# Financial Metrics that Determine Shareholder Value

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**If you own** or run a private company and don't have an MBA in finance, you are not alone. In fact, it is rare for successful entrepreneurs to have much training in finance. But understanding financial metrics can significantly impact your ability to enhance the value of your business and most entrepreneurs focus on the wrong metrics.

The majority of private company owners and CEOs gauge the financial health of their businesses primarily by what is happening with the top line, i.e., sales. If revenues are rising, they assume the value of their company is increasing. Many others focus on the bottom line; they argue that profits are a more crucial performance measure. After all, business is all about making a profit, right? Still others target their equity account or book value, as the primary indicator of shareholder wealth creation. If the line on our personal financial statement that says "net worth" is the most important yardstick, why wouldn't that apply to a business? Which of these various financial metrics is the most important determinant of the company's value? Surprisingly, the answer is none of the above.

Last summer, during my 20th reunion at Harvard Business School, one of the professors conducted a session for private company owners. He opened by asking what metric the owners monitored most meticulously. About 90 percent immediately responded "Cash!" Despite all the sophisticated financial analysis tools we learned in business school, is understanding the value of a company as simple as looking in the bank account? Not exactly, but understanding and measuring the company's ability to generate cash is essential to maximizing its value.

Ultimately, every company — regardless of where it is located, what industry sector it is in, the markets it serves, the products or services it sells or its size — really is in the same business: generating cash. Consequently, the price you will receive when you sell your business is most closely tied to the company's ability to generate cash. Focusing on any other metric can lead to busi-

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ness decisions that sub-optimize the value of the company.

Measuring a company's cash flow is not a straightforward exercise. Unfortunately, attempting to make any sense out of the statement of cash flows in a CPA's financial report is generally a waste of time. To truly understand your company's performance, you need to establish your own spreadsheet that properly measures cash flow and update it on a routine basis.

When it comes time to sell the company, you can rest assured that any sophisticated buyer will base their offer primarily on this performance measurement. Even if you are not contemplating selling your business anytime soon, if you expect to make managerial decisions today that will increase the company's value, you need to be using cash flow as a compass. Your banker may not focus on it and your CPA may not measure it, but you should.

Before I explain how to properly measure cash flow, it is important to acknowledge that other metrics can send misleading signals about financial health. Increasing revenues do not always reveal a healthy business. I had one client whose salesforce was paid a commission exclusively on revenues, which is not unusual. The company managed to show double-digit sales growth for several years in a row. Because the CEO did not have adequate controls in place, he instructed the plant to fill the ever-increasing orders. Unfortunately, the product mix shifted every year to lower-margin products, which, not surprisingly, were easier to sell. The company grew its way into insolvency.

Likewise, profits can be a very misleading measure of value creation. There are a number of non-cash charges that can impact and distort profits. Depreciation is a big one. As you depreciate assets, your profits are reduced. But in many cases, the true value of certain "depreciating" assets such as real estate may actually increase. Similarly, if the company operates with antiquated technology or equipment, significant investment in capital expenditures will be required to remain competitive. But while capital expenditures require cash, only a fraction of the outlay hits the bottom line in the year of the purchase. Moreover, most private companies incur discretionary charges that lower profits, but they don't necessarily lower the value of the company because a new owner would discontinue the expense. For example, your spouse's salary or the lease on the Mercedes may lower profits and taxes, but not necessarily value.

Book value, or the equity account on the balance sheet, may have no correlation whatsoever to true economic value. Of course the balance sheet is what most bankers focus on, so many business owners are deluded into thinking net asset value drives company value. But in most cases it doesn't. The reality is that most bankers could not value your business if they had to. So they use a simple approach to lending; they try to assure that if you go bust, they can sell your assets and repay their loan. This is a simple mathematical exercise for quantifying the downside of operating your business, but it is hardly a lens for understanding true value creation. I recently sold a company for $40 million that had a book value of less than $2 million.

So how is this enigmatic cash flow number that drives shareholder value computed? You start with the company's pre-tax earnings. Add back any interest charges, which gives you earnings before interest and taxes, or EBIT. Next, you need to make some adjustments by adding back all documentable expenses that would not be incurred by a third party seeking to maximize cash flow. Add-backs include toys such as non-essential cars and boats, as well as expenses for such items as family vacations and salaries for family members who don't really do any work.

Generally, the largest adjustment is for the owner's compensation. In any company in which the CEO is a key shareholder, his or her annual remuneration is a combination of the salary they receive for performing their job-specific duties and some return for being

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a shareholder. To arrive at the proper adjustment for executive compensation, you need to determine what an unbiased owner would pay someone to perform the same duties currently performed by each senior manager. Any amounts they receive above fair market rates are add-backs. Conversely, if you are underpaying key employees, this constitutes a negative adjustment. You now have an "Adjusted EBIT," which is the primary number sophisticated buyers will apply a multiple to (based primarily on the growth opportunities in your business) to arrive at what they will pay for the company.

In many industries, particularly those that are capital intensive, the cash flow number buyers focus on is further adjusted by adding back depreciation and/or amortization expenses, which are non-cash charges to earnings. This gives you an "Adjusted EBITDA" number. For reasons that escape me, despite the fact that this number most accurately predicts the value of your company, it never appears on any financial statement produced by your CPA.

Any of the more common financial metrics, including sales, profits and book value, are simply proxies for measuring cash flow and often ineffective and misleading proxies at that. If you want to understand whether your business is creating shareholder value and if you would like to make managerial decisions that will enhance that value, you need to be running your spreadsheet to measure cash flow on a regular basis. You can rest assured, any buyer for your business who knows what they are doing will be running the same spreadsheet someday. c

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