by Eric **Skie**

THE VALUE TRIANGLE

A BALANCED APPROACH TO BUILDING A MORE VALUABLE BUSINESS

For many entrepreneurs and business owners, business assets comprise the vast majority of their net worth. Protecting the value of these assets becomes critical to protecting the financial future of the entrepreneur and the employees, families and communities that depend on the business owner.

It is often assumed that managing financial performance is the key to building a more valuable business. Clearly, financial performance is critical in any organization and is a driver of business valuation. However, anyone buying a business today is going to look at the financial results and ask "How likely are those results to continue in the future?" The answer lies not in the financial statements, but in other areas of the business that often are not managed nearly as proactively as the financial results.

Financial results are a lagging indicator that tell you the financial impact of what has already happened. Once a buyer understands the historical financial results, the focus will quickly shift to the leading indicators of success — activities that are predictive of future performance. Businesses that strike a balance between managing their leading and lagging indicators experience improved profitability, reduced business risk, increased business value and create more succession options for their owners.


SKIE

WHEN AND WHERE

Eric Skie, managing principal, and Samantha Metcalf, principal with CliftonLarsonAllen LLP will discuss the "Manufacturing and Distribution Outlook: Beyond 2016," **Sunday, Nov. 6** from **8:30 - 10:00 a.m.** and again from **10:30 - noon.**

The underpinnings of strong financial performance are a solid business model and the discipline to stay within that model as market conditions and circumstances change. Beyond that, the lagging indicator of financial performance is driven by the leading indicators of market conditions (growth), business processes (execution) and most importantly, leadership.

CONTINUED ON PAGE 92

PHOTO: JIRSAK

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A simple visual model called The Value Triangle illustrates this interdependency and teamwork, and the competencies required to achieve long-term success. Excellence in any of these areas can create bursts of short-term success. However, consistent attention to all four creates high performance organizations that can compete in the global marketplace.

FINANCIAL

Conventional wisdom tells us that financial performance depends on a balance of management practices and marketplace dynamics. But in manufacturing and distribution, best-in-class performers see management practices (those issues within their control) as the driving force to profitability. Simply said, they see operating profitably as a choice. Average to below-average performers tend to credit or blame changes in the market-place as the most significant force impacting profits.

History has shown us that profitability and financial performance are mostly choices made by leadership and management. When it comes to financial performance, the ability to consistently generate cash flow under varying market conditions becomes a primary focus of any buyer. Profitability and consistent cash flow fuel the investments needed to sustain long-term growth. On the flip side, inconsistent profitability or weak cash flow significantly increases business risk and makes an organization vulnerable.

GROWTH

Growth and profitability for many manufacturing and distribution companies are now at pre-recession levels. This is welcome news and confirms that growth opportunities do exist, especially for strong performers at the entrepreneurial end of the supply chain.

Two areas that can dramatically impact valuation in any manufacturing business are the revenue concentrations and the unique value proposition of the business. Revenue concentrations with customers, industry sectors, production capabilities or geographic areas exist in every manufacturing enterprise. How effectively those concentrations are managed and mitigated can be critical to survival, especially during periods of volatility.

WHILE THE ECONOMIC DOWNTURN WAS TRAUMATIC, IT ALSO FORCED MANY MANUFACTURERS WHO WERE CAPTIVE TO A SINGLE INDUSTRY OR CUSTOMER TO LOOK FOR OTHER **GROWTH PROSPECTS**.

While the economic downturn was traumatic, it also forced many manufacturers who were captive to a single industry or customer to look for other growth prospects. In addition to increasing business risk, revenue concentrations are a value detractor to a potential buyer.

In order to remain relevant, manufacturers and distributors must understand their unique value proposition and how it aligns with their customer needs. Differentiators like superior engineering and design skills, exceptional quality and delivery performance consistently outrank price when industry leaders are asked what distinguishes them from foreign and domestic competitors. For small to medium-sized manufacturers, the ability to differentiate can create growth opportunities in any economy.

EXECUTION

The best manufacturing and distribution companies execute throughout the organization. Execution is not just the ability to produce a quality product on time. It includes the ability to implement strategic plans, to flex and scale operations (up and down), and to continually drive improvements. Companies that are strong in execution have a robust operating system that makes daily performance and continuous improvement the norm and not a fire drill.

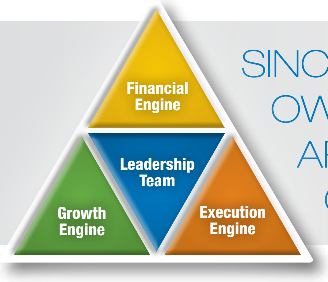
Organizations with strong execution also maintain company assets, building a strong foundation for the future. Companies that are strong in this area will tend to be more profitable and require less capital to operate. This has a very positive impact on valuation.

LEADERSHIP

Leaders are responsible for connecting the financial, growth and execution functions into a cohesive, high-functioning team. But leadership teams are not static. They evolve over time as people join and leave. Strong organizations actively manage and plan for the ebb and flow of the leadership team.

Many in the baby-boom generation are reaching an age where they are planning for the next phase of their lives. Since small to mid-sized manufacturing ownership

CONTINUED ON PAGE 94



SINCE SMALL TO MID-SIZED MANUFACTURING OWNERSHIP IS DOMINATED BY BABY BOOMERS, THERE ARE MANY BUSINESS OWNERS WHO ARE CURRENTLY CONTEMPLATING THEIR SUCCESSION OR TRANSITION.

is dominated by baby boomers, there are many business owners who are currently contemplating their succession or transition.

One of the riskiest periods for a small business occurs during leadership or ownership transitions. With the right planning and approach, this can also be a period of revitalization and new ideas. It takes time to prepare for a transition that maximizes value for the current owners and ensures sustainability for the new owners. The best organizations start the process years ahead of an expected change.

A business driven by a high functioning team has enterprise value. A business driven by an owner/entrepreneur has individual value that leaves when the owner leaves, creating a disappointing valuation at the time of sale.

FORWARD FOCUS ON VALUE

The innovation and resiliency demonstrated by manufacturing and distribution company owners and leaders is truly inspiring. While the Great Recession recast the competitive landscape for many industries, companies that have paid attention to the underlying fundamentals of The Value Triangle have met the challenge and continue to move forward. The opportunity to drive improved performance and enhance business value is significant. CS

Eric Skie is a managing principal with CliftonLarsonAllen LLP's Chicago office. For the past 20 years, he has been an advocate for the manufacturing industry as an advisor, speaker and volunteer. He is a frequent speaker to organizations such as the National Tooling & Machining Association (NTMA), Business Owner's International (BOI) and several regional manufacturing associations across the country. He can be reached at www.CLAconnect.com.