BEYOND BANKING: A TEXAS CAPITALISM® SERIES

REALIZE THE TRUE VALUE OF YOUR BUSINESS

The middle market best practices that close the valuation gap

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REALIZE THE TRUE VALUE OF YOUR BUSINESS

The term "middle market" is increasingly becoming a buzzword across much of the small business community from clubhouse conversations to professional services organization happy hours. To be classified as a "middle market" business today is considered a badge of honor for many founders and entrepreneurs, because it increases the valuation of your company in the eyes of bankers, and potential buyers or investors. In fact, middle market companies achieve nearly a full turn of EBITDA (earnings before interest, tax, depreciation and amortization) higher on average in valuation multiples than their small to midsized counterparts. So what do middle market companies do to achieve the full valuation their company deserves? The answer is… it depends on to whom you're talking.

Some organizations broadly classify the middle market as businesses with $250 million to $2 billion in annual revenue. Others, such as the National Center for the Middle Market, define it as companies with between $10 million to $1 billion in annual revenue.[1] Neither definition is right or wrong, but that is because to be "middle market" is as much subjective as it is quantitative.

So, as a corporate banker who partners with business owners on a daily basis, I'd like to offer up my definition of what a middle market business is and what they do to separate themselves from their small or midsized counterparts. **Applying these same practices to your business can help you close any valuation gap that may exist between how you value your company, and how a banker, buyer or investor analyzes and values your company.** Ultimately, that higher valuation can mean lower cost credit, a better sale price or more favorable investment terms.

If it stood alone, the U.S. Middle Market in aggregate would be

THE 3RD LARGEST GLOBAL ECONOMY[1]

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MIDDLE MARKET BEST PRACTICE #1

INVEST IN PROFESSIONAL SERVICES

Have you ever heard the old adage that the best way to get a read on what someone is like or the quality of their character is to look at their five closest associates or friends? The same adage applies to how outsiders (namely investors, lenders or potential buyers) assess businesses. But instead of looking at friends and colleagues, we look at whom that business has selected as their primary professional services providers (i.e., CPAs, attorneys, bankers, HR and payroll providers, and insurance and benefits firms).

Put simply, a middle market business differentiates itself from being a small or midsized business by leveraging professional services that are more robust and/or cater to larger businesses. This is not to say that a $10 million revenue company should be using KPMG or Deloitte, but are they working with an accountant that deals often and frequently with larger businesses, or are they using the same CPA who completes the business owner's personal tax returns each year? The point is simple—professional services firms that work and consult with larger companies will understand what their largest clients have done to be successful and will be able to apply that learning to provide more suggestion and partnership potential to a smaller business. If the business is the largest client for its service providers, it may get more customized attention for less money, but fewer opportunities to learn from peers through shared partners. Middle market businesses recognize that service providers offer immediate value in advice and consultation, but they also realize that higher quality service providers improve the soft components to their business' valuation or credibility when looking to secure financing, sell or pass down a business.

As a banker, I've helped numerous companies through mergers and acquisitions. It's never a surprise to me when the companies that spend money up front on financial statement audits, retaining the right corporate counsel and developing solid relationships with their banks, end up achieving the valuation they expect. Those middle market business owners see the up-front $50,000 annual cost of an audit as a long-term investment that helps improve valuation while a commercial business owner may see an audit as a "thing my bank makes me do to get a loan every year." This view is both flawed and shortsighted when you consider the potential value missed.

The U.S. Middle Market represents
NEARLY 33% OF PRIVATE SECTOR GDP[1]

Professional services firms that work and consult with larger companies understand what their largest clients have done to be successful and will be able to apply that learning to provide more suggestion and partnership potential to a smaller business.

MIDDLE MARKET BEST PRACTICE #2

BUILD THE RIGHT BUSINESS STRUCTURE

Admittedly, this differentiator is very subjective. Think of structure in a business less as "does my business have rigid protocols and procedures?" and more as "can my business survive without [name any key employee]?" Broadly speaking, middle market businesses differentiate themselves by putting some form of management structure in place that is well known to the employees. This is important mostly for internal continuity of business, employee morale and clear delineation of decision making in key areas of the business.

In the eyes of bankers, investors and potential buyers, a middle market business has clear, diagrammed management team responsibilities with delegated authority. The reason why a delegated structure is important is it helps to minimize "key man" risks. Unfortunately life is uncertain, and while a remote possibility that a key person does get struck by lightning or is suddenly incapacitated may be a tough question to tackle, decision-making authority delegated throughout the business is key to ensure business continuity if the unexpected happens.

Structure in business evolves over time, usually as a result of growth, but often commercial businesses or closely held businesses are slow to evolve their business structure because business owners try to control too many elements in their business. It's ironic, but typically some of the best running businesses and corporations have very few everyday operating decisions made from the top. So perhaps the key for business owners to achieve middle market status and optimal valuations is to actually do less and rely more on the teams they built.

The U.S. Middle Market represents

1/3 OF ALL U.S. JOBS[1]

In the eyes of bankers, investors and potential buyers, a middle-market business has clear, diagrammed management team responsibilities with delegated decision-making authority.

3

MIDDLE MARKET BEST PRACTICE #3

UTILIZE DATA, INVEST IN TECHNOLOGY AND PLAN STRATEGICALLY

Out of all differentiators that classify business as middle market rather than small to midsized, the use of data and tracking may be the most difficult to implement. This is because for business owners and decision makers to begin tracking data, a significant investment in technology and labor hours is typically required before you can create actionable data-driven plans. In addition it requires leadership within the businesses to change "well that's how we've always done it" mentalities. Driving this kind of change is extra work, especially initially, but it's well worth the effort in the long term.

Two of the most significant data and technology investments with the greatest ROI are accounting and ERP systems. The timing of these investments is critical, because the larger a business grows the more difficult it is to change these systems. However, implementing a robust business software system too early can be uneconomical relative to the cost. In reality the core backbone of any business is its books and records—ultimately, what valuations are based on (unless you're a high-tech Silicon Valley business). Additionally, a business's books and records are the first things that outside capital providers look at to assess risks. Middle market businesses understand this and make the investments in technology prior to growing and scaling.

Clear and accurate data about your financials, capacity, fulfillment and integrated sales pipelines enable decision makers to make smart investments in people and focused advertising. In addition, with enough historical datasets, the best businesses can begin predicting with higher effectiveness their short, intermediate and long-term sales and cash flows, allowing them to operate more effectively. Lastly, if you have a robust accounting and ERP system it will allow your CFO to focus on forward-looking initiatives and growth rather than simply keeping the reporting accurate.

In my experience, if you're making decisions based on feeling and not data, chances are you're falling behind the times and at some point it might bite you from a valuation or cash flow perspective.

The U.S. Middle Market represents more than

$10 TRILLION IN ANNUAL REVENUE[1]

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MIDDLE MARKET BEST PRACTICE #4

AUTOMATE BUSINESS PROCESSES TO UNLOCK WORKING CAPITAL

When assessing lending risk, I'm most impressed by the private commercial businesses that have figured out how to automate processes effectively across all or most business disciplines. Middle market businesses recognize that while there is a direct cost in implementing process automation, namely through technology investment, they recapture the investment quickly by reducing opportunity costs.

Perhaps the most overlooked process automation opportunity is in managing cash flow. For example, when they start, most businesses tend to send and receive payments the "old school" way, by check. As they grow, often their accounts payables and receivables processes don't scale along with the company. They simply continue cutting and depositing checks because that's how they always did it. However, when you add up how much these manual processes actually cost versus automated processes that accomplish the same tasks, it's a substantial opportunity to save money and unlock cash that's trapped in the balance sheet.

For example, if you're paying all of your operating expenses by check, first you have to purchase the check stock. Let's say that's $200 per 1,000 checks. Then you need to pay for the ink at $15 per month for a volume of 500 checks per month, and postage of $0.55 per stamp. Layer in the employee cost, and you've got an additional cost of $81 assuming it takes nine hours per month to have an employee paid at $9 per hour handling your payables. When you summarize all of this together it equates to $471 per month in pure overhead just to send payments to vendors or suppliers. Under the same 500 outbound payments per month scenario, let's now assume an average cost per ACH of $0.45 and approximately three to four employee hours per month at $9 per hour. The effective total cost is $252 versus $471, a 46% real cost savings. This example is just on the payments side, but in effect there are many ways to automate and speed up and/or extend payments and collections to optimize cash flows and unlock working capital.

What middle market companies do differently is partner with a working capital specialist to develop customized solutions to automate these processes, and continue that partnership as the business evolves to ensure their working capital structure changes with their needs.

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MIDDLE MARKET BEST PRACTICE #5

PAY ATTENTION TO AND INCENTIVIZE SCALE AND MARGINS, NOT JUST REVENUE

Now, let's talk about growth…one thing that unites business owners of companies of all sizes is their passion for growth. For many business owners and sales organizations the focus is often on top-line sales revenue. Revenue is obviously important, but it's not the answer to every problem. Ironically the business "event" which puts more companies in trouble than anything is when companies encounter explosive growth. Usually it's because there is a lack of working capital in the business.

The most common practice I see in successful middle market businesses is they track, think strategically about improving margins, and incentivize the sales organization based on margins. Margin is tough to fully understand without the appropriate accounting platform because fulfillment times, inventory turnover, collections and volume are all important factors. If you don't know what you are making on the sale of a particular product or service, how can you appropriately budget your costs as your business grows? This is why it is so important to look at the whole picture before assuming that revenue growth is the cure to all business problems. If you're not sure of where to start, there are tons of books that take a quantitative approach to helping you solve this problem which are worth the read—literally!

It is very rare to find businesses that struggle in the long term when their sales teams are appropriately incentivized according to net profits or gross margins. By aligning sales leaders with the goal of profits, you eliminate the single biggest point of potential for conflict between business owners and employees that commonly exists. Furthermore, this incentive structure can help you recruit better salespeople. Overnight you shift your product sales pitch from "price" driven, to "value/service" driven.

Of course there are still some pitfalls to a margin-based incentive model with price gouging as the biggest risk. However, this risk is mitigated by putting internal controls and pricing scales around products or services to ensure you deliver a consistent message to your consumers.

People always ask me how Texas Capital Bank—which was a mere start-up in 1999—organically grew without any mergers or acquisitions to over $600 million in annual revenues and assets to now greater than $22 billion. It is nearly unheard of in banking, but the answer is simple. Our leaders aligned banker incentives to reward margin, retention and quality customers, and the result of our sales team incentive model is simply incredible.

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SUMMARY

There are many practices that differentiate small and midsized businesses from middle market companies, but by no means can you differentiate on revenue alone. I have seen middle market companies with less than $10 million in revenue that have robust technology, clear structure and delegation of authorities, optimized working capital structures, and sales models designed to reward based on margin and retention. In these cases, the business owner and I tend to see much more clearly the potential valuation of the business and, for that matter, the ability to attract debt or equity capital. I also see $100 million businesses that are still in my opinion "small businesses" in terms of how their company is run, and these are the cases where there is a valuation and credibility gap between how the business owner values the company versus how I do.

Ultimately, there's no right or wrong way to become and be perceived as "middle market," but my hope is that business owners—especially those who anticipate having capital needs, a buyout or bringing in an investor—are mindful of this advice. The value of implementing these best practices could potentially be a significant valuation increase compared to the costs.

Ultimately, there's no right or wrong way to become and be perceived as "middle market," but my hope is that business owners – especially those who anticipate having capital needs, a buyout or bringing in an investor—are mindful of this advice.

HOW CAN WE HELP YOUR BUSINESS REALIZE ITS TRUE VALUE?

Texas Capital Bank sees valuation gaps as an opportunity to help companies optimize for the future. Our deeply experienced bankers are well-versed in the business practices that affect business valuations. Our bankers recognize that these changes don't happen overnight, but they specialize in helping businesses achieve their full potential through a strategic consultative process. Plus, our network is your network; we're always happy to connect our clients with contacts within our network with expertise on a particular topic, or who have overcome similar challenges.

Contact a Texas Capital Bank relationship manager to discuss the future of your business: 214.932.6611 or info@texascapitalbank.com.

REFERENCES

1. National Center for the Middle Market, "3Q 2016 Middle Market Indicator Infographic." http://middlemarketcenter.org/infographics/3q-2016-middle-market-indicator-infographic (*Nov. 28, 2016*).