



# VIEWPOINT

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## CREATING VALUE: PART I UNDERSTANDING OPPORTUNITY

By Elliot Williams, President

*When two companies operate in the same market space, what makes one company more valuable than another? Why does one company sell for a multiple on revenues while another fetches a multiple on earnings? Most importantly, how can you be sure you are focusing your efforts and resources on the factors that will result in your business being courted by multiple buyers and receiving top dollar?*

*It is important to understand that there are many factors you can control about your company's value and there are some you cannot control. To be sure, every company's value changes constantly as the market fluctuates. Although market timing is a major piece of the valuation equation, in this Viewpoint and in our April issue, I will write about the value-building factors that are within your control.*

In our work with mid-market companies, we find that while company leaders are experts in their industries, many do not have a strong understanding of the factors that drive the decision making of potential buyers. This was confirmed in recent interviews with two private equity professionals who regularly sit on the buyer's side of the negotiating table.

"Many owners are inexperienced with respect to the acquisition process, and the factors buyers look at can be foreign to them," said Jay Jester, managing director at Audax Group, a Boston-based private equity firm. "As a result of this inexperience, people can have unrealistic expectations about value."

"We're buying companies in the middle market," said Jeff Newton, managing director at Gemini Investors, another Boston-based private equity firm. "Some business owners in this market sector are more sophisticated than others, but typically they often don't have a strong sense of what drives value."

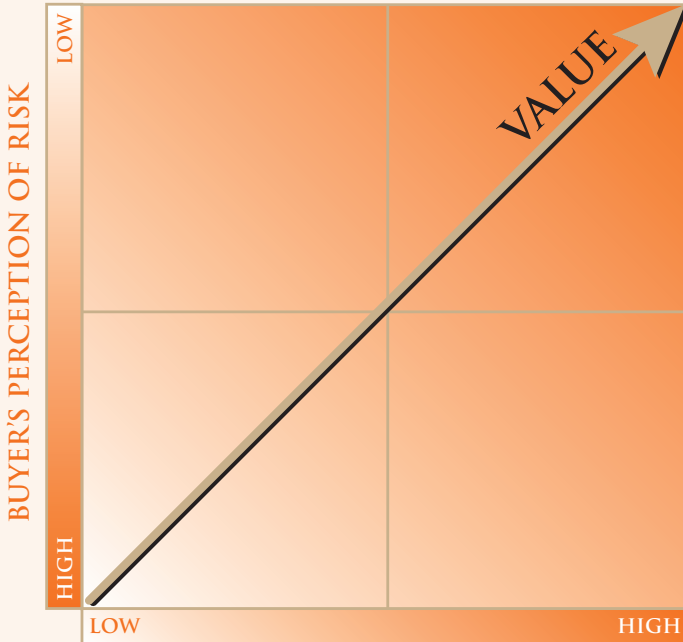
### WHY THIS MATTERS:

- *Thoroughly understanding what factors buyers consider when acquiring a company gives you a roadmap for maximizing your business's value.*
- *Being thoroughly familiar with the factors that build value can help you understand which buyers are the best match for your business.*
- *Knowing how buyers view value puts you in a better position when you're at the negotiating table with a potential acquirer.*

## THE BUYER MINDSET

So how do buyers think of value? As Exhibit 1 shows, all buyers evaluate two broad components of value: perceived opportunity and perceived risk. Value is driven by minimizing a buyer's perception of risk, maximizing a buyer's perception of opportunity, or better yet, accomplishing both.

Exhibit 1



### BUYER'S PERCEPTION OF OPPORTUNITY

When thinking through what factors impact a buyer's view of risk and opportunity, we looked through our list of closed M&A transactions and found that the value drivers generally fell into ten primary categories, shown in the list in Exhibit 2. Each of these factors affects both risk and opportunity to some degree but some are weighted more heavily in one direction or another. For this reason, we have grouped them into "factors that affect perceived risk" and "factors that affect perceived opportunity." Increasing the opportunity drivers while minimizing the risk factors will push your business into the "magic quadrant." This is the upper right quadrant of Exhibit 1, where value is maximized because opportunity is highest and risk is lowest. While it is safe to say that all buyers see value this way, it is important

Exhibit 2

FACTORS THAT AFFECT PERCEIVED OPPORTUNITY	FACTORS THAT AFFECT PERCEIVED RISK
SYNERGIES STRATEGY INNOVATION SCALABILITY MARKET CHARACTERISTICS	FINANCIAL VISIBILITY PERFORMANCE OPERATIONAL EXCELLENCE BARRIERS SIZE

to understand that each buyer perceives opportunity and risk differently based on their individual circumstances. In other words, different types of opportunities appeal to different buyers, and some risk factors represent big red flags for one buyer but not for another.

## COMPONENTS OF PERCEIVED OPPORTUNITY

The rest of this Viewpoint is devoted to a discussion of opportunity and the April Viewpoint will focus on the factors that impact risk. The factors driving opportunity and therefore increasing value are: synergies, strategy, innovation, scalability, and market characteristics.

Let's explore each opportunity factor at a high level, including some of the critical business issues that each encompasses.

- SYNERGIES** Two types of synergy can arise from an acquisition. The first is the opportunity for cost cutting through the elimination of duplicative overhead functions, usually in areas such as finance, administration, and marketing. Cost savings can also occur through the elimination of duplicate manufacturing plants or other infrastructure.

Another form of synergy arises when a buyer can leverage the various strategic assets of the seller. This type of synergy occurs, for example, when a buyer can take a product that has been generating \$20 million in revenues for the seller, and by moving it through the buyer's more robust distribution channels, can quickly increase that volume to \$100 million.

Synergy value can be difficult to plan for, given that it is highly dependent on the nature of the ultimate buyer. That being said, it is important for every business owner to "take inventory" of their company's strategic assets. Look at your products, intellectual property, best practices, proprietary processes, domain expertise, management, unique skill sets, distribution channels, and brand. How can they be further improved? How do they fit into the broader industry picture?

During the process of selling your business, the buyer will create a joint operating plan that combines your operations with theirs. It is important to have identified synergies in your business as well as their impact on the buyer before negotiating price. If negotiated properly, these assets and cost-savings will increase your company's value.

- **STRATEGY** In large part, strategy should be driven by customer and market need, but it is also important to have a strong understanding of the big picture view as well. This means knowing where the market is headed at a very high level, identifying where your company fits into broader industry trends, and communicating how your company should be thought of in this broader context. This is an area where almost all owners and CEOs could improve. Not only should you understand your strategic position in an industry, you should be “marketing” your value proposition to the press, large industry players, and industry observers (such as IDG, Gartner and other industry research firms).

I often hear people in the technology market express frustration about “a lesser” technology company being acquired for a significant premium. The reason is often linked to strategy alignment of the buyer and seller.

Jeff Newton also sees this as an area where many companies fall short. “It’s striking how often we see entrepreneurs who have built a business but don’t have a growth and value strategy in place,” he said. “They just respond to industry opportunities as they come along. Being able to articulate how you’re going to double in size over the next five years and pointing to the resources you have put in place to execute that plan enhances value dramatically.”

- **INNOVATION** Innovation creates intellectual property that if properly positioned and protected can be highly leveraged by buyers to create new features, new products, and better systems for innovation.

**New features** in current products can both increase the value (and therefore price and margin) of products through

## CASE STUDY: SYNERGY BECKWITH ELEVATOR & OTIS ELEVATOR

Here’s an example of how being able to identify a strong synergy can add value. In 1998, Mirus sold Beckwith Elevator, a Boston-based company that provided design, installation and service of elevators, to Otis Elevator, a division of United Technologies and the largest elevator company in the world. Beckwith generated approximately \$20 million in revenues and \$3.9 million in pre-tax profit, but the company’s historical revenue performance showed significant cyclicality.

During the sale process, Mirus identified a number of strategic assets but put particular emphasis on Beckwith’s unique ability to design and service custom elevators. Because of its focus in Boston, Beckwith had become highly skilled at designing and retrofitting elevators into old buildings – small elevators, multi-door elevators, and uniquely shaped elevators. We positioned Beckwith as not only a market share leader in Boston, but as a “custom elevator design group” for Otis. Otis could use Beckwith’s expertise to design, install, and service custom elevators in other older cities, such as Philadelphia, New York, and Chicago. Otis bought Beckwith for \$34 million in cash, which represented one of the highest relative valuations ever reported for an elevator company.

differentiation, and they can extend the life of current products.

**New products** developed through a full R&D pipeline represent new markets, revenue, and profits in the medium and long term. They also offer differentiation, avoiding the common “one trick pony” syndrome that exists with some smaller companies. Companies with a proven record of multiple innovation successes can allow a buyer to be more expansive in value with the promise of new markets and new revenue and profit streams. I would argue that Microsoft’s acquisition of Groove Networks was as much about future development as it was about Groove’s current products.

**Research talent, systems and processes** are in and of themselves highly valuable. We have sold companies that generated a significant premium based solely on the company’s development team, tools, and best practices for innovation. In these cases, the IP of the company’s end products was of no particular

interest to the buyer.

- **SCALABILITY** Companies that have created business models that are capable of scaling rapidly and profitably are more valuable than businesses that grow revenues and expenses in a linear fashion. In other words, businesses that can generate exponential sales and profits on incremental investments are highly valuable.

If your business has the ability to move in this direction, you should strongly consider making the investment to get there. Good examples of scalable businesses are software companies that have embraced the Software as a Service (SaaS) model and online information and subscription services that sell the same content across a growing customer base.

- MARKET

### CHARACTERISTICS

This value-creation factor is often overlooked by business owners. The size and growth of a market can have significant valuation implications since it provides a framework for buyers to think about the overall opportunity presented by the seller. If your business generates \$50 million in revenues in a \$100 million market that is growing at 5% per year, this seriously limits your growth potential and therefore limits value. Growth is a more difficult task in markets with limited size and/or growth. If you're in this situation, your path to greater value would be to consider how your market position and strategic assets can be leveraged to attack new or adjacent markets.

### HOW TO USE THIS INFORMATION

Understanding how buyers think about value gives you a framework for maximizing the value of your business and for

## CASE STUDY: MARKET CHARACTERISTICS DATICON & XIOTECH

Understanding broad market dynamics can be critical to creating value, as this case study illustrates. Earlier this year, Mirus sold Daticon, a provider of paper and electronic legal discovery services, to Xiotech, a manufacturer of data storage equipment. Daticon generated approximately \$20 million in revenues and was losing money on two consecutive years of revenue decreases. Mirus positioned the business for sale, emphasizing the rapid growth of this industry and Daticon's enviable position, brand and customer list in the rapidly growing electronic discovery market.

Xiotech's core market of data storage equipment had become commoditized, causing companies in the market to fetch low valuations. Xiotech was searching for a new market to enter that was adjacent to data storage but would afford a higher valuation from the market. Mirus positioned Daticon as a great opportunity for Xiotech to capture the entire value chain around data storage. By acquiring Daticon, Xiotech would be able to capture, store, manage, produce, archive and analyze electronic evidence. Most importantly, they would be positioned as a major player in electronic discovery, a market that is garnering very high valuations. Xiotech outbid some of the largest names in data processing and document management and bought Daticon for \$30 million in cash.

creating a better company with more solid fundamentals. As your company moves through the growth cycle, you will face numerous important decision points. Along with your customer and your market, value creation should be one of the factors you consider in making these key choices.

According to Jay Jester, "Right now it is a very hot market, and good companies that continue to perform well are commanding hot prices because people perceive that there is a lot of opportunity in the market."

Whether you're seeking to take advantage of this strong M&A market or want to position your company for continued strong growth, paying attention to the value creation levers will put you on the path toward achieving your goal.

*(Watch for April's Viewpoint for a discussion of the other side of the value equation, the factors that drive a potential buyer's perception of risk.)*

*Elliot Williams is president of Mirus Capital Advisors, Inc. Mirus is a middle-market investment bank that specializes in advising companies in strategic mergers and acquisitions. By combining a proven process, industry and transactional expertise, creative thought, and personalized service, Mirus has completed hundreds of transactions for both public and private companies. Mirus is a registered broker-dealer and NASD/SIPC Member. For more information, visit [www.merger.com](http://www.merger.com).*

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