Henshaw/Vierra Management Counsel, L.L.C.

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Where Does Value Come From?

There are so many things going on in the payroll / workforce management world that it is sometimes hard for a manager to know which way to turn. We know that this is a great business: it's a key business function which almost all businesses need; it's repetitive income; for most, it is not expensive to enter the business – you can license or rent to operating systems, what hardware you need continues to come down in price, customers can use secure web interfaces and private clouds, with some effort managers can add new services to get more use out of customer generated data bases, and the industry leaders have been able to add value and raise prices year after year. What's not to like?!

Well, the business is competitive; technology and new technology driven business lines are capital and marketing intensive; and, new applications not only drive new revenues but also drive new costs, new risks, and a greater demand for scale. These factors cause thoughtful managers to consider the calculus of keeping their company where it is, investing in growth, or selling out.

I get asked questions all the time: "what's the value of my company". My answer is, it depends. It depends what your timeframe is for holding and for selling. Most managers will run their company differently, depending on their holding periods. I didn't say that I approved of this, but I do observe this all the time. They correctly believe that there are two values for their company: the value in running the company for their benefit, and a value which they hope is higher which would be paid by a third party based not really on over-all performance but on some vague multiple of revenues. There is another value discussion which is coming up more often now, "what is the value of my company if I sell a part of it, or contribute it into a joint venture with a benefits administration company or insurance brokerage firm". More on that to come.

For those managers I would like to point out what reduces values to third parties, where value really comes from, and some math they might use to plan, hopefully after working with us, for that day when they want a third party to come knocking.

What reduces value: poor internal operations which cast doubt on the strength of the company and the veracity of the numbers; customer concentrations; too much debt on the company books which puts note holders in charge in making any deal; unrealistic seller terms and conditions; not being prepared to sell, and not really knowing what you are selling. Believe it or not, if you don't understand what you are selling, a real buyer will find that out in due diligence, and values will go down. Value can also be reduced if the seller spends time with unqualified or under capitalized buyers.

Where Does Value Come From? (cont.)

Where value comes from: sound management, discipline, motivated employees; and, growth in the customer base, revenues, and EBIT. Bigger is better for most qualified buyers. Buyers who respect and value growth records and profitability will be buyers a seller can do business with. Buyers who want market share in a market in which they have little or no share will be buyers a seller can do business with. Buyers with industry experience, as opposed to strictly financial buyers, will be buyers a seller can do business with. A financial buyer is a buyer a seller can do business with, but the seller's approach to that buyer needs to be different from those listed above, (that will be a subject of a future Payroll Tribune). But, if you have a financial buyer pounding on your door and would like to talk about it, call me at 510-749-3225. We can help even up the sides a bit.

Core value comes from "free cash flow". It is best derived from repeatable revenues (use 75% as a good standard) and, proportional and well managed expenses. The result before taxes is Operating Margin / EBIT. A strong margin comes from good management, and scale. If a seller has a low operating margin, they need very good explanations for it. The easiest explanation is the lack of scale. The company needs a core set of resources to run its business. If they do not have enough customers to cover their fixed and variable costs, they don't make much money. If they show strong growth in customers and revenues, they can overcome a buyer's hesitancy.

Let's review how the industry looks at value. Since most buyers are looking for market share, they focus on the seller's customer list, the concentrations (small number of customers with an out-sized number of checks), and the revenues. These buyers generally do not look at the sellers' employees, the company's role in the community, and special services a seller provides their customers. They express their bid in terms of a multiple of revenues then adjust their bid for customer attrition during the closing period caused by customers just leaving the seller and customers leaving to avoid conversion hassles when the buyer moves them to their own operating systems.

Let's look at a deal. Seller has a bureau with $3,000,000 in average revenues over the last 12 months, 750 customers, and a 30% EBIT of $900,000. Buyer One bids 2.4 times revenues, subject to adjustments after the customer base is converted to their operating system. Buyer Two bids 7 times EBIT, and is not currently planning to change operating systems. How should the seller compare the bids?

Buyer One: $3,000,000 x 2.4 = $7,200,000 x .66 = $4,752,000 or 1.58 times revenues

Buyer Two: $900,000 x 7 = $6,300,000 or 2.1 times revenues.

I always like to look for wiggle room for the seller. With Buyer One the seller knows that the buyer has the capacity to do the deal. But, they have little way to effect the attrition related to the conversion.

With Buyer Two there are more moving parts. The Seller can normalize EBIT. Sellers can argue for a change in the multiple based on their specific EBIT margin. A better run company can push the number up to 8 or higher with a normalized margin of 30% or better. Of course, if their margin is 15% less, the buyer could drop the multiple to 5. So the seller to Buyer Two can see a range based on their efficiency of from $2,250,000 to $6,300,000. The less efficient seller would pick Buyer One if their EBIT was 25% or less and they could not get a multiple of 7 or better. A well run seller with margins of 30% or more would take Buyer Two.

Henshaw/Vierra is Moving

Henshaw/Vierra Management Counsel is moving it's main office. Our new address will be:

2410 Camino Ramon

Suite 224

San Ramon, CA 94583

We will be moved in by mid June. If you need to contact us by snail mail, please send to:

P.O. Box 2045

Danville, CA 94583

Our website and phone numbers will remain unchanged. You can reach Guy with any questions at (510)749-3225 or (925)944-5890

Henshaw/Vierra Management Counsel

Henshaw/Vierra has been working with the owners and managers of payroll/ work force management companies since 1995. We focus on building better managed companies to give the owners the advantage of creating a more profitable and well-run company…a company which gives them the more competitive advantage whether they decide to make it more profitable, and/or grow it, and/or sell for a fair value.

Go to www.henshawvierra.com for more ideas on creating value.