

# Creating Sustainable Business Value

**ENRIQUE C. BRITO, CFA, AVA, CM&A**

## Introduction

For most business owners, their business represents the largest portion of their net worth, generally from 65% to 85% according to recent surveys. Hence, it is critically important that entrepreneurs focus as early as possible on designing and implementing a plan that will create sustainable business value as the venture grows and matures. Likewise, for the most part an entrepreneur's departure objective should not be based on working until a particular date in the future, but on achieving a valuation level that will provide them



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**CFA, AVA, CM&A**

with financial security once they exit the business. This financial security, in the form of an after-tax income adjusted for inflation, should be high enough to enable the business owner to maintain a chosen lifestyle for years to come.

The critical issue is how to go about designing a strategy to ensure the creation of business value in a sustainable manner right from the start. The answer

is found in being able to align three crucial elements in operating a business: vision, strategy and execution. This will significantly increase the odds that the business owner will be able to achieve his or her long-term goals.

## The Essence of Business Value

Before describing how to design a plan that ensures that the business owners' vision, strategy and execution are

aligned to create sustainable business value, it is important to define what business value means, how it is quantified and which forces drive it.

The term "value" has many definitions depending on the purpose for which it is used and the interests of those defining it. However, value is best defined when it can be applied almost universally. When value is defined as a risk-adjusted benefit ( $\text{Value} = \text{Benefit} / \text{Risk}$ ), it becomes clear that value is created by increasing benefits (increasing the numerator), decreasing the risks associated with obtaining those benefits (decreasing the denominator), or a combination of both.

In the world of investments, benefits take the form of cash flows while risk is quantified through the investor's expected rate of return. In fact, the higher the risk associated with obtaining future cash flows, the higher the expected return on the part of the investor. From this perspective, the value associated with an investment is influenced by both the potential for creating future sustainable earnings and the perceived level of risk associated with the realization of those earnings.

In terms of a business enterprise, the benefits (i.e. the projected net cash flows to the capital providers) are driven by the expected growth in revenues, profits, and capital base of the business. Risk, on the other hand, is quantified by the so called "weighted average cost of capital" or "WACC" which is just the average return expected by the providers of both equity capital and debt capital to the business. As such, the weighted average cost of capital is a function of both the cost of equity (return on equity) driven by investors' requirements, as well as the cost of debt (after-tax interest rate) driven by the external environment and the internal capabilities of the business.

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### **Strategies for Value Creation**

As previously stated, the entrepreneur's vision, strategy and execution must be aligned at the operational level in order to realize his or her long-term goals. In practical terms, if value is defined as a risk-adjusted benefit, aligning a business' vision, strategy and execution translates into identifying those strategies that effectively increase the future cash flows of the business and/or reduce the risks associated with the realization of those cash flows.

At its core, value creation is a function of a company's growth potential as determined by the business' capability to increase its revenues, profits and capital base, as well as its ability to earn returns above and beyond its cost of capital. In essence, in order for a company to increase its value it must increase its net cash flows and/or reduce its cost of capital.

Net cash flows are determined by several crucial elements including: sales volume, operating margins, tax rates, and investment requirements for working capital and fixed assets. The cost of capital, on the other hand, is determined not only by external market conditions affecting the level of interest rates, but also by the internal capabilities of the business based on its real or perceived operational strengths and weaknesses, market opportunities, and competitive threats.

### **Drivers of Value and Risk**

In the final analysis, every company regardless of the products or services it offers, the industry in which it operates, or the markets it serves, is in the same business—producing cash flows. And, as previously stated, what ultimately drive business value are cash flows and the likelihood of their realization.

Although some value drivers and risk drivers are very specific to certain industries and even companies, there are some universal factors that have a definite impact on value creation. Some examples of these factors include:

Value drivers: quality of revenues, consistency of profits, quality of assets (tangible and intangible), management team's depth and breadth, proprietary rights, growth potential for the business/market and favorable economic and industry conditions.

Risk drivers: lack of customer diversification, potential contingent liabilities, inexperienced management team, poorly maintained assets, high operating costs, frequent contract renewals (bidding), high employee turnover and financing costs.

### **Conclusion**

Creating sustainable business value is a goal within the reach of most entrepreneurs. It begins with a clear definition of what value is. This facilitates the identification of factors most influential in increasing the benefits and decreasing the risks associated with operating the particular business. When these factors are made the focus of the business' strategy, this makes possible the alignment of the owner's vision, strategy, and execution, which enhances the likely maximization of the business' potential, and the ultimate attainment of owner's long-term goals and financial security.

**About the Author: Enrique C. Brito, MBA, CFA, AVA, CM&A is a managing director of The Mclean Group, a private investment bank providing merger and acquisition, valuation and private equity financing services. He has over 17 years of corporate finance and investment banking experience and lectures nationally on the subjects of business valuation and M&A. He can be reached via e-mail at [ebrito@mcleanllc.com](mailto:ebrito@mcleanllc.com) or call 703-827-5093.**