EXTRACTING VALUE FROM YOUR BUSINESS

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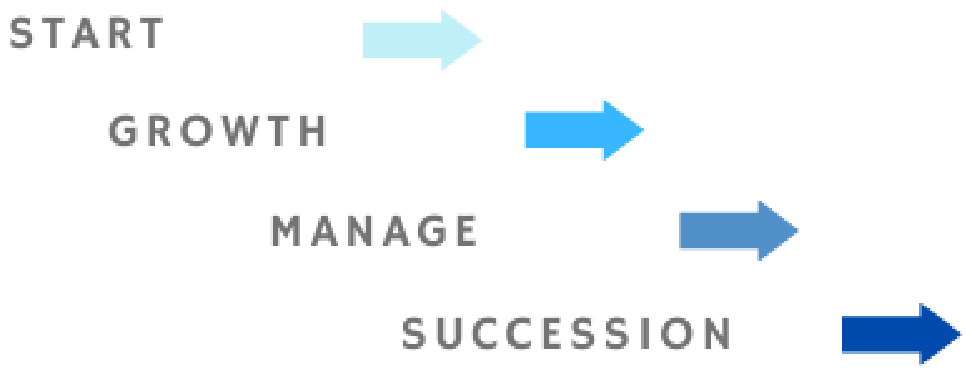
INTRODUCTION & OVERVIEW

Welcome to this publication of our Business Guides.

If you are reading this; congratulations on the success of your business to date, however long the journey has been! Or, if you are thinking of starting out, we hope that this gives you a little inspiration to take the first steps.

Whether you are starting out, experiencing growth and expansion, or looking to exit, there is always the need to check in to make sure you are on track.



It is, of course, impossible to plot all aspects of building and operating a **Business** ("SME"). However, from the inspiration, vision and excitement that got you going in the first place, through to the inevitable stresses and strains of operation, we hope that the content we share inside this Guide resonates with you. And more importantly, stimulates some action too.

Section 1 – The Cradle

The Start

As a business owner, we all have different reasons for doing what we do. We call this **"The Why"** as we read more about it a little further on. This is a great place to start.

There is often conflict between the business itself and its owner(s). In this guide we interchange freely between each and do our best to define them.

At a macro level, we touch on some of the key building blocks of your business such as Sales, Marketing, dealing with Customers. However, before we market or sell anything, you need to know how your business is positioned.

To balance "The Why" we feel it is important to understand your own risk profile and position. The decisions that you make, and the decisions that are made around you, including ones that are beyond your control, need to be aligned to your business vision and objectives.

So often we are buried operationally in the business, you may need some time to check in to ensure that our personal and business objectives are aligned.

On that theme of thinking – it is a chance to assess whether we have a business that is both sustainable and can ultimately operate independently from the owner/founder if that is an objective.

As we will see as we move forward, many people exist as being "self-employed" as opposed to operating a business. Often this distinction is subtle, but it is very important.

Section 2 – You & The Business

Running a business is stressful and hard for the owner to be "out of the weeds".

We may need to wear multiple hats, and often decisions need to be made on your business. It can be very hard to be objective about what you have built and to critically evaluate the impact of decisions on the business.

Once you have clarified your role in your business, we can consider the operational components and your best role in it. Even if you are a sole operator it is important to be aware of your strengths, preferences and the gaps that may need filling.

We are all different. In the context of business, you need to "know thyself" as we discuss further. For example:

- ✓ Are you great at Sales but not so strong in managing customers?
- ✓ Do you struggle to get new Sales opportunities?
- ✓ Does your business have an active Marketing plan?
- ✓ Do you think there is a difference between Sales and Marketing?
- ✓ What are your Customers saying about you? Do you know? How do you measure that?
- ✓ Do you know what the key drivers in your business are?
- ✓ Can you analyse the performance of the business?

To answer the above, reading each module may help provide you with an objective view of where you and your business sit right now, and whether you see any opportunities to **define it**, **refine it** or **change it**.

"The Why"

"The Why" is fundamental to both our actions, and how we feel or think about our business on an ongoing basis.

Assuming we know why we got into business in the first place it is always important to "check in" and evaluate why.

More broadly, why is linked to Purpose? All businesses need one and this is very different from goals, visions, objectives etc.

The Merriam Webster Dictionary defines Purpose as:

"The reason why something is done or used, the aim or intention of something and the feeling of being determined to do or achieve something."

Without a clearly defined, documented and communicated Purpose, you and many other stakeholders in your business may feel directionless.

How do you clarify the Why?

For existing business owners, try to go back to that time when you first had the burn in the stomach to get started. You may go back to the feeling of wanting independence, escaping corporate life, financial reward for example. It will however go deeper than the outcomes.

Sharing an example, for this author it was all about helping the financial awareness of the people that I worked with. So, I defined my purpose in business to "Help Improve Financial Literacy".

Having a purpose is a guiding light. As your business grows or evolves or gets impacted by things outside of your control, you can draw back to it to make sure that decisions are aligned to your purpose.

UNDERSTANDING YOU: THE BUSINESS OWNER

1. Risk Profile

Risk awareness is critical. Your relationship with it is a key determinant that will drive the destination of the business.

A major source of internal conflict for many business owners, however, is their lack of awareness around their own risk tolerance.

It can be argued that most business owners have a higher-risk tolerance due to their decision to be in business in the first place, but in our experience, this is not always the case.

The decisions you make, both large and small, including decisions to invest and spend money, are largely driven by your personal risk profile. This will be reflected in your preferences and behaviours and will ultimately have a huge impact on both the performance and the culture of the business.

Many business owners seek to mitigate risk to ensure that they will not experience loss. However, without some material level of risk business is unlikely to grow and benefit from any relevant opportunities that arise.

The more you understand your risk profile, the better you can marry both your purpose and vision for the business, and make sure these are properly aligned.

There are tools that allow you to assess your risk appetite. They typically need to be in a context, and investment risk for example, is a good one to select.

2. Risk Capacity

Risk Capacity is very different to your Risk Tolerance. It is focused on your individual set of circumstances, specifically related to financial affairs.

Unlike risk tolerance, which might not change over the course of your life, risk capacity is more flexible and changes depending on your personal and financial goals—and your timeline for achieving them.

Risk Profile for Small Business

You may be surprised to know that many small business owners show behavior of a risk adverse profile, or as we highlight later, an inability to leverage.

For example, there are over 2 Million Small Businesses in Australia.

Of these:

- Over 60% do not employ any staff; and
- Only 9% employ more than 5 people.

Source: *ABS Cat. No. 8165.0, Counts of Australian Businesses*

In our experience, many business owners don't like to take risks like employing staff or other leverage opportunities such as business acquisitions. If that is not aligned to their Purpose or other circumstances, then that is understandable.

Other times it might be a lack of confidence, experience or capital to take the next steps in business.

There can be advantage and arbitrage for those businesses willing to undertake some considered risk and as a result access a range of opportunities.

So, a key for your Business is to:

- Define and/or Refine your Purpose; and
- Understand & Acknowledge how you react/feel about Risk.

Role in the Business ("The Quadrants")

We acknowledge that business owners often do or have responsibility for a variety of operational and strategic roles in a business.

You may make decisions depending on the different capacity that you find yourself in during business.

The roles and responsibilities in each area are succinct and can sometimes be in conflict.

For example, what if maximizing shareholder return means exiting a long-term referral relationship, exiting a long-term customer or geographical market?

Most SMEs do not have a Board of Directors or hold Shareholder meetings which is an understandable reality. However, be mindful that you may need to think and act according to multiple hats as below.

QUADRANT OF THE BUSINESS OWNER

1. SHAREHOLDER Focus is on building and sustaining the value of the business. Appoints the Director(s) and must critique and assess the performance of management.	**2. DIRECTOR** Focus on the stewardship of the business and executing on behalf of the shareholders. Must think strategically about the positioning of the business.
3. MANAGER Manages the operation aspects of the business and executes the strategic plans as outlined by the directors. Supervises the employees.	**4. EMPLOYEE** Serves faithfully and carries out duties in accordance with their contract with proper care.

As a business owner you will act in a different mindset across the four different quadrants.

It is an understatement to say it can be a lonely position sometimes. So, consider getting some support. This may be in the form of a Mentor or even a Coach, or you may consider putting together an Advisory Board that can provide a structure for performance assessment and support for key decisions.

Functionality

Following on from the Four Quadrants, one of the biggest challenges we see for business owners, is creating an environment of clearly defined and communicated roles within a business.

Are the many roles and processes in your business clearly defined? What are they and who is responsible and accountable for them?

We see so many functionality issues in most small businesses. With many functions being duplicated, and other roles not being done at all.

For example, for multiple business owners or managers, is it clearly defined who is in charge of which tasks?

The Functionality Test

For businesses with greater than 5 people

Does the business have a CEO?	YES / NO
Is there a centralised decision-making process?	YES / NO
Is everyone in the business clear on responsibility for all roles?	YES / NO
Are the roles and functions documented and shared?	YES / NO
Is every employee clear on who is responsible?	YES / NO

If you have answered "No" to any of these, there is an opportunity to drive in some change.

Do you Run a Business or are you Self-Employed?

We talked previously about the massive volume of small businesses in Australia.

This may be confronting for some, but how many of these operate a business as opposed to relying solely on our own personal exertion to generate revenue?

Many of you may be aware of the book ***"Rich Dad, Poor Dad"*** written by *Robert Kiyosaki* and his concept of the **Cashflow Quadrant.**

For those of us running a business or for anyone who is interested in their financial management it is a great read and outlines some very simple but outstanding messages.

In summary, he talks about "owning a system" as opposed to "owning a job". For many in the industry it is worth pausing to apply to our own businesses.

Source: Rich Dad, Poor Dad (Rich Dad #1) by Robert T. Kiyosaki, Sharon Lechter 1997.

The messages in Mr. Kiyosaki's book are broader, but for the purpose of this Guide, we will focus on the concept of generating income from being Self-Employed as against running a Business.

We discuss these factors further when we look at factors that impact valuation outcomes. In the following table, we compare some traits that are examples of the difference between self-employment and business ownership.

Self-Employment Traits

- Business cannot operate for a sustained period without your direct involvement.
- The brand is "you".
- You are the primary contact for all key functionality areas.
- Cannot grow past "The Single Owner Cap".
- Exit value only involves the transfer of your client base.

Business Traits

- Business continues to drive referrals and operate for a sustained period without you.
- There is brand equity created that could be sustained beyond the operator.
- There are others that play a role in designing or delivering key functions in the business.
- Leveraged Growth is achievable.
- Exit includes the client base, and potentially key processes, referral relationships and people.

Your Business Test

Is the owner(s) responsible for execution of most sales?	YES / NO
Is the owner(s) responsible for the review of work before customer delivery?	YES / NO
Can the owner(s) take time out from the business, and all processes continue?	YES / NO
Can the owner(s) take time out from operations, with forward orders sustained?	YES / NO
Is the owner(s) solely responsible for the financial management of the business?	YES / NO

Importantly, there is no right approach here and no cause for judgment. Ultimately it is the up for the individual to decide.

However, if you have answered "No" to any of these, are you able to assess and address the impact it would have on your business if you were absent for an extended period?

The "Single Owner Cap"

Applying some of these broader concepts to SMEs, I would like to raise a common challenge for growing businesses that I call the "Single Owner Cap".

This refers to the inability for a single owner to grow beyond a certain size. This is understandable, as the volume of clients and loans increase – so do both the servicing and loan run off.

This is usually linked to the manner and structure in which the business earns income.

There is a lot of good research on Stages of Business. I like the *Harvard* research which looks at five (5) succinct stages and traits of each as below:

1. EXISTENCE	2. SURVIVAL	3. SUCCESS	4. TAKE OFF	5. MATURATION
Customer Acquisition	Customer Renewal	Customer Sustained	Customers Developed	Brand Equity
Initial Cash Investment	Initial Earnings	Earnings Developed	Cash for Growth?	Earnings Sustained
Owner Driven	More Owner Driven	Pursue Growth?	Can Owner Leverage?	Not Owner Reliant

Harvard School of Business by Neil C. Churchill and Virginia L. Lewis (May 1983)

For some SMEs, this is a journey that can look something like this:

- Stage 1 & 2 of starting and building a business, whilst challenging, is often the easiest in terms of growth (not distracted by client maintenance/management etc.).
- There is a cluster of businesses at "Success" (Stage 3) that are unable to achieve "Take Off" (Stage 4).
- Owners reach saturation, have squeezed their operational tasks and costs as far as possible.
- Cannot build leverage in managing or attracting new clients at a rate that drives growth.

At this point – it is very important to acknowledge and point out that there is nothing wrong with being self-employed. Getting to Stage 3 (Success) may indeed be your intended destination.

The Power of Leverage

Strongly related to The Business Test, is the "Power of Leverage".

Leverage in our mind is a critical component for businesses that seek growth or for owners that want to be or develop into a "Business" and not solely operating in the mode of "Self-

Employment".

The Merriam Webster Dictionary defines Leverage as: *"Influence or power used to achieve a desired result"*.

Though in the context of business, we define it as the ability of doing more of what you do well. As an example, there are many highly paid professions that can be self-employed and make exceptional financial returns.

A complex medical specialist, taxation lawyer etc. come to mind as examples. Whilst they may extract great personal financial return, their ability to leverage is limited. How easily can they train people in their organization to see more patients/clients? Yes, they can be more efficient and get some support, but ultimately, they need to be applying their own personal exertion to generate income.

Early in my own journey of self-employment a story stuck with me. A close friend's father was self-employed as a Plumber. He had an excellent reputation for over 30 years in his local area, with repeat customers. When he wanted to retire however, there was no sustainable business to sell, as it was all based on his personal exertion and the tight personal relationships he held with the customers.

Again, there is no judgement, and often self-employed people are very aligned to their own Why.

What we are talking about here is **Leverage**.

Leverage can either allow a business to stay small and not be at all solely reliant on the owner, or it can build a system for its growth.

The best businesses we have seen are the ones that "do it often, do it well". Repeatable processes that are supported by great marketing & sales programs, systems, great internal culture and customer service but that don't unduly rely on individual expertise at an operational level or "black art".

There can be great leverage opportunities in these types of organisatons. Whatever the owners' motivation, the operation will be more saleable if both the business operates without undue reliance on the owner and there is opportunity for leverage.

Lastly, and most significantly, the essence of many SMEs reflects their founders. That can be a strength and weakness in equal measure. I always recall a quotation from the creative genius **Paul Arden**, *"Your vision of where or who you want to be is the greatest asset you have"*.

It is very important to keep this in mind with all the inevitable distractions that can come along the journey.

Section 3 – Business Foundations & Building Blocks

1. Positioning

Much like the Business Owner needs to understand their own profile and tendencies, so too does the Business have to establish its own. Many people call this "Positioning" and it is a great way to reference your business.

Positioning is defined as "*shaping how individuals perceive your organisation or service*".

Whether deliberately managed or not, your SME will have an identity and be positioned in the mind of your target audience and stakeholders, relative to competitors.

Indeed, the position your organisation takes in the mind of your target audience may be the only means of differentiating your service offering from a competitor.

Without clarification of Positioning, you cannot have the other building blocks of your business existing in harmony.

Let's use an example of a well-known and successful business such as *McDonalds*. Most of us have been to one of their restaurants at some point so picture yourself there right now. You walk in on an ordinary day and order a Burger, Fries and Coke and get change out of $A15. As you sit down at a table – the table is covered with a silk tablecloth, with fresh flowers on top. Your meal is then delivered with table service and they are offering complimentary French Champagne to all customers.

Whilst you might be pleasantly surprised, there will be conflict running in your mind as it would not be the experience you are expecting the brand to deliver.

Ok, crazy example. Though in this case the elements of Positioning are not clearly aligned, and this would not be a sustainable business model for McDonalds.

There are many relatable examples in SMEs that centre around the nature of the services offered and who they are offered to.

What if I am an established business but do not know my Positioning?

Some starting points to consider:

- ✓ Go back to your "Why" and define or refine your purpose;
- ✓ Ask, who is your target customer and define their characteristics;
- ✓ Consider your core values and see what makes you different from the rest of your market; and
- ✓ Audit your value proposition and your current brand message.

2. Sales & Marketing

Ah, the “Sales & Marketing” person or team. Did you know there is a difference between the two? In fact, we should never use them together in the same sentence.

I have seen so many businesses that are great at making some Sales, but terrible at Marketing. And of course, vice-versa.

So, let’s define and distinguish between them and then piece them back together and add them together with Customer Management.

2A. Marketing

Marketing is the long-term need for a business to develop strategies to understand customer needs, influence customer perceptions, and position itself for that.

Marketing techniques and strategies are based on what it takes to identify the right product mix, pricing, target customers and how it is communicated to the market.

A good marketing process should make sales easier. Though most SMEs efforts in Marketing are haphazard and disjointed. Every business needs to think about its broad strategy and connecting all the individual activities and efforts, so they are relevant for the positioning of the business.

In the modern marketing era, experts now talk about the customer experience or journey. It sounds a little fancy perhaps, though it is acknowledging that your customers don’t always take a direct and simple route to your business. More and more, you can’t send them down a path or process that doesn’t suit their needs or preferences.

So, you need to be prepared to understand and respond to that.

There are lots of great resources on marketing, including some great innovation companies like ***HubSpot*** that are making the process of marketing a little easier to understand. Most SMEs underspend on marketing. I have always believed, much like you have an accountant, all SMEs should partner with a marketing agency too.

Don’t know where to start? Go back to your Positioning and think about what message you want to provide to your customer. You will probably need some help with that so be prepared to seek out advice.

The opportunity that most miss is the one to connect their marketing, sales and customer management activity with a good CRM which I will touch on further below.

2B. Sales

Sales is the short term need to complete what needs to be done to sell your product or service. Sales strategies and activities are typically based on what it takes to 'close a deal'.

Obviously, this is crucial to any business of any size or industry. There is a sales function in every business even if it is sometimes not discernable or have a structured process.

2C. Customer Relationship Management or "CRM"

A key plank of the Marketing, Sales and Customer Management function is a well-maintained CRM.

I often hear experts refer to it as "the single source of truth". I never actually really understood what they meant by that but seeing how many businesses struggle with coordinating data I get it now.

CRMs are more than a collection of names and contact information. It should be at the centre of all your marketing efforts and:

- ✓ Segment your Customers by key criteria such as geography, size, industry etc.;
- ✓ Connect across your business so all information is centralized and up to date;
- ✓ Customise messages to each of the segments you have created;
- ✓ Measure the performance of your outbound messages and campaigns; and
- ✓ Help ensure compliance with all relevant Privacy Laws etc.

3. Adding Staff

The common risk profile of many business owners means that scaling with new people can be a challenge.

The critical success factors in our experience include:

a) Good Documentation

Many businesses do not invest the time to ensure that they clearly articulate and sufficiently document the HR process.

HR documentation is more than the employment contract or licence agreement. It is critical that there are also an updated employee handbook and induction document.

All key business policies should be documented, and made readily available, so that all relevant people in the business can easily access.

b) Good Recruitment Processes

It is an understatement to say that good recruiting decisions are so critical for small business success. In smaller enterprises with smaller teams, a new person will represent a more material part of the totality of the business.

Considering that, it is surprising how many businesses do not have a structured recruitment policy or process.

All businesses that employ staff should invest in specialist advice in this area. As a minimum you should ensure:

- ✓ It is clear what the new role is for and why the business needs it;
- ✓ There is a documented and detailed Role Description;
- ✓ There is an established and tested interview process; and
- ✓ The candidate is very clear on the role description, and you are comfortable that they have the expertise to deliver on the role.

There are some outstanding resources including books, blogs and related tools. The key things I have seen successful Business Owners do include:

- ✓ They always hire on "Character" as that cannot be taught;
- ✓ They trust "their gut" but they have a framework that supports it; and
- ✓ They consider the needs of others in their business. A fit for the Business itself and not just a connection to the Owner.

4. Customer Management

Congratulations. If you have a Customer, you must have a Positioning established and have marketed a product or service that has produced a sale.

Whilst we appreciate the importance of customers, most businesses underinvest in the Customer management process, especially post sale completion.

a) The Customer Experience

Good businesses have a system in place that measures the experience your customer has received. Again, there are some excellent resources and reading that can you do to help formulate a strategy here, and it does depend on the nature of your business. For example, a retail business with multiple low value transactions will need different approaches to a business that has higher value, lower volume transactions.

Firstly, a sobering reminder about customers. You may have positioned your businesses but the experience your customer receives will dictate how <u>they</u> position your business.

I am not just talking about how they rate the experience they had (say through a popular concept such as "*Net Promoter Score*"), but in the context of your positioning.

Let's go back to the McDonalds example. Customer has the tablecloth dining experience which exceeds their expectations and they refer others. An NPS of 10 will not be helpful as the Positioning in this case is flawed.

Social media and other lower touch feedback tools have played a significant role in the business world, especially for service businesses like SMEs.

b) Measuring Customers

So, you have processes in place to receive feedback, do you review your own customers?

What makes the ideal customer or referrer for your business? Perhaps there are a few obvious things that come to mind, like whether they are good to deal with. But beyond that how do you really know?

An effective tool we have utilised successfully in business is crudely called **"Shoot the Dogs"**^. Now that I have your attention let's give some background to this.

Every business needs Revenue, but not all Revenue is good. Is the Revenue leading to Profit? Is the Customer relationship a good and compliant one?

For SMEs it may be different as many customers are transactional in nature. It is often more relevant to look at Referrers as the Customer.

If we look at these two desired features of a Customer, we can build a model such as the below:

The "X" axis represents how **Desirable** is it to do business with each customer, while the "Y" axis is how **Profitable** they are to the business. We build this model to determine our average of each, and the lines intersect at this level.

Say that Business XYZ offers commercial & mortgage broking. Firstly, we have looked at their drivers and have determined that Gross Margin is the most relevant and important barometer of financial success for XYZ.

In discussing and reviewing its data, XYZ achieves an average Gross Margin of 30% (after paying the finance broker that writes the deal and the referral fees) for their ten (10) major customers that make up 80% of total revenue.

In terms of quality of these relationships, they are not sure across the business but think they are largely satisfactory.

Profitability (Y)

Simple enough. The average is 30% so the model plots on the X axis where each customer sits on this matrix.

Desirability (X)

XYZ is not sure how to measure Customer Desirability. As a first step, they itemise what they ideally want in a Customer.

XYZ came up with the "Desired Features" below which is unique to their business.

^ - Source Unknown.

No.	DESIRED CUSTOMER FEATURES	RATE
1	Good people to deal with - Build a Relationship	7
2	Do they pay invoices on time?	8
3	Is the Service we do a Match for our Skills?	9
4	Do we have good Conversion from Lead to Completion?	10
5	Time Line - Will the Customer exist long term?	6
6	Willingness to "Take Up" other Products & Services	5
	TOTAL	**45**

XYZ identifies the six (6) most important features they desire in their customers. You can include more but this is not recommended.

After we have collated these features, we then take this analysis further and **rate** the importance of each of these features out of a score of 10. This determines their relative importance to each other.

For example, they have identified that *Conversion from Lead to Sale Completion* (10) is twice as important to them than cross selling other Products (5).

In this model, a score of 5 above doesn't mean that it isn't important – just in this example it is considered the least important.

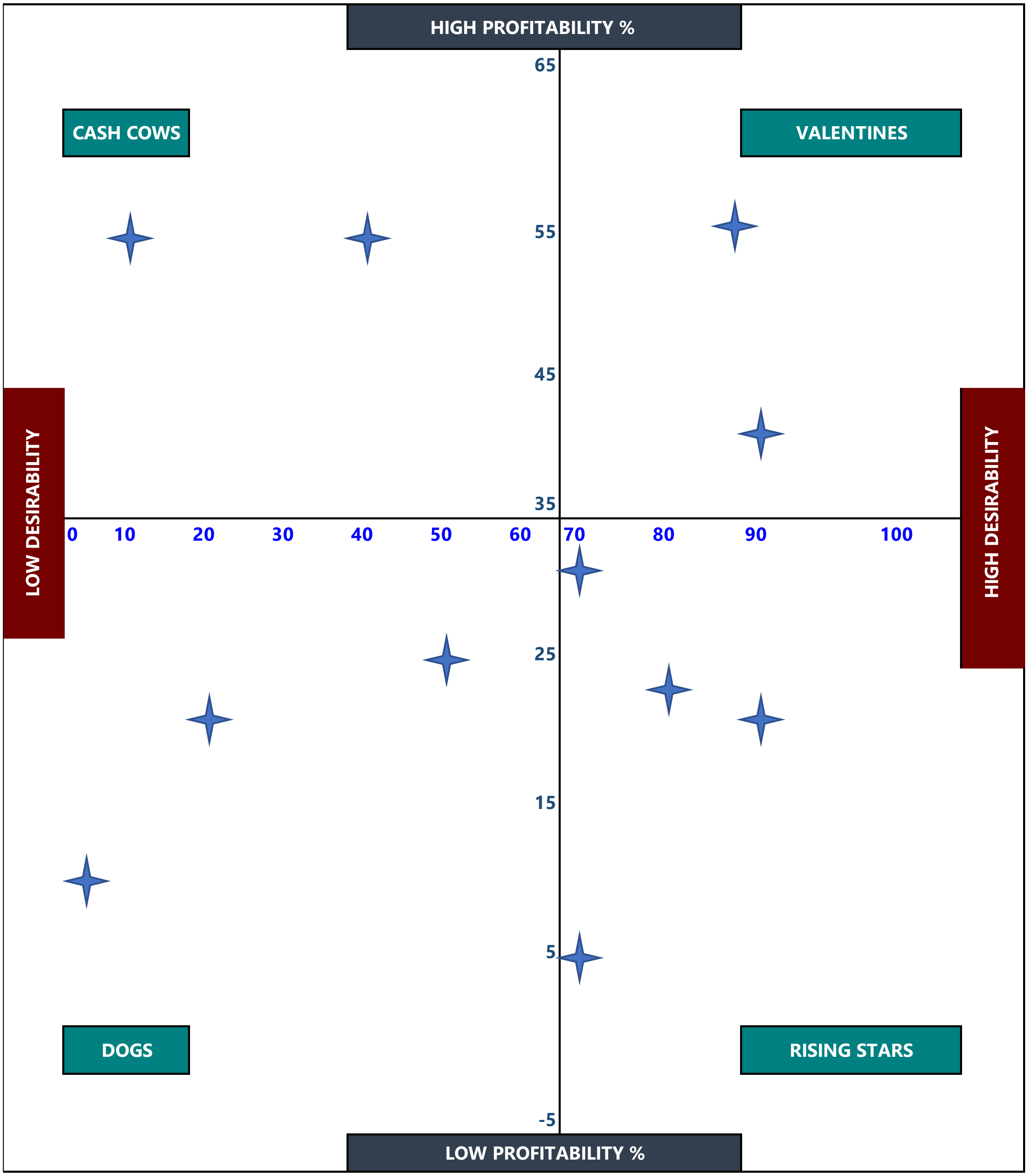
You can then evaluate Customers/Referrers and rate them individually (out of 10) as below:

Customer Code				**AA**	**BB**	**CC**	**DD**	**EE**	**FF**	**GG**	**HH**	**II**	**JJ**
No.	**DESIRED CUSTOMER FEATURES**	**RATE**											
1	Good people to deal with - Build a Relationship	7	**INITIAL RATINGS**	3	5	5	9	10	9	8	8	5	3
2	Do they pay invoices on time?	8		3	3	5	10	8	7	8	8	4	6
3	Is the Service we do a Match for our Skills?	9		4	5	5	9	10	8	8	8	8	4
4	Do we have good Conversion from Lead to Completion?	10		3	5	5	8	8	8	8	9	2	3
5	Time Line - Will the Customer exist long term?	6		3	5	5	9	7	7	9	8	6	3
6	Willingness to "Take Up" other Products & Services	5		2	5	5	10	5	7	4	8	8	2
	TOTAL	45		**18**	**28**	**30**	**55**	**48**	**46**	**45**	**49**	**33**	**21**
	Factored to 100% from Weightings	**2.22**		**30.9**	**46.4**	**50.0**	**90.7**	**82.4**	**77.3**	**76.1**	**82.2**	**52.2**	**36.2**
	Financial Performance (Gross Margin %)			**10.0%**	**14.0%**	**18.0%**	**22.0%**	**28.0%**	**32.0%**	**35.0%**	**38.0%**	**42.0%**	**44.0%**
	Average Gross Margin	**30%**											
	Average Customer Rating	**67%**											

In the output above, the 10 Customers get a "Weighted Rating", and we also include the financial return (measured in this case as their Gross Margin) below.

Once complete, the model presents the completed analysis below based on the itemisation of the two factors.

Shoot the Dogs Customer Analysis



Average of 67%

You will see above that Customers can be attributed into one of four categories or quadrants:

Category	Profitability	Desirability	Quadrant
Valentines	Above Average	Above Average	Top Right
Rising Stars	Below Average	Above Average	Bottom Right
Cash Cows	Above Average	Below Average	Top Left
Dogs	Below Average	Below Average	Bottom Left

The most desirable category is **Valentines**, they are both above average Financially and in Desirability. Make sure you look after these customers or referrers!

Rising Stars are the most contentious. We like dealing with them, but they are not financially lucrative. Is there scope to improve financial return and take them towards Valentines?

Cash Cows are just that. We may not enjoy dealing with them, but they produce financial returns. This can be become a more emotional consideration for the Business to what degree they seek to retain them.

The **Dogs** are the exact opposite to Valentines and urgent action is needed. Unless immediate improvements can be made, the business should make the decision to exit the relationship.

Whilst it is very brave to say no to Revenue, you can deliver an enormous long term benefit to the business (your staff may also be grateful if they are difficult to deal with) by freeing up capacity to focus on other customers that do or can fit in other quadrants.

Growth for Businesses

In the context of SMEs, growth can be a contentious topic. Many established businesses are not growing. That may be a choice of the owner in many cases.

How do I keep my SME growing?

There are many good resources to read on growth, better than any specific insights listed here. Though in the context of growth, engrained in my head is the words of a successful business mentor of mine. He would always remind me to "Focus on the Revenue".

His message was that when businesses grow, they tend to invest a lot of time in activity that is not highly valuable. They then fall into a cycle where Revenue falls, and a cycle of cost reduction follows.

But Why Grow?

There are several, and perhaps obvious, potential benefits of growing which can also include merger or acquisition activity too. Some potential benefits include:

- Some diversity can reduce business risk;
- Opportunity for your people to develop, provide careers and retain them;
- A recovery of your fixed overhead or excess capacity;
- Broaden your own experience and skills; and
- Utilise the capacity in your business.

The options for growth can be divided into four categories:

1. New Product, Existing Customer Provide some **new** services that you have decided to start offering to your **existing** customer base.	**2. New Product, New Customer** Provide some **new** services that you have decided to start offering to a **new** customer base.
3. Existing Product, Existing Customer Sell more of the **existing** services that you already have/do to your **existing** customer base.	**4. Existing Product, New Customer** Sell more of the **existing** services that you already have/do to a **new** customer base.

These options may seem obvious; however, it is a good template when looking at your options should you choose to grow.

Can I pivot into other Services?

A common theme for SMEs is to extend their service offerings to other services. An example of New Products to New or Existing Customers.

Whilst this makes sense to support new and existing customers – it is important to build the proper support mechanisms to ensure that these services are delivered appropriately.

A common example is a mortgage broker seeking to pivot to commercial finance introductions. The business case is an obvious one and there has been material growth in the number of brokers offering commercial finance services.

Most commonly however, the broker does not have the will or the skill to delivery these services on a professional basis.

If you are to do this, invest some time into designing what the service will look like, who you will provide it to and determine the skills your business needs to acquire before doing this properly. Then seek out the support, tools and resources that you need to deliver on a sustainable basis.

Is it Worth Buying a Business?

The purchase of a business can be the fulfillment of dreams or fall short of expectations. This is an example of providing your Existing Products to New Customers.

We have seen success and failure in equal measure. Successful examples typically involve the following traits:

- They engage pro-actively with the vendor to ensure the most effective transition of the customers;
- They respect the heritage branding, and acknowledge that most customers don't care about the purchaser's business, they care about their own needs;
- They build strong CRM capability (including importing of key customer demographics);
- They do their due diligence and understand the customer base; and
- They customise their messages to meet the needs of the customer base.

The decision to purchase is obviously tied to the financial implications which we address under valuations, below. Advice should be sought if you do not have previous experience.

The volume of merger and activity in SMEs is not as material compared with other professional services industries. We touched on the risk averse nature of SME owners as one contribution to this fact.

When seeking funding support for acquisition, banks cannot draw on any volume of precedent performance.   As a result, getting bank support for funding can be a little challenging.

Building Succession / Exit

"Your business is always for sale". Well, maybe not but that should be the mindset of the owner because at some point you will have an involuntary or voluntary exit from your business.

It is rare that Business Owners have a clear and documented exit strategy. That may be understandable in some instances, but it is not ideal.

There is no exact science on this point, and the optimal time for each owner will vary based on a number of factors.

One optimal time may be before you hit the Single Owner Cap, especially if you are unlikely to push through and grow the business.

It is important that as a business owner, you seek advice to work through your options for the end. This plan can be fluid, but it should be updated regularly.

Again, this is where good advice is so important. Succession planning should align with other related objectives such as:

- Retirement Goals;
- Asset Protection;
- Estate Planning; and
- Taxation Planning.

For many SMEs, their business is their biggest asset outside of property interests.

By waiting too long, many of the key referral relationships can become stale, the loans age and there is generally no value to the business beyond the value of the recurring trailing commission.

VALUATION METHODOLOGY

As we have touched on previously, when looking at the value of your business you need to determine whether you have a “Business” or a “Book of Loans” which implies a self-employment model.

Business

- Can be leveraged from the owner.

Valuation Methodology – Based on a Multiple of EBIT <u>or</u> Trail Multiple

Loan Book

- No leverage outside owner (restraint of trade risk).

Valuation Methodology – Based on Multiple of Recurring Income

i) Valuation Inputs

Determining a value for the business is not an exact science. A buyer will have a range of motivations and objectives in assessing the price they will be willing to pay.

In most cases, an educated buyer will consider both the numbers (quantitative) and other factors (qualitative) that will create a view of the business.

An up to date understanding of your numbers is not only good management practice but a key behaviour when presenting a business for sale.

ii) Valuation Methodology

There are several methodologies that can be adopted to value a business, and more specifically a service business including:

Measure	Relevance to Larger Businesses	Relevance to Smaller Business
Multiple of Recurring Income	High	Very High / Predominant
Multiple of Adjusted EBIT	Moderate	Low
Percentage of Revenue/Fees	Low	Low

1. Multiple of Adjusted EBIT

This is not common for this industry, generally because of the typical size and unleveraged nature of these businesses.

It is also a challenge for industries that they are not viewed as developed in the manner in which others are viewed.

There are a number of reasons for this of course; one prime one being the average risk profile of those in the industry does not easily allow multiple owner practices to grow.

However, where earnings are robust and consistent, this should always be a preferable option and may deliver a more positive valuation outcome compared with a multiple of trailing income.

This typically involves determining the multiplier to apply, and also to "normalizing" Earnings as they are often inconsistent.

Generally, in a small business, the multiple used is significantly lower than larger or publicly listed companies. As a rash generalisation, a range of around three to six times a normalised EBITDA would be considered for more premium service businesses.

Looking at your SME on this basis is very important in the long term. Having a business that has sustained value on exit makes your business potentially more attractive to a wider market.

Let's look at an example below of a simple SME:

Profit & Loss Analysis

Operating Revenue	2021 F	2020	2019	2018
Consulting Income	$211,250	$214,500	$227,500	$260,000
Recurring Income	$209,100	$204,000	$195,500	$183,600
Other Service	$7,500	$7,500	$7,500	$7,500
Total Revenue	**$427,85**	**$426,000**	**$430,500**	**$451,100**

Operating Expenses	2021 F	2020	2019	2018
Rent & Occupancy	$20,000	$20,000	$20,000	$20,000
Salary & Wages	$70,000	$80,000	$80,000	$100,000
Compliance & Insurance	$15,000	$15,000	$12,500	$12,500
Marketing	$7,500	$7,500	$7,500	$15,000
Administration & IT	$10,000	$10,000	$10,000	$10,000
Total Expenses	**$122,500**	**$132,500**	**$130,000**	**$157,500**

Operating Profit before Taxation	**$305,250**	**$293,500**	**$300,500**	**$293,600**

Of course, all SMEs will have different cost bases, largely dependent on the "will and skill" of the owner. In this example, the owner is not paid a salary but rather collects the Operating Profit.

When looking at a business value on this basis we need to go past the Profit & Loss. This means making the adjustments to "normalize" the net earnings such as the example below:

Adjustments to Earnings before Interest, Depreciation, Amortisation, Owner Salary ('EBITDAO')

	2021 F	2020	2019	2018
Market Salary for Owner	-$150,000	-$150,000	-$145,000	-$145,000
Depreciation	$2,500	$2,500	$2,500	$2,500
Owner Personal Expenses	$7,500	$7,500	$7,500	$7,500
Total Adjustments	-$140,000	-$140,000	-$135,000	-$135,000
Adjusted EBITDAO	**$165,350**	**$153,500**	**$165,500**	**$158,600**

Commonly, the most material adjustment from OPBT is adding a market salary to reflect the contribution of the owner.

This is a common oversight when presenting a business for sale, the existing owner needs to be costed for both the value and the time they spend in the business.

One common goal for owners is to migrate from self-employment to business owner. The extent to which this is achieved will have a material impact on the appeal and value of the business.

The next step is to apply a "multiple" to the Adjusted Earnings as below:

Indicative Business Value – Using Earnings Multiple

Average Adjusted EBITDAO	**$160,738**	**$160,738**	**$160,738**	**$160,738**
Indicative Earnings Multiple	2.50	3.50	4.00	4.50
Indicative Valuation	**$401,844**	**$580,081**	**$662,950**	**$745,819**

Determining the appropriate multiple of earnings is not a simple exercise. A multiple at the higher end for an SME is rare as there is not the expectation that earnings will sustain easily.

There are some participants in the industry where information is freely available, such as entities listed on the Australian Stock Exchange; however, they rarely represent appropriate comparisons to the typical SME.

Their accounting treatment is also very different to most SMEs. For example, applying accounting standards means that these "reporting entities" allocate the future value of trailing commissions on their balance sheets as an asset. A typical SME would not do this as there is no driver or taxation implications in doing so.

When looking at a business on this basis make sure that you seek the appropriate advice.

2. Multiple of Recurring Income

This is the most common valuation methodology that applies in the many industries.

This is generally utilized as:

- The majority of valuation/sales transfers for small businesses;
- The businesses generally do not include any goodwill outside of the contribution of the owner(s); and
- The businesses are not growing materially, with the value of the trailing commission near or greater than the value of new upfront income.

Whilst some purchasers would use modelling as a guide to valuation, in my experience the rule of thumb assessment of valuation remains the most prevalent.

Taking the previous example of an SME, the following valuations would be extracted:

Indicative Business Value – Using Recurring Income Multiple

Net Annual Recurring Income	$209,100	$209,100	$209,100	$209,100
Indicative Earnings Multiple	2.00	2.20	2.40	2.60
Indicative Valuation	**$418,200**	**$460,020**	**$501,840**	**$543,660**

The relevant industry marketplace may consider this mode of valuation as an industry standard. Usually this is based on a "rule of thumb" estimation.

More sophisticated buyers also consider the actual financial profile of the cash flow. A common financial model is Net Present Value ("NPV") that compares the present value of money today, to the present value of money in future, taking inflation and returns into account.

This would generally include an assessment of just the quantitative inputs to determine the likely value result.

3. Percentage of Revenue

This methodology typically applies to professional service firms like accounting and legal where the client base is highly portable.

We do not see this as an appropriate methodology for many trading businesses.

Final Considerations

If you are reading this Guide, congratulations on the progress of your business to date. It may stimulate some thinking on some of the following issues:

- Is it worth investing to reduce your loan Run-off?
- Can you create value in the business beyond the customer base / trailing commission?
- Consider building your business so that a valuation based on a multiple EBIT is a realistic option.
- Can you avoid the "Single Owner Cap" and what action can you take to stay ahead?
- When considering a pivot to providing other services, make sure you have both the will and the skill to do it successfully.
- If you are to Exit – get the timing right and do not leave it too late!