

Considerations for Strategic Valuation

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We get asked all sorts of questions as it pertains to measuring value in the past, present, and future. In a recent meeting, the following inquiry arose:

“What sort of milestones should our leadership team have in mind as we build our business and think about a future exit?”

There is no perfect answer to this question. Every company has its own facts and circumstances. And every company will have its own timeframe of organizing, growing/developing, and maturing. Despite the natural variation of each company’s situation, there are nevertheless stable concepts of value to guide each company to a strong path.

To begin, let’s look at high-level concepts before diving deeper into specific considerations:

- All else being equal, higher ongoing profits and cash flow will enhance enterprise value.
- All else being equal, a lower risk profile increases value.
- All else being equal, greater growth prospects translate to higher value.

Valuation can become measurable based on these fundamental levers of value, which are influenced by facts, circumstances, and perceptions. The foundations of how companies are built, managed, staffed, marketed, resourced, and so forth, represent the internal environment in which value positives and value detractors sit.

In addition to these internal value drivers, there can also be broader factors at play. For example:

- How do market forces impact enterprise value (e.g., economic cycles, industry consolidation, politics, global trends, etc.)?
- What is the right, strategic buyer willing to pay?
- How can structure, terms, and available financing impact the potential payout of a deal?

In short, key stakeholders can be on lookout for highly favorable, external circumstances. Until then, leaders can focus inward on controllable, more directly influenceable aspects of value creation. Each of the three internal value drivers branch out to more tangible operational concepts to be considered. Here are some general ideas along those lines.



Customer, Personnel, and Resource Overreliance

Your biggest customers are not inherently good or bad. If Customer A represents 40% of your business, and is very profitable, you are hard pressed to walk away from that relationship. However, if there is a reasonable risk of losing Customer A at any point in time, that will be a burden on corporate value, all else being equal.

Worse still would be to compound the general risk perception of retaining Customer A with having that relationship tied to the overwhelming efforts of one key person in your organization. For example, Customer A is really a customer of one of your company's owners – working 80 hours a week to keep Customer A happy. Customer A just happens to be paying your company, while their closer ties are with the individual leader.

Anywhere there is an overreliance on one thing, you may be creating risk reward imbalance. Further examples: your widget factory gets its principal

raw materials from vendor; your business location is in one spot, can't be moved, and the landlord might kick you out next year; your firm sells one specific software application that is in high danger of becoming obsolete.

Repeat, Repeat, Repeat

The more easily business can be picked up, executed, and repeated, the higher enterprise value it should have. It has a lower inherent risk of execution, it has a lesser risk of going away, it hopefully is more immune to key-person problems. \$1.00 of that profit or cash flow should be worth more than more risky alternatives.

Customers that can be served by staff, not by leadership, can be highly valuable. Think about highly recurring businesses like insurance agencies. When you renew products like homeowners and auto insurances with your insurance agency, do you necessarily care who is picking up the phone to check that box?

Pursuing Growth

Growth prospects are important. It is easy to talk about growth from the perspective of top line revenue. But to be clear, this also needs to translate to the bottom line.

Hypothetically, let's look at a business that is largely tied to its principal owners' reputation and relationships. The principal owners are restricted by their ability to keep the clients and their market happy and well served. Maybe they could grow the business 5 to 10 percent per year over the long term if economic and market conditions support it, but it may also largely evaporate when the owners retire. What if instead the owners' most valuable skills were largely translated into tools, resources, and products that are more efficiently run by lesser skilled staff, and/or technology? Would you invest in growing that as a core business, and might it persist beyond the retirement of its key individuals?

Regardless of where customer relationships are derived, sometimes companies' customer lists need a closer look. An overused point would be to say that for some businesses, 20% of customers might deliver 80% of your revenue. But in this overused example, what happens if you don't take a closer look at the 80% of customers that deliver very little? With a careful, respectful pruning of customers – and an eye towards mitigation of any negative consequences of this exercise – would the reclaimed time, energy, and internal resources result in a healthier company with bandwidth to enhance its prospects?





Cost Management

Lean cost structures can raise that \$1.00 of profit to something better. Maybe you find a way to save 20 cents in your cost structure, and now you have \$1.20. If your cost cutting techniques do not have inherent risk-increasing side effects, or threaten the growth engine of your business, that 20% increase in the bottom line is now mathematically more valuable. Companies small and large can potentially cut costs and deliver more to the bottom line through embracing technology, negotiating with and/or consolidating vendor services, and investing in training and resources for their labor force, among other things.

At the same time, higher cost resources might create efficiencies and actually save you money or time in other areas. Would you like all of your customers to pay you by credit card, and incur the roughly 3% fees to the tune of tens of thousands of dollars a year? A knee-jerk 'no' reaction may be incorrect for your business if you consider the following questions:

- What if you are more likely to get paid on time?
- What if you save countless hours every month chasing down your customers for payment?
- What if the payment technology is tied to a system that leaves you less likely to need to take on an extra administrative staff person?
- What if there is peace of mind knowing you more regularly have money in the bank when it's time to make payroll or pay your vendors?

As the questions above indicate, the initial higher cost proposition might produce a healthier, more attractive outcome. Sometimes a cost might be better perceived as an investment.

Let's assume it takes your business several months to get paid by its customers. This could be both restrictive to growing your business and could be a big hurt on cash flow even if you do manage to grow. Hypothetically your business has \$1,000,000 in sales, and \$100,000 in profit each year. Let's say your receivables are approximately \$250,000 at any given point in time, as well. If you want to grow 10% every year, let's start by measuring that in next year's terms. If all else being equal, you now have \$110,000 in profit, but an extra \$25,000 of your profit just got tied up in receivables, was that good? If I'm trying to buy your business, all else being equal, do I love the prospect of chewing up cash flow?

The Next Layer

The various hypotheticals and questions in this article are but a few example considerations for value creation. You must ask yourself whether the core business can be grown, can it profitably and efficiently produce cash, and does it have a high probability to sustain itself regardless of who is at the helm. More attractive operational and risk-reward fundamentals can compound enterprise value. Then you may be able to compound that enterprise value again with a highly motivated buyer, in a great market, with great financial backing.

- Can your fundamentally sound company now de-risk your buyer's overall business?
- Can your profitable business help your buyer's business to save money, be more profitable, generate more cash flow, etc.?
- Can your profitable business complement the buyer's business, or the other way around, to accelerate market penetration, growth prospects, and so forth?

While there is certainly subjectivity involved, companies can not only measure how to improve some base, fundamental enterprise value internally, but they can start to build assumptions if ever put in position to ask outsiders for maximum value.



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