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GUEST ARTICLE

CREATING LASTING SHAREHOLDER VALUE IN SERVICE COMPANIES

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A few years ago, I met with the owner of a West Coast based marketing services firm who expressed an interest in selling his company. The firm, with more than 200 employees and a blue-chip client list, had successfully established itself as the premier brand in its category, with an international reputation. The quality of the work was widely regarded as second to none. The owner had reason to be very proud.

It became clear from our initial discussions that the company represented the bulk of the founder's assets and that a sale was intended to provide for the long-term financial security of his family. After several rounds of discussions and due diligence, we began discussing valuation. The owner spoke repeatedly of "reputation" and "quality of work" and was

convinced that his high quality brand would command a premium offer from our group.



It is fair to say that our offer, which was based on our assessment of fair market value, rattled him to the core. Our proposal was more than 50% below the value that the founder thought his business was worth. After explaining our rationale and the principles underlying our valuation, he seemed heartbroken and confused. Could he afford to retire? At this late stage of his career, how could he have miscalculated so badly?

As an experienced investment banker who has valued hundreds of firms, I've seen many crestfallen faces when owners learn that the fair market

value of the business they have built is nowhere near what they perceive it to be worth. Yet, this fairly common situation can be avoided- valuations can be increased substantially-if owners run their businesses with a different mindset.

The owner/founder in my example assessed the value of his enterprise in terms of "quality," "reputation" and "longevity." And while his firm truly represented the premier brand in its category on these measures, its fair market value was depressed for two primary reasons: The enterprise lagged its competitors in profitability and the business was too reliant on its founder and lacked a strong management team.

The day-to-day demands of building a successful business-cultivating a blue-chip client list and consistently delivering high quality marketing services-had

gotten in the way of the business's longer-term need to create enduring value.

Business owners typically get to the end of the year, subtract expenses from revenues and what's left is profit. But that shortsighted approach doesn't create long-term value. The purpose of profit is to ensure a business has the capital it needs to grow.

Sharing Equity: A Surefire Tactic To Creating Value

One of the surest ways of improving profitability is to share equity in the business with key employees. Relinquishing ownership in the business can actually make the owner's stake worth more when it comes time to sell. The simple truth is that sellers value a company more when the owner does not control all the shares. In fact, from a buyer's perspective the most important considerations in evaluating a prospective purchase of a company are: profitability, a strong, seasoned

management team with a direct stake in the success of the business and a clear succession plan.

In exchange for giving employees equity in the business, owners can reduce employee costs and offer employees an incentive in the form of a bigger pay-off when the business is either sold or taken public. When these overhead expenses are reduced, profitability automatically increases by the amount of the overhead reduction.

A second benefit-and value-added to a potential buyer of the business-is the commitment of the company's executive team that equity signals. To a potential buyer, it says that the company has the bench strength of a solid management team.

A third financial benefit of sharing equity accrues to the owner of the business and his shareholders when the company is sold. A highly profitable

business with a committed management team, in addition to being more attractive and marketable, usually brings a higher multiple on the sale of the business.

Business owners who are thinking of selling their firms should act now rather than later. They should identify their management team and lock them in as early as two to three years before they are ready to sell, because a seller must typically show several years of solid financial performance to tweak a buyer's interest.

By developing a different mindset about their business, owners can increase the long-term value of the enterprise-sometimes significantly-and achieve a valuation in line with their expectations.

AdMedia Partners is an investment banking and financial advisory firm that focuses on the advertising, marketing services, media, publishing and interactive industries.