

How to Measure Value?

Definition: The value of an ownership interest in a company is equal to the present value of the future benefits of ownership.

Financial Components:

- Free Cash Flow (FCF) = cash available to be distributed to the owners after reinvestment in the business
- Risk = likelihood of FCF materializing, indicated by the discount rate

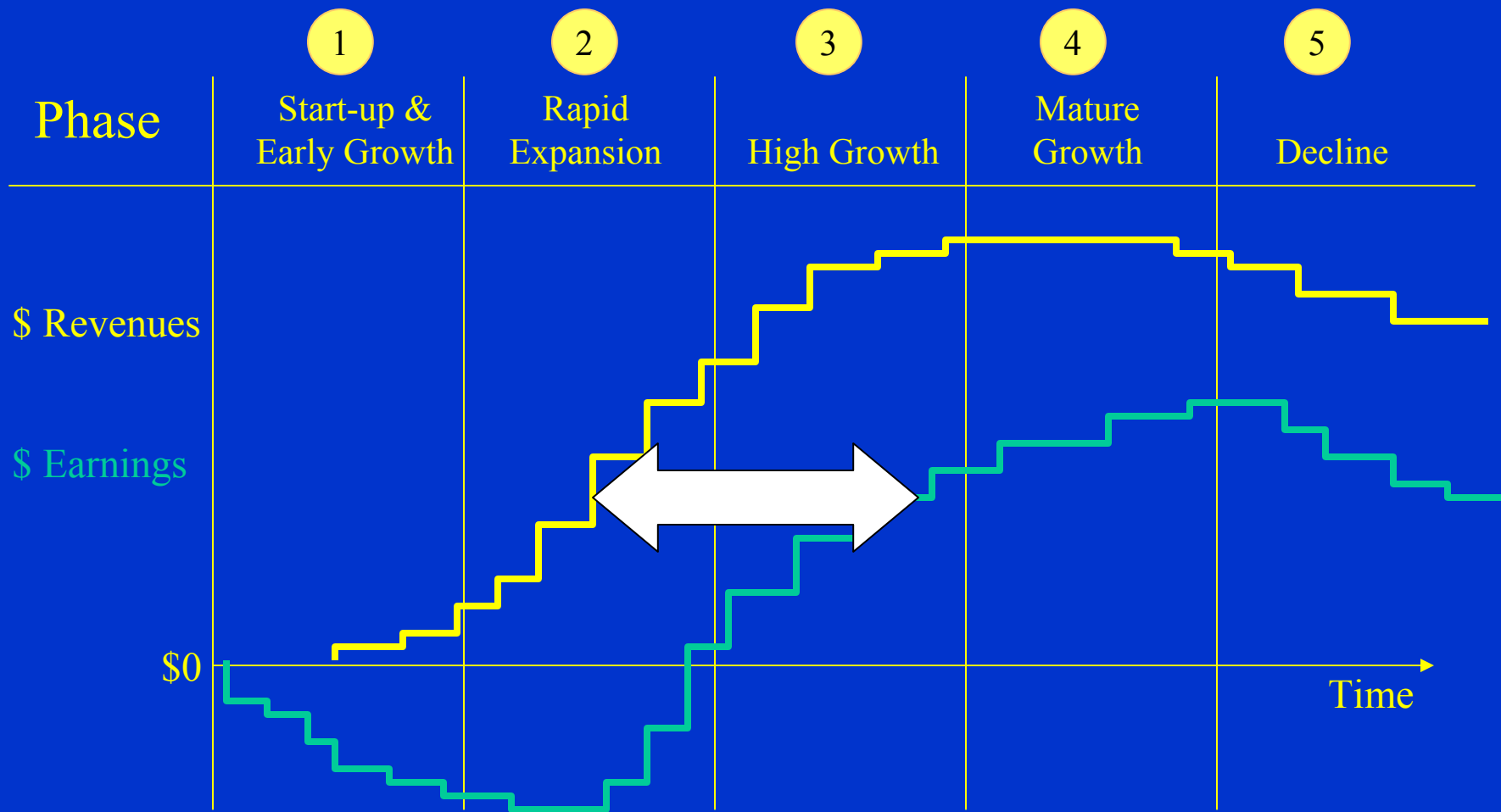
$$\text{Value} = \frac{\text{FCF}^1}{1/(1-\text{DR})^1} + \frac{\text{FCF}^2}{1/(1-\text{DR})^2} + \frac{\text{FCF}^3}{1/(1-\text{DR})^3} + \frac{\text{FCF}^n}{1/(1-\text{DR})^n}$$

Impact of Risk on Present Value

Present value of \$1.00 of cash flow in year 5:

Company	Discount Rate	Cash Flow	Present Value
Low Risk	10%	\$1.00	\$0.59
High Risk	20%	\$1.00	\$0.33

Value Life Cycle



Financial vs. Strategic Value

- Financial value is the price a buyer is willing to pay based mainly on financial returns.
- Strategic value is the price a buyer is willing to pay because of unique synergies between the two companies.
 - ✓ Customer base
 - ✓ Patents and IP
 - ✓ Distribution channel
 - ✓ Geographic market
 - ✓ Product add-ons
 - ✓ Key employees
 - ✓ Manufacturing capability
 - ✓ Brand name or goodwill

Notable Strategic Deals

Buyer	Seller	Strategic Value	Purchase Price
J&J	Link Spine Group	Artificial Lumbar Disc	\$600 million (200x revenue)
UPS	Mail Boxes, Etc.	4,300 Retail Outlets	\$185 million (2.3x revenue)
Cingular	AT&T Wireless	# 5 Cellular Network	\$41 billion (2.6x revenue)

Using Value Drivers: A Planning Tool

What is a “Value Driver”?

A factor in the business that:

- has a large impact on value and
- can be managed.

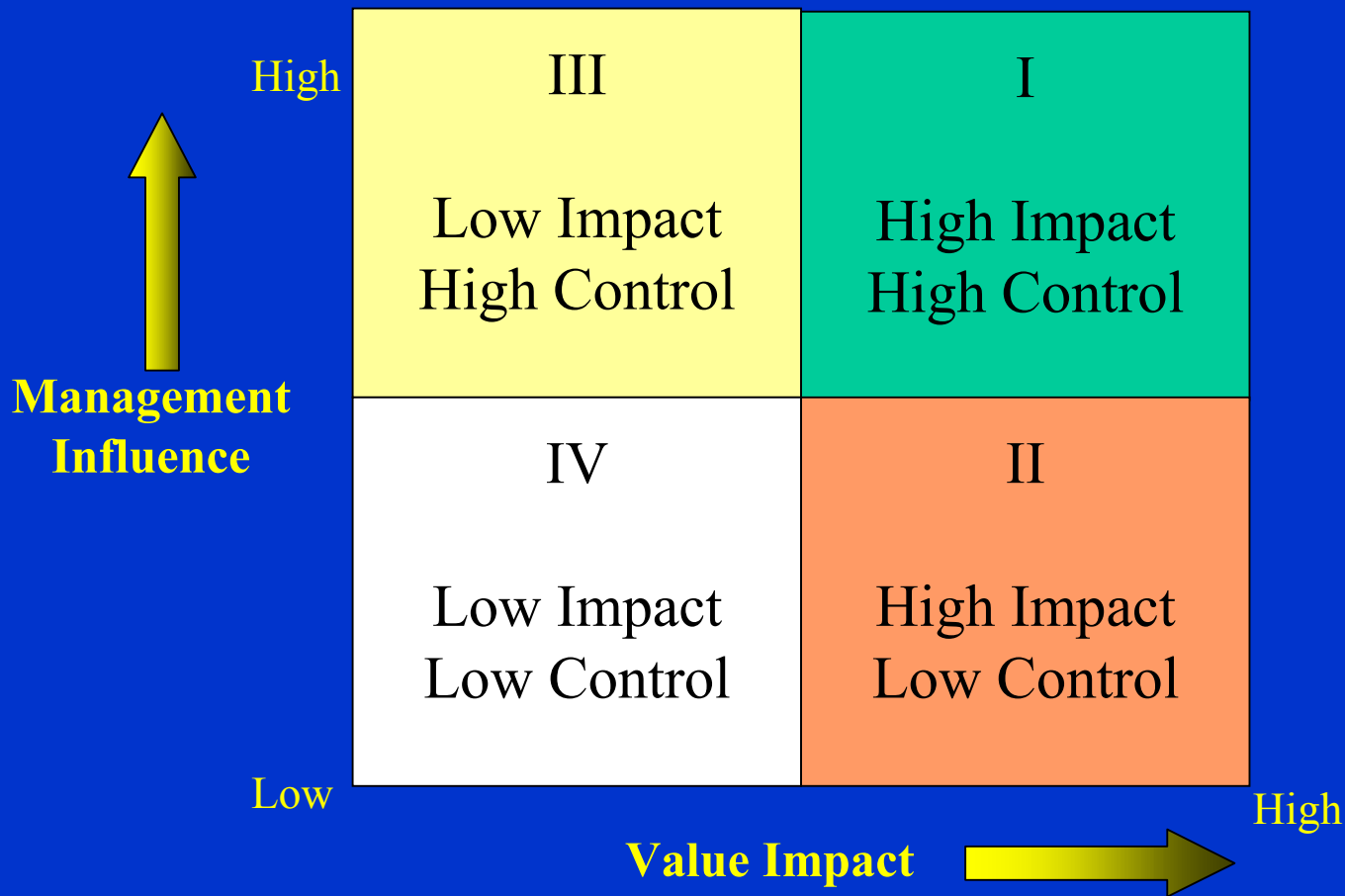
Why focus on value drivers?

Prioritizes commitment of resources on factors that build shareholder value.

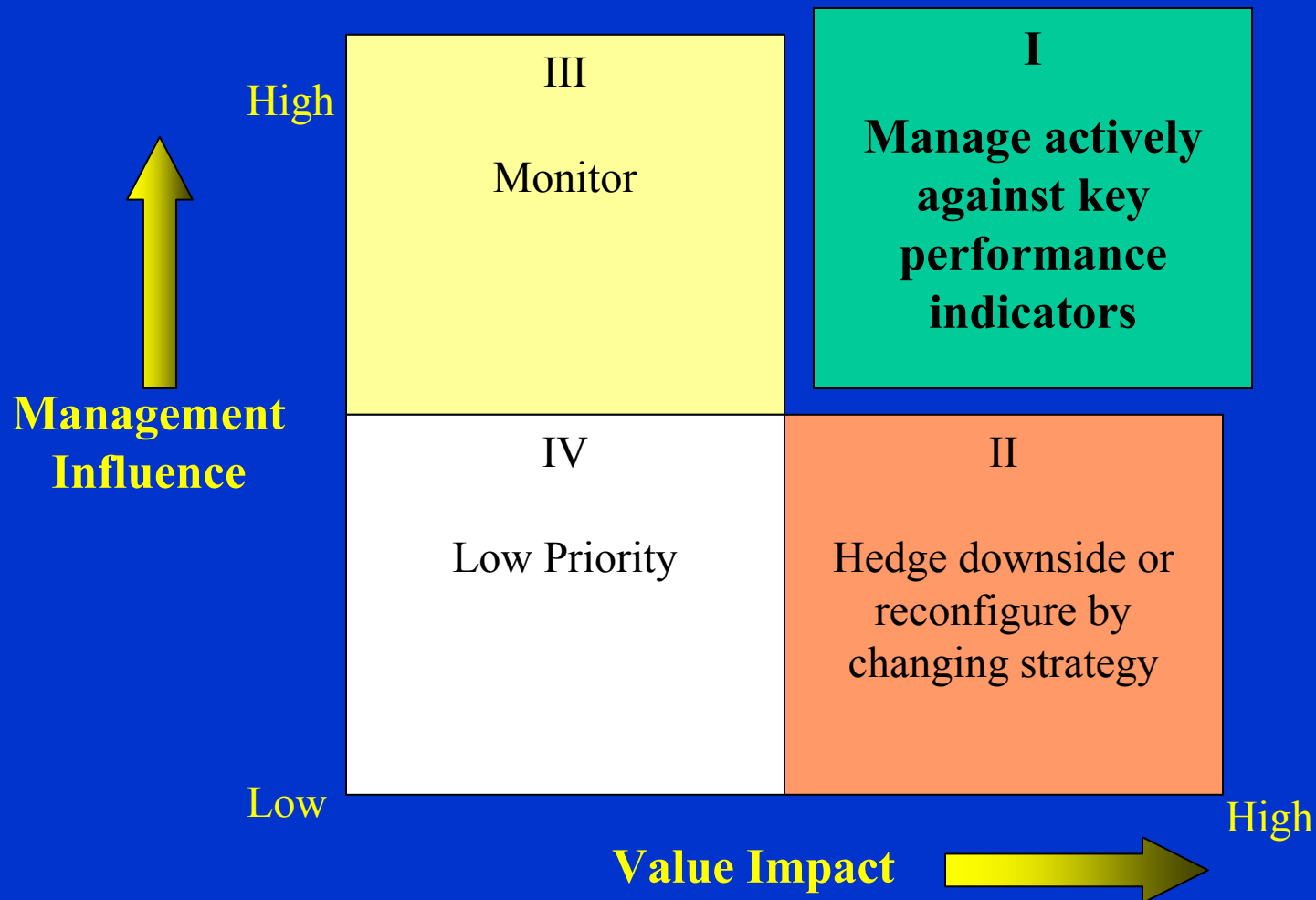


Avoids spending valuable resources on factors that don't.

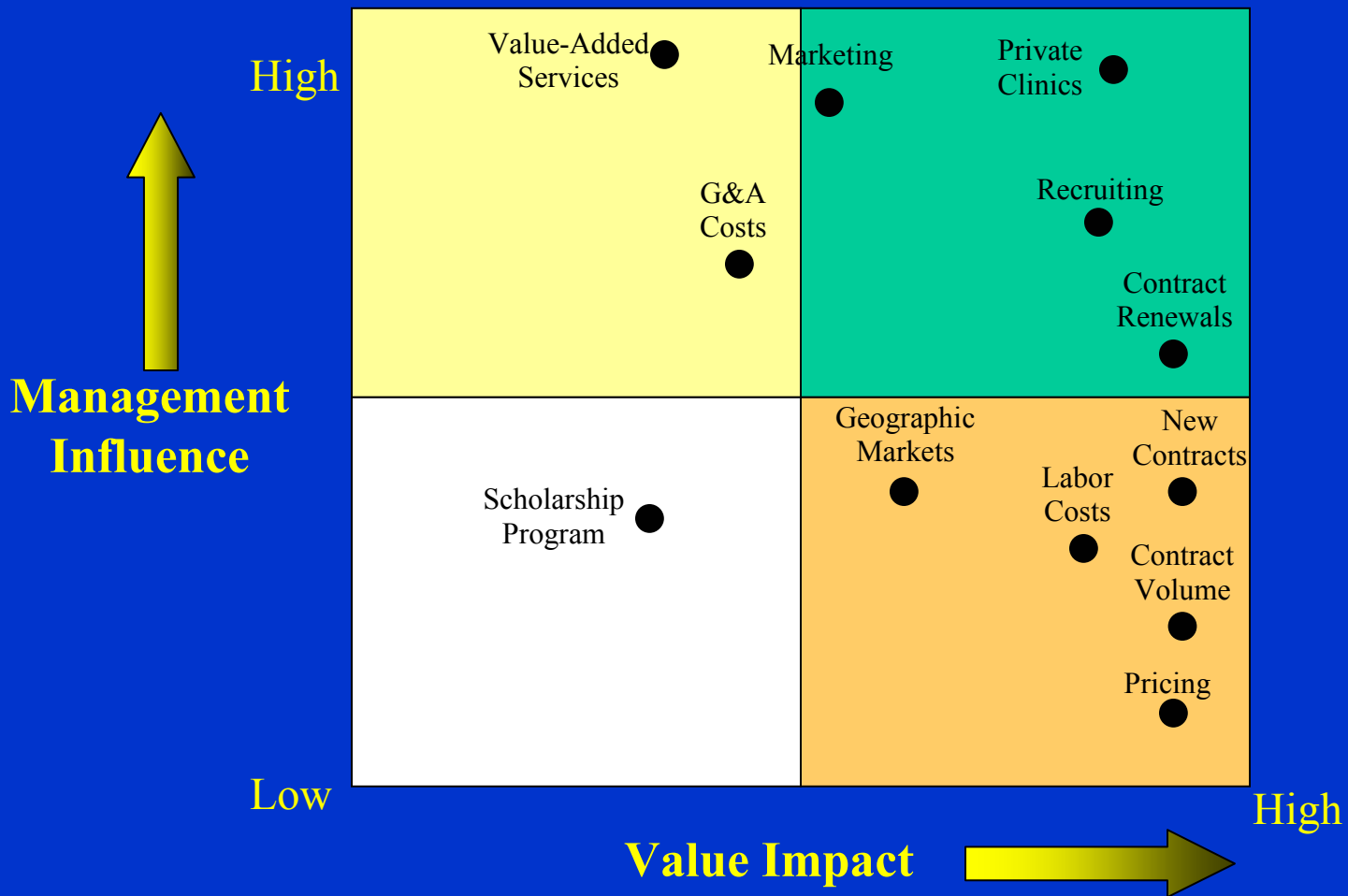
Value Driver Analysis



Using the Value Driver Analysis



Staffing Company Example



Case Study

Institutional products & services company

Case Study: Milestones

- 1983: Founded by industry entrepreneur
- 1988: Purchased \$2 mm manufacturing facility
- 1993: Engaged CMM for valuation and strategic plan
- 1999: Marketed company and received \$30 mm offer; withdrawn as arch rival (#2) went bankrupt; purchased arch rival with all debt
- 2001: Received \$50 mm offer; offer withdrawn
- 2002: Received \$52 mm offer; reduced to \$42 mm + \$7 mm earn-out
- 2005: Considering sale with expected price of \$40 mm

Case Study: Financials

\$MM	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Revenues	17.0	19.2	21.0	24.2	28.0	30.9	38.3	52.3	55.4	56.6	63.3	72.1
Adj EBIT	2.5	3.5	4.0	5.2	6.0	4.9	5.1	6.9	7.1	6.8	5.3	6.5
Adj EBIT Margin	14.7%	18.2%	19.0%	21.5%	21.4%	15.9%	13.3%	13.2%	12.8%	12.0%	8.4%	9.0%
Adj EBIT Growth		40.0%	14.3%	30.0%	15.4%	-18.3%	4.1%	35.3%	2.9%	-4.2%	-22.1%	22.6%

Case Study: 1993 versus 2005

	1993	2005
Management	Excellent; strategic; early50s	Top 5 execs over 60 and one is retired
Reputation	Excellent reputation and brand	Reputation diminished due to QC problems
Distribution	Strong relationships with distributors who dominate the market	Distributor consolidation and buying groups have squeezed margins
Manufacturing	Strong manufacturing and low cost producer	Rising QC problems
Performance	Strong consistent financial track record	Margins down significantly
Market	Stable, steadily growing, and non-cyclical	Under heavy cost pressure
Products	Recognized Product Development Leader	Only one new product in recent years
Competition	#4 in market; many small companies; lots of room to grow	#2 in market; practical limitations on ability to gain market share
Revenues	\$17MM	\$72 MM

Case Study: Successes & Mistakes

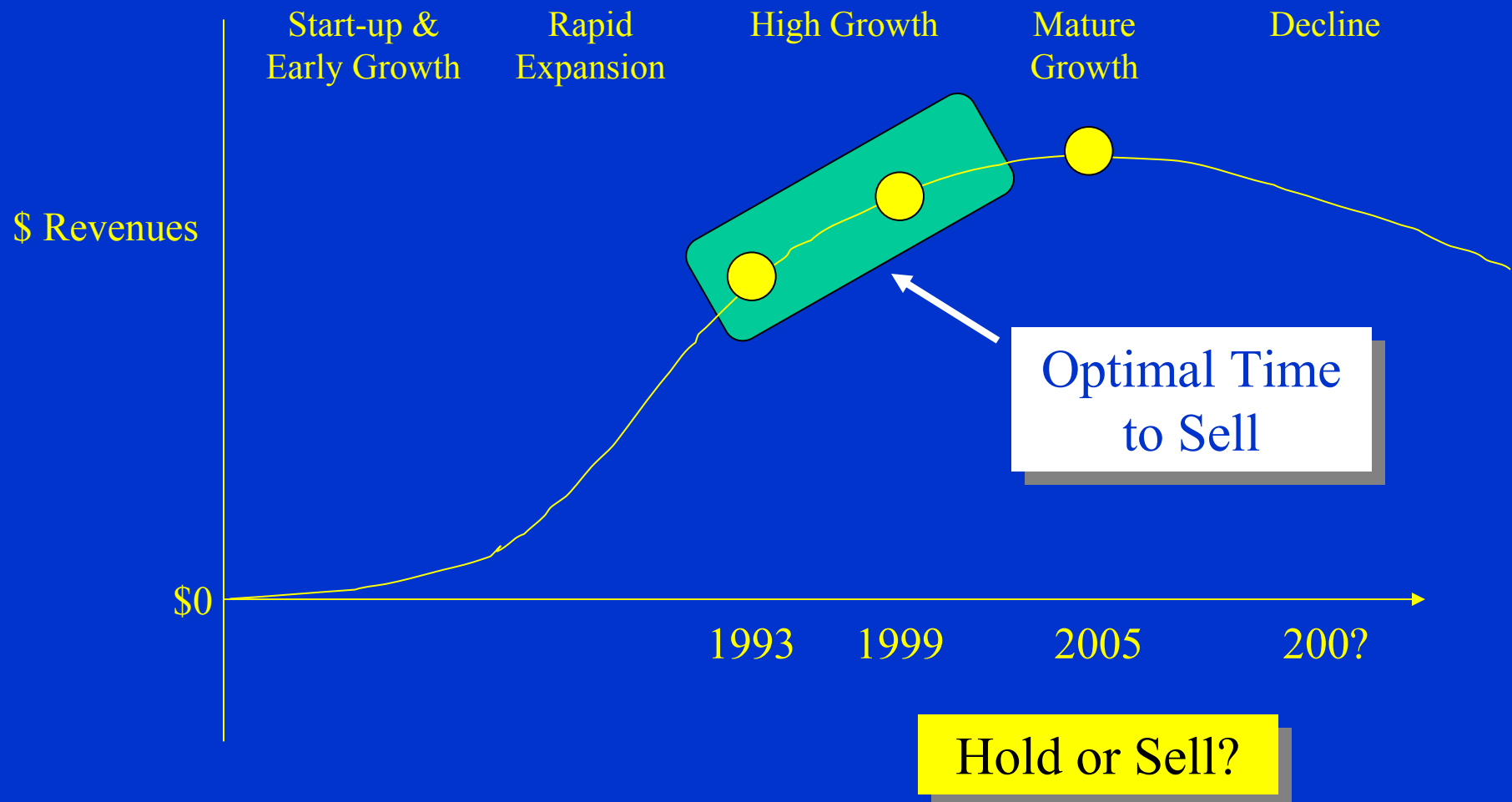
- Successes

- Key business decisions were evaluated strategically
- Created barriers to entry through product innovation
- Committed to and supported distributors; did not bypass
- Configured sales strategy to sell “solutions”, not products
- Kept debt low

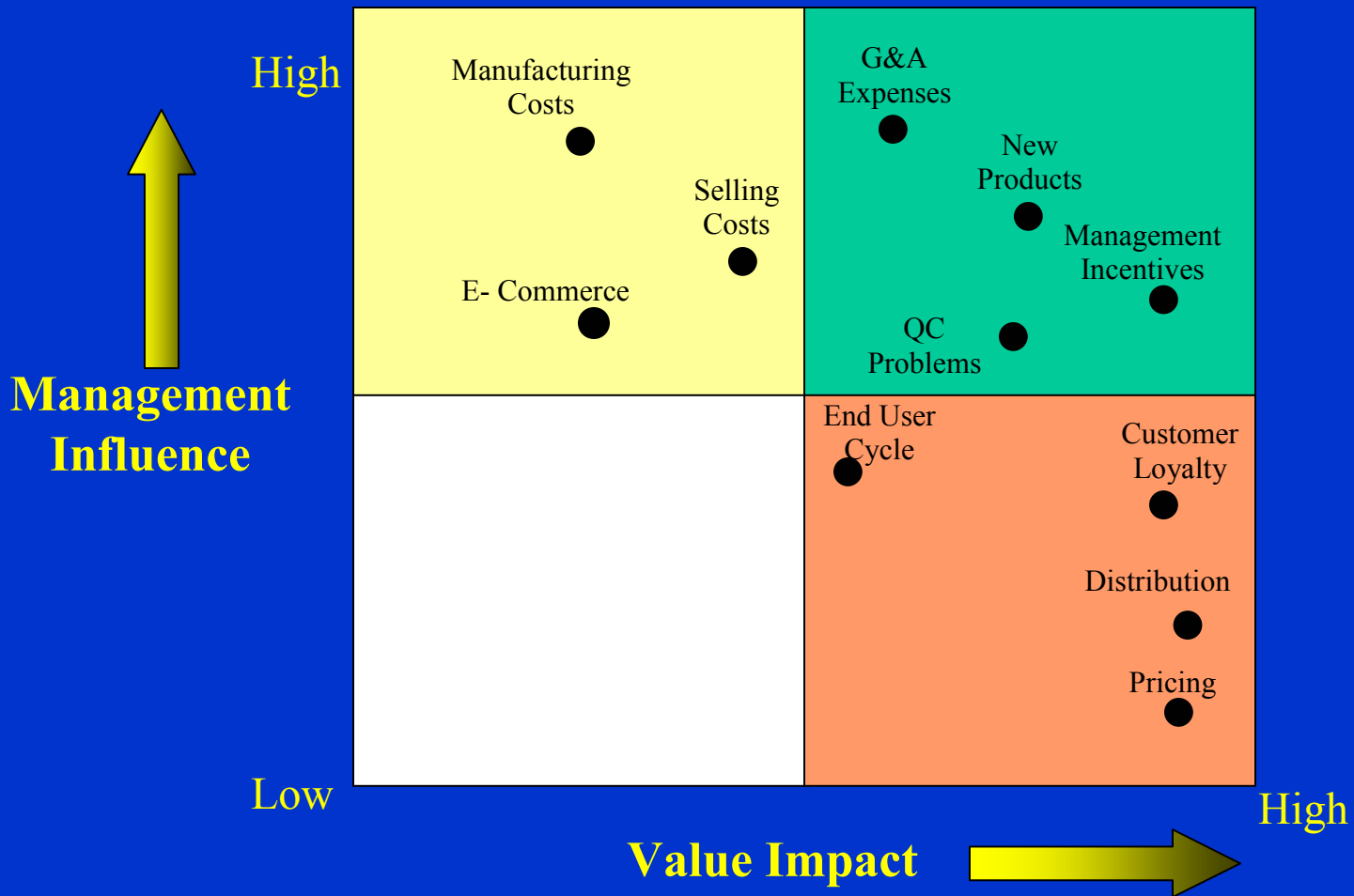
- Mistakes

- Failed to align management accountability with compensation
- Under-estimated difficulty of acquisition
- Failed to anticipate distributor consolidation and buying groups
- Kept executives that were not team players
- Entered equipment business w/o adequate QC capability

Case Study: Value Life Cycle



Case Study: Value Driver Matrix (2005)



Case Study: Lessons Learned

- Hold people accountable
- Strategy needs to be reviewed periodically (#4 → #2)
- New product development should be an on-going process
- Acquisitions are difficult and risky
- Stay close to customers to get IQ
- Make the owner replaceable
- Sell your business before “maturity”

Recommendations

Understand How Your Company is Measured

- Obtain a valuation from a reputable business appraiser
- Research public companies in similar lines of business
- Speak with investors, investment bankers and underwriters
- Understand strategic buyer synergies
- Develop a potential exit strategy
- Focus on maximizing shareholder value (FCF and RISK)

Enhance Expected Free Cash Flow (FCF)

- Execute on Value Driver Analysis
 - Focus on HIGH PRIORITY Value Drivers
 - Acquire resources to execute (people, capital, partners)
 - Align MANAGEMENT RESPONSIBILITY
 - Manage actively against performance indicators
- Track Industry Investment Trends – Follow the \$\$
 - Mergers & acquisitions
 - Private equity buy-outs
 - New products and services
 - Technology innovation (patent filings)

Reduce Risk Profile

- Reduce capital requirements (less financial risk)
- Improve Consistency of Results (reduced volatility)
 - Manage against business risks
 - Build annuity revenues
- Improve Quality of Information (transparency, reliability)
 - Obtain audited financial statements
 - Account properly using industry norms (be conservative)
 - Keep financial systems and controls ahead of growth curve
 - Track non-operating, non-recurring expenses to show recasted FCF

Implementation Steps

Resources

✓ People, Technology, Systems

Responsibility

✓ Aligning Management

Metrics

✓ Value Driver Specific

Reporting

✓ Monitoring and Feedback

Compensation

✓ Reward Performance