

“The Convergence of Strategy & Valuation – Shareholder Value Maximization”

By

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Feedback. If you work for a publicly-traded company, you receive continual feedback regarding the strategic and business decisions you are making as reflected in fluctuations in the stock price. What about for the privately-held company though? Are the strategic and business decisions that your company is making increasing or reducing shareholder value?

The volume of merger and acquisition activity as well as the valuations the selling companies is receiving in the government contracting marketplace remain at or near record levels. Many companies see these transactions in the marketplace and assume the multiples these companies are receiving are applicable to their company. However, with multiples ranging from 3 – 18 times EBITDA, how do you know whether the strategic business decisions you are making will translate into a 3 multiple or one in double digits?

This article will discuss the concept of the convergence of strategy and valuation, a process that I call Shareholder Value Maximization.

The Strategic Planning Process

Most companies undergo, either formally or informally, some variation of strategic planning. Overall company goals and measurable objectives for the three constituents (Customers, People, Shareholders), for the next year and even beyond, are established. These goals and objectives are then translated to the various divisions of the company, as well as its various product or service lines. Many successful companies will then translate these into individual goals and objectives for each of the employees of the company. This ensures that each individual knows and understands their role in the achievement of the company's goal and objectives. Once these goals and objectives have been cascaded throughout the organization, strategies for achieving these are then developed.

It is during this strategic planning process that Shareholder Value Maximization should be incorporated. A baseline valuation should be established as well as a target number to be achieved. Each and every goal and objective should be analyzed to determine their potential impact on value and whether they are contributing to the achievement of the target valuation. The company should give serious consideration to eliminating those matters that do not contribute to increasing shareholder value and replacing them with those that will.

Valuation Concepts

Very few privately-held companies undergo the process of having their company formally valued. So what are the variables analyzed as part of a valuation? The primary variables include growth, profitability, value of tangible and intangible assets, as well as the industry marketplace value drivers. In addition, one should consider the concept of risk. There exists an inverse relationship between risk and valuation. The more risk associated with a company or a particular variable being analyzed, the lower the valuation. Fortunately, the government contract industry is considered less-risky than other industries due to factors such as:

- Long-term contracts
- Reliable customer payments
- Consistent cash flows
- Predictable results.

As was mentioned previously, a government contractor can expect to see value multiples on normalized EBITDA in the range of 3x to 18x. This produces a very wide range of possible valuations. So what makes one company worth a 3x multiple while another is 18x? The answer lies in how the company lines up with the marketplace value drivers.

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Marketplace Value Drivers

Assuming that the company has established a goal of maximizing shareholder value, aligning its strategic planning with the marketplace value drivers will produce measurable results. What follows is a general discussion of some of these marketplace value drivers.

Financial Performance

Valuations of any company, in any industry, are first and foremost driven by the financial performance of the company. The historical and projected profitability of the company, its ability to generate positive cash flows, the growth trend in revenue, profitability and cash flow of the company, the management of its indirect rates and the strength of its Balance Sheet are among the most important factors that a buyer considers in developing an acquisition price. A company with a history of erratic earnings, inadequate backlog and liquidity, and one wrought with various contingencies (pending or threatened lawsuits, years of outstanding government audits, excessive unbilled receivables, etc.) will see their value reduced significantly from that of its competitors.

Company Characteristics

The characteristics that make a company unique can also impact its value. First is the depth and quality of the Company's management team. If too much functionality is tied up with one or two principals, (as is typical of most small entities), value can be negatively impacted. This is due to the fact that the transfer risk (risk of losing business and profitability due to the transaction) is significantly higher with these entities.

The niche or focus (or lack thereof) of the company is also important. For small to mid-sized companies, having significant depth in a few areas is preferable to having little depth in many areas. In some instances, having revenue in non-core areas adds little to no value to the equation.

Having a diversity of contract platforms available to a possible customer is important.

This would include being on a variety of GSA Schedules and Agency GWAC's. These vehicles provide a buyer with access to these agencies that they otherwise might not have.

Personnel with security clearances are the most sought-after persons in the workforce. With the scarcity of these individuals and the logjam the government is experiencing in processing the clearances makes these persons invaluable. Making an investment in one's people, through sponsoring their security clearance process, can pay tremendous dividends for the company in the form of new revenue opportunities and larger valuation upon sale.

Finally, the size of a company can affect its value. Larger companies are deemed to have less risk associated with them through the diversification of clients, contracts and capabilities and thus worth more.

Contracts/Customers

A history of winning recompeted contracts is an indicator of customer loyalty that adds value to a company. Prime contracts are more valued by a potential buyer than are subcontracts. The contract type also affects valuation. Cost reimbursable contracts are good vehicles to recover indirect costs, however, their profitability potential is among the lowest of the three primary types and thus receive the lowest valuations. T&M and Fixed Price contracts are more favorable as long as the company is able to manage its cost structure and contract performance.

The types of products or services that are offered also impact the value. Currently, higher-end information technology, management consulting, network security and software development services are the receiving premiums in the marketplace. Finally, the Agencies that the company is performing work for also impacts its value. Those agencies with growing budgets are the most sought after. This would include the Intelligence Agencies, Department of Homeland Security and Department of Defense among others.

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Aligning Strategy with Marketplace Value Drivers

There is no magic formula that is applied to each of these value drivers to determine an overall multiple for a company. Each and every buyer will assign its own value to each item depending on their individual motivations and needs. Regardless, a company should be developing goals and objectives, as well as the strategies for achieving them, which are in alignment with these value drivers.

The following example will illustrate this point. Company ABC is looking to pursue new revenue opportunities in the government space to help it achieve its revenue growth goal of 10%. It has identified two equally-sized potential opportunities that fit its core capabilities, one with the Dept. of Education and one with the Dept. of Homeland Security. If it does not have the fiscal resources to pursue both, which effort would be better to pursue? The value drivers in the marketplace are placing a premium on revenue with Agencies who are experiencing growth in their spending budgets. The Dept. of Education’s budget has been declining over time while Homeland Security’s budget has been greatly increasing. To most prospective buyers, they would place a premium on the revenue stream generated from Homeland Security. Therefore, with the goal of maximizing shareholder value, the strategic decision to make would be to pursue the Homeland Security effort.

Conclusion

Strategic planning of most privately- held companies has always been done in a vacuum, without regard to the effect the decisions being made are having on shareholder value. If the intention of a company is to sell sometime in the future, performing the strategic planning function with the goal of shareholder value maximization will ensure the company’s value is maximized at the point of sale.