Examining the Business Model: Value Creation Strategies for Improving Financial Viability Before Selling

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Abstract:
The Value Examiner (September/October 2024): Reliable industry sources report that only 10 percent of businesses listed for sale eventually sell. Of the companies that do sell, business owners may not be maximizing the proceeds they receive. Often, the root cause of these fumbles is a lack of advance planning and preparation. However, a common question that arises is, "Where should I begin?" To answer this question, this article provides a roadmap to uncovering opportunities for value creation in advance of selling a business. To identify these opportunities, a study was conducted of business advisors and dealmakers who work with small business owners. For business owners and advisors, a good starting point for rewriting this narrative is to examine a company's business model and identify value creation opportunities. All companies have a business model that explains how they create, capture, and deliver value. The four main parts consist of the offering, customers, infrastructure, and financial viability. This article focuses on uncovering value creation opportunities related to financial viability, specifically in the areas of cost structure and revenue streams. Designed as a qualitative study, business advisors and dealmakers who work with small business owners were asked open-ended questions to capture their unique value creation suggestions extended to small business owners. The summarized responses of this article serve as a resource and idea starter as business owners and advisors work to build value and ultimately best position a company for sale. Similar to staging a house for sale, the more presentable the business when it hits the market, the better chance of receiving interest and obtaining maximum value.

Keywords:
selling a business, M&A, exit planning, business consulting, business for sale, entrepreneurial exit, business model

Examining the Business Model: **Value Creation Strategies for Improving Financial Viability Before Selling**

By Kipp A. Krukowski, PhD, ASA, CVA

By failing to prepare, you are preparing to fail.
—Benjamin Franklin

Reliable industry sources report that only 10 percent of businesses listed for sale eventually sell.[1] Of the companies that do sell, business owners may not be maximizing the proceeds they receive. Often, the root cause of these fumbles is a lack of advance planning and preparation.[2] However, a common question that arises is, "Where should I begin?" To answer this question, this article provides a roadmap to uncovering opportunities for value creation in advance of selling a business. To identify these opportunities, I conducted a study of business advisors and dealmakers who work with small business owners.

For business owners and advisors, a good starting point for rewriting this narrative is to examine a company's business model and identify value creation opportunities. All companies have a business model that explains how they create, capture, and deliver value. The four main parts consist of the offering, customers, infrastructure, and financial viability.[3] As shown in Figure 1, these parts can be broken down into smaller components to better explain how a company is structured.

The offering consists of the customer value proposition. The customer piece is further broken down into customer segments, channels, and customer relationships. Infrastructure consists of key activities, key resources, and key partners. Finally, the components of financial viability are cost structure and revenue streams. Both existing and nascent companies can document these nine components together through what is known as a business model canvas.[4] "Thinking through all nine components of your business model helps you understand how the various

parts work together: the value you'll create for customers, the processes you must implement to deliver value, the resources you need, and the way you'll make money."[5] As these nine components exist for all companies regardless of age, size, industry, or location, the business model and business model canvas components provide a natural way to explore potential value creation opportunities.

The study focuses on financial viability, examining the areas of cost structure and revenue streams. The cost structure represents all expenses of executing and running the business model. Revenue streams relate to the way companies earn income from their customer segments.

1 Arnez Rodriguez, "Business Brokers in the U.S.," *IBISWorld Industry Report* OD4796 (2021).
2 Kipp A. Krukowski, "Business Advisor and Dealmaker Testimonies: Deficiencies in Privately Held Small Businesses Leading to Failed M&A Transactions," *The Value Examiner,* July/August 2024, 4–9.
3 Heidi M. Neck, Christopher P. Neck, and Emma L. Murray, *Entrepreneurship: The Practice and Mindset* (Thousand Oaks, CA: Sage Publications, 2019).
4 Alexander Osterwalder and Yves Pigneur, *Business Model Generation: A Handbook for Visionaries, Game Changers, and Challengers*, vol. 1 (Hoboken, NJ: John Wiley & Sons, 2010).
5 Neck, Neck, and Murray, *Entrepreneurship: The Practice and Mindset*, 120.

Figure 1: Business Model Components

- The offering
  - o Customer value proposition
- Customers
  - o Customer segments
  - o Channels
  - o Customer relationships
- Infrastructure
  - o Key activities
  - o Key resources
  - o Key partners
- Financial viability
  - o Cost structure
  - o Revenue streams

Research followed a grounded theory methodology,[6] allowing survey participants to relate their experiences helping business owners prepare to sell their businesses. As a qualitative inquiry, findings are exploratory. The analysis involved evaluating and coding the responses of 50 certified business intermediaries and exit planners with a median advisory experience of 15 years working in small business M&A and exit planning. To capture their unique value creation suggestions, participants replied to open-ended questions in their own words, and these answers were captured by the survey tool, Qualtrics. The participants spent a median time of 40 minutes per survey, and each participant was paid $50 to encourage thoroughness in their answers. Data was analyzed outside of Qualtrics, removing any personal identification. Participants were assigned a number, BA01–BA50, which was tied to their specific responses.

In addition to qualitative questions, advisors were asked two additional questions:

1. When you work with a business owner to help prepare for their transfer of ownership, how often do you offer value creation suggestions for improving elements of the [cost structure/revenue stream]?
2. Generally, how many months, on average, are needed to implement and observe measurable impacts of value creation suggestions related to [cost structure/revenue stream]?

These questions were asked to confirm the belief that business advisors provide value creation suggestions in these areas. The results are shown in Figures 2 and 3.

Figure 2: Frequency with Which Value Creation Strategies are Recommended for Specific Areas of the Business Model

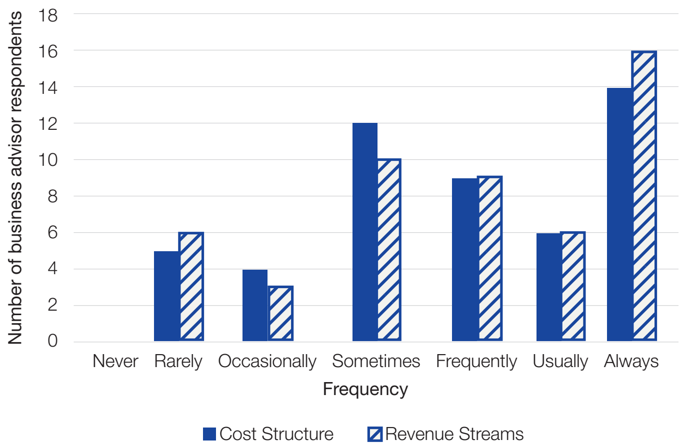
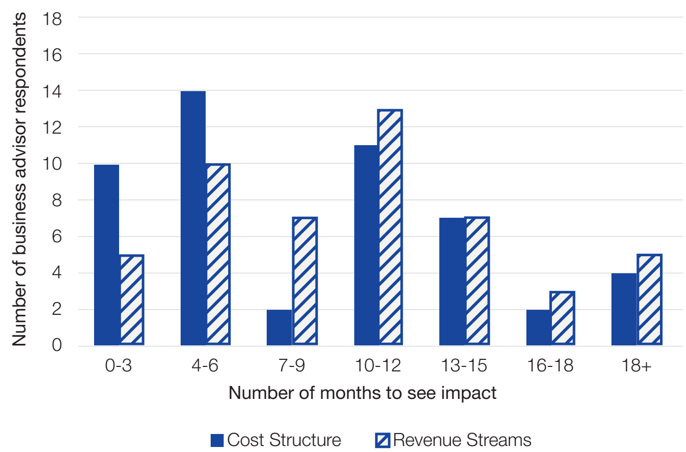


Figure 3: Average Implementation Time Needed to Make Measurable Impact on Business



The questions were general, so it is important to interpret them cautiously. Some value creation strategies take longer than others to implement. One takeaway from Figure 3 is that generally, cost structure improvements seem to affect businesses earlier than revenue stream improvements. Figure 2 shows that business advisors often make recommendations to business owners regarding value creation strategies in these two areas; very few respondents answered with never, rarely, or occasionally. This is good news for business owners, who might believe that business advisors are purely transactional. Business advisors often provide value creation strategies to best position a business for sale, which is also very evident in the qualitative responses that were received and analyzed.

6 Barney Glaser and Anselm Strauss, *The Discovery of Grounded Theory: Strategies for Qualitative Research* (Abingdon, U.K.: Routledge, 2017).

Understanding the existing cost structure is an important first step in uncovering opportunities.

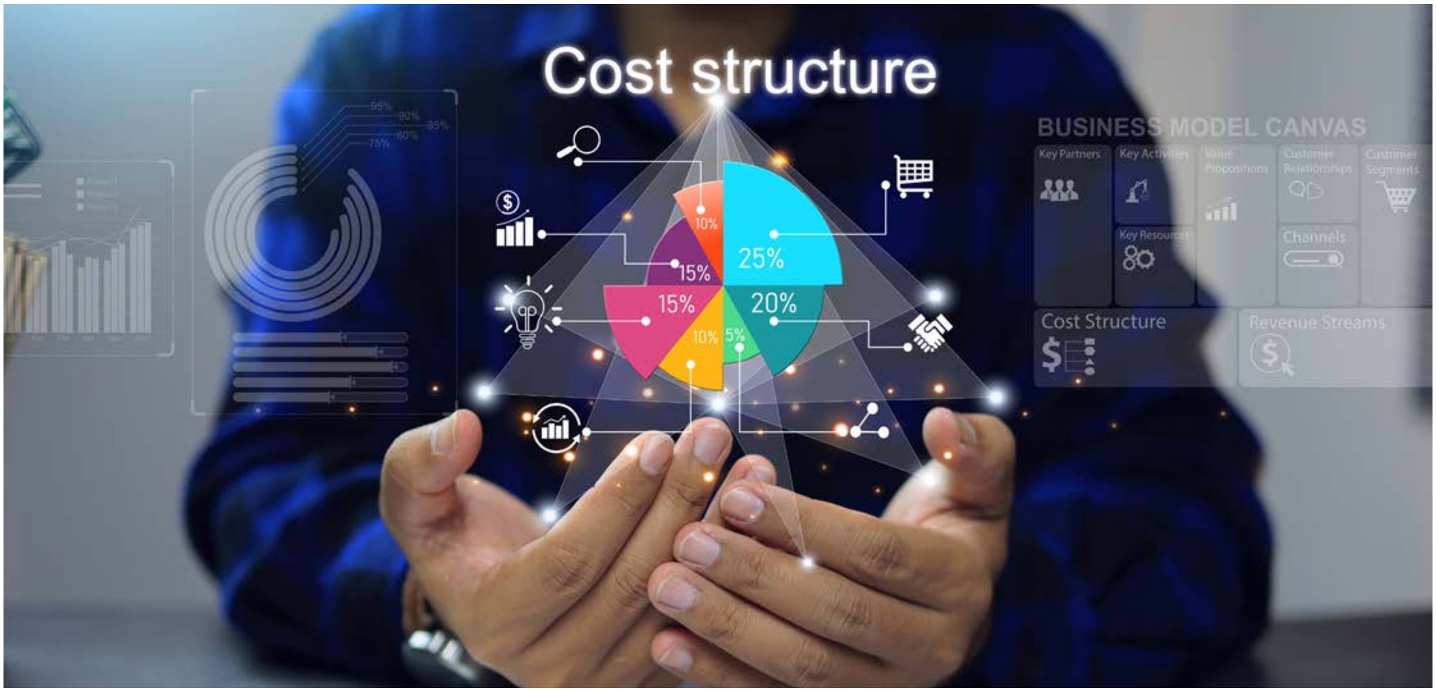
Through the analysis, several themes emerged. First, there is an evaluation stage in which business owners and advisors assess the existing situation. While this may seem obvious, it may have been some time since a business owner reflected on why specific decisions were made related to both company costs (e.g., vendor selection) and revenues (e.g., pricing strategy). The second stage involves evaluating potential modifications to the existing business model and the associated risks and rewards. The final stage is implementation of the strategies that make the most sense based on timing. While these themes are useful, the value of this study lies in the details; the information obtained from experienced business advisors was rich with value creation strategies. Responses were grouped according to themes, creating a narrative using both direct quotes and summaries of value creation ideas. These ideas are shared below.

Cost Structure

As one respondent noted, the role of the business advisor is to "help the sellers to understand what significant issues the buyers will be focusing on, and what contributed to those potential issues and how those potential issues might be avoided or improved in the future." [BA31] For example, another respondent stated, "we conduct a complete review of cost structures to determine areas that, if managed differently, could increase the exit value. We do this not only to uncover areas of near-term savings or efficiency, but to thoroughly understand the business so that it can be articulated to the prospective buyer. We ask a lot of whys." [BA05] Understanding the existing cost structure is an important first step in uncovering opportunities. "Many owners do not track their financials to see if they are in line with businesses of their size (revenue-wise) or industry." [BA10] Resources, such as RMA Statement Studies, provide comparative industry benchmark data for small and medium-sized businesses. To understand where there may be unnecessary expenses, an in-depth discussion with the owner is required. "This is done as we walk through the income statement with the seller, asking about every line item, from labor costs to cost of goods sold, etc." [BA27] "If an expense seems to be higher or lower than norms, we will get an explanation as to why" [BA43] as "costs need to be proper for the business model." [BA38] Once the business's required expenses are understood, "eliminating redundant or unnecessary expenses can boost the bottom line." [BA47] An example is a vehicle expensed through the business that is for personal use. [BA01] By comparing the subject company with peers, along with comparing multiple years of data to understand consistency, one might identify areas of "leakage" or "shrinkage" resulting from managerial errors or even theft. [BA49]

Once the current situation is understood, cost structure changes can be explored. Cost reductions can be achieved through improved efficiencies [BA13] as well as changing processes and procedures. [BA18] For example, outsourcing accounting, marketing, and HR functions can reduce or reallocate internal resources. [BA03, BA29] Cost savings may be found by changing suppliers [BA16] or renegotiating contracts with existing vendors for possible discounts. [BA06] Simple changes, such as switching merchant service providers, could result in savings. [BA44] Other potential small changes include switching information technology or insurance providers. [BA16] Opportunities might also be revealed when evaluating the effectiveness of marketing channels [BA16], leading to elimination of those with low sales conversions.

Business owners should determine whether their personnel costs align with business needs. As one advisor observed, "if a business is stagnant or in a decline, they [the owners] typically don't scale back on personnel quickly enough. This is mostly an emotional decision rather than a business financial decision and can create stress in [the] owner/sellers. Many times, changes can be made by temporarily switching some of the key people from 100 percent salary positions to partial salary and partial performance-based pay until the stagnation or decline turns around. Involving everyone in a key business shift can many times greatly improve employee morale if done correctly." [BA33] Businesses might also consider the pros and cons of having tasks completed by employees versus independent contractors. [BA37]



Business location may present cost reduction opportunities. When appropriate, owners should consider negotiating rent with their landlords. [BA06] Relocation may also be an option. "For example, I recently [worked with] a business which was in a retail location and didn't need to be. They moved and cut their rent by two-thirds and also cut their labor, as they didn't have to maintain retail hours." [BA19] Some businesses pay excessive rent as a result of a misalignment of the business's age, industry type, and location. Over time, real estate may become too valuable for the type of business located there; if the business owner owns the property, the business may become unprofitable after adjusting for fair market rent. [BA40] The owner may be better off relocating the business and selling the property so that its highest and best use can be realized.

Inaccurate financials may exist in both the expense and revenue sections of the income statement. Small business owners often run their businesses without the intention of exiting, so they work to minimize taxes. They may decrease profits by increasing expenses or reducing revenue. "I often see business owners charging personal expenses to business books. While some of these can be 'added back' to discretionary earnings, they often create suspicion with buyers and lenders. I tell them to keep personal and business expense separate." [BA15] Ensuring that only business-related expenses are included in the financials is important. [BA26] For past years, financials can be adjusted to take these into account, but buyers may not give full credit for these adjustments. Excluding the owner's personal expenses [B07] and removing nonessential family from payroll [BA06] can reduce expenses.

For small "cash businesses"—those that often receive payment from customers in cash versus traceable forms of payment—revenues may not be reported accurately. "I sometimes see cash that never hits the books, and I will not take this into consideration when valuing a small business." [BA15] Reporting accurate numbers can increase revenue and profitability.

Based on the responses from business advisors, while income statements tend to attract the most attention, evaluating balance sheets can also present opportunities. "Evaluating whether or not equipment and inventory values are within similar ranges as comparable businesses may also identify areas of potential improvements." [BA33] For example, excess machinery and equipment that is not used in generating the present level of revenue can be sold (unless the owner is trying to "sell" the idea that additional capacity is available for expansion). Similarly, excess inventory can be "right sized"—that is, taken down to a level that is normal for the industry. If this excess inventory is sold, the owner may be able to recognize this profit while maintaining a normal amount of "gas" (inventory needed for normal operations) in the tank. By comparing income statements and balance sheets with comparable businesses, it "allows our client and our buyers to understand where improvement should be or could be made." [BA23] It is important to understand

capital expenditures and determine whether they are accounted for accurately; some small business owners expense capital items through the income statement instead of using depreciation. When considering adjustments to the financials, for example, it may be necessary to "[look] for one-time expenses, such as capital expenditures, that [should be] spread over several years." [BA01] Additionally, owners may want to evaluate the impact of owning versus leasing furniture, fixtures, and equipment [BA37] as the decision will affect the business's future cash flows.

Timing plays into decisions regarding cost structure change initiatives. "It depends on when in the process the seller approaches us. If it's early in the decision to sell (ideally three years before going to market) then I spend a lot of time on these types of issues, coaching the seller on all of the ways they can maximize their earnings in order to capture the best and most qualified buyers, as well as the business qualifying for bank financing. Our focus is understanding the business's realistic CapEx as well as identifying and minimizing discretionary spending for the cleanest books possible." [BA25] One advisor warned about waiting too long to implement cost structure changes: "If the business is being put on the market in the near future, there is not much we as brokers can do to change operating expenses. We do add back nonrecurring expenses and discretionary expenses, but the expenses are what they are unless we are consulting with the owner regarding ways to improve profitability during the next few years prior to putting the business on the market." [BA20]

Value Creation Ideas for Improving Cost Structure in Advance of a Business Sale

- Identify opportunities through peer benchmarks
- Discuss financials at line-item level to identify non-required business expenses
- Implement cost reductions through efficiencies and process changes
- Investigate changes to or renegotiate with vendors
- Reevaluate resource needs such as location and personnel
- Implement accurate revenue and expense recognition processes
- Evaluate inventory needs and areas of potential loss or shrinkage
- Consider changes to balance sheet through owned and leased assets

Concentration risk should be measured by percentage of revenue, looking back several years, as this will give the potential acquirer an understanding of the consistency and magnitude of the issue.

Revenue Streams

Turning our attention to the revenue portion of the business model, customer concentration is a major concern for small businesses. Lack of diversification and high dependency on a small number of customers increases risk, and thus warrants a detailed discussion between business advisor and owner. [BA24] "Customer concentration is always a critical point of discussion, as it not only affects the value of the company, but most banks will refuse to make loans due to this issue." [BA08] Sellers should work to diversify to reduce this risk. [BA03, BA13] "The key concern to buyers, in my experience, is customer diversification (more than 10 percent from one customer is a red flag and generally a concern to a buyer)." [BA25] Concentration risk should be measured by percentage of revenue, looking back several years [BA31], as this will give the potential acquirer an understanding of the consistency and magnitude of the issue. Diversified revenue streams help mitigate perceived risk for buyers. [BA48] "I look at the composition of the revenue streams and learn what drives the business. If it appears they could add products or services or decrease reliance on one income source, I make those suggestions." [BA19] While diversifying may require obtaining new customers, some companies can gain diversity by growing revenue with existing customers. "I review sources and possible future growth by source." [BA02] Customer acquisition costs are typically higher than maintaining existing customers, so opportunities may exist to upsell current clients by adding products or services. [BA03]

Depending on the industry, it may be beneficial to analyze customer concentration by product or service type. [BA39] If a particular product or service experiences demand changes, similar concentration risks may exist. [BA01] Risks associated with seasonality of products and services should also be considered. [BA50] These risks may be amplified by weather and other outside factors. Sellers and business advisors should also consider customer channels and how they interact with the business. For example, some products may now be purchased and delivered to the doorstep when they were previously purchased in-person at a brick-and-mortar store. "I challenge business owners to diversify revenue streams, particularly in ways that promote the business 'virtually.'" [BA15] Improving online sales through an improved website and online marketing [BA42] provides an opportunity to increase sales. [BA37] "When benchmarking a business, we discuss revenue streams the seller may not have engaged but others in the industry pursue." [BA17] These new revenue streams might be created by slightly modifying processes or expanding delivery channels. For example, a business might implement a third-party delivery platform [BA09], leading to a new customer base. Or services that have been subcontracted or outsourced might be "pulled in-house and vertically integrated into the operation." [BA37] While these strategies may provide opportunities, one business advisor cautioned that "the business should not go outside of their core competencies. Some things fit, others not so much." [BA38]

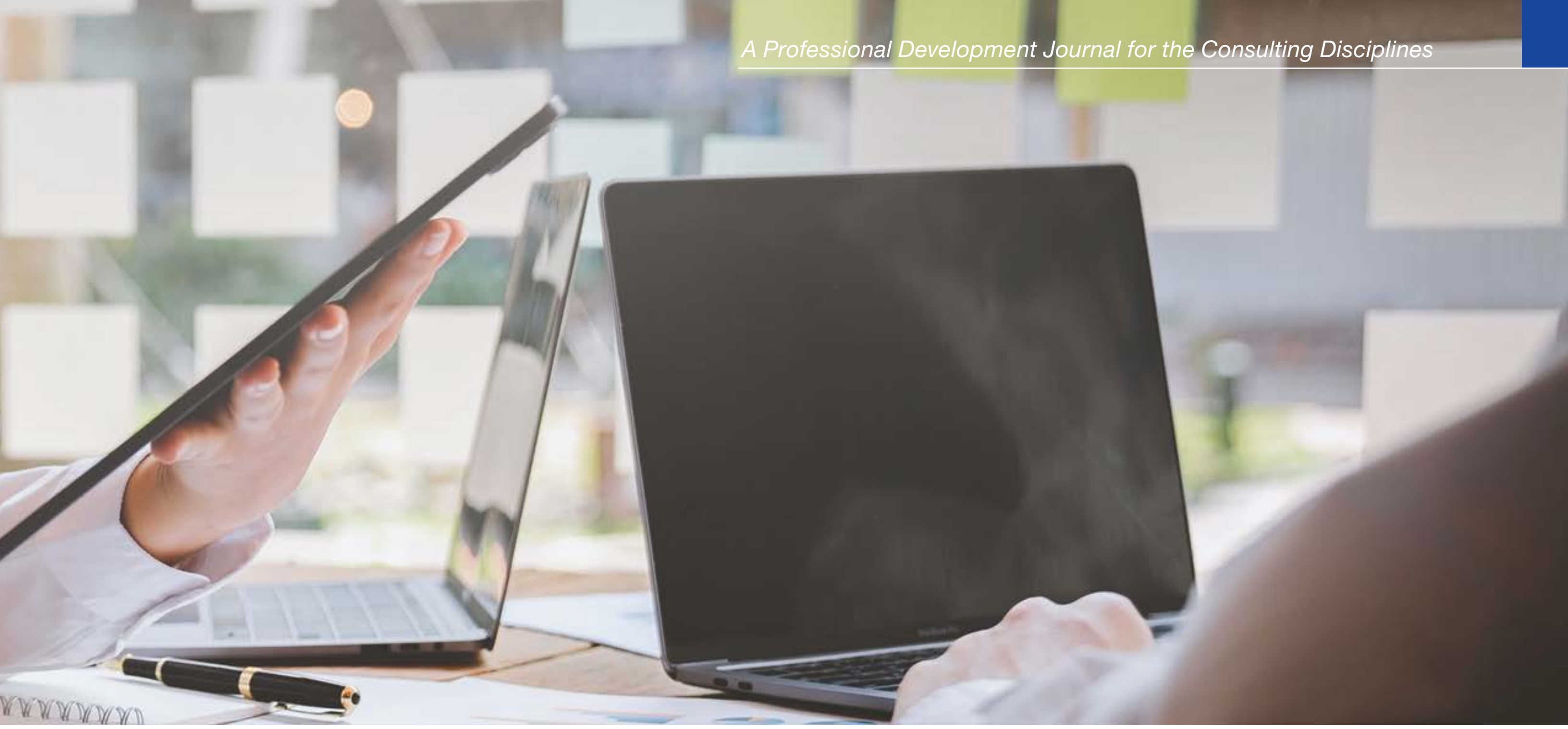
Concerns about revenue continuance may emerge during due diligence. For example, is the revenue recurring or does it come from one-time sales? [BA25] Are there revenue streams that will not stay with the business when sold? [BA01] These are critical questions to be addressed prior to a sale. Gaining an understanding of key contracts is also important when evaluating revenue streams. [BA26] Written agreements to buy products and services [BA03] can help provide some security for future sales. In small businesses, there may be concerns about the relationship between the owner and customers. To gauge the likelihood that revenues will continue, it is important to understanding who in the company holds the key customer relationships for all major accounts. [BA31] "It is important to prepare the owners on how to handle communications with the various customer

accounts regarding pre-closing and post-closing messaging." [BA31] Recurring revenue reduces some of the risk and increases the value of the business. [BA07, BA16, BA34, BA43] "For example, an HVAC company … [that] is service based and has service contracts in place [is likely more valuable] than an HVAC company of the same size that is new-construction based. Our specific advice is to create 'sticky revenue'—revenue that is repeated from the same clients. Each profession is different, but all can create 'sticky' revenue." [BA23]

Buyers want to see that the business is going in the right direction, or at least has leveled. "I tell business owners that the number one killer to trying to get a transaction done is if their revenues begin to decrease or if there has been a history of decreasing revenue. In these cases, a buyer will typically wait until the revenues reach some sort of 'basement' before stepping in. Steadily increasing revenues is what we like to see when taking a business to market." [BA27]

Another business advisor commented, "Depending on the sophistication of the records, we may identify more or less profitable streams and … have them focus on growing the more profitable ones." [BA43] Developing a good understanding of customer pricing and profit margins may lead to changes within existing revenue streams. "Often, there is a need to adjust pricing and we can give them suggestions of where they can increase prices or stop offering goods or services that are not making profit for them." [BA18]. As one business advisor observed, "[we recommended] changing price structure—one owner had not increased her prices in 12 years!" [BA06] Another advisor stated, "[We] ensure a pricing model will produce industry standard margins at a minimum" [BA16] while another noted that there is often "reluctance to raise prices, which in most cases will increase profitability … [providing] additional cash for investing in the business if and when appropriate." [BA05] Sellers should also be prepared to answer questions related to gross margins on key customer accounts and how they may be improved in the future. [BA31] Part of the pricing discussion might involve helping business owners understand their value proposition to the customer. [BA35]

As with cost structure changes, timing plays a role in identifying value creation opportunities related to revenue streams. As one business advisor commented, "rarely [do I] make suggestions, but if there are obvious additional streams to be mined quickly, I will discuss." [BA26] Another added, "I ask what opportunities there are for income diversification, the time and cost to implement, as well as break-even time frames." [BA04] For example, is the company actively using a database to collect customer information and market to existing customers? [BA30] Implementing a customer relationship management (CRM) database might result in a fast return on investment (ROI). Upselling past customers with service contracts [BA37] can quickly add revenue. Other expansions might require more time, such as expanding the product or service into new territories or regions [BA30] or expanding product or service offerings. [BA31] If expansion is being considered, sellers should identify products and services that have the potential to scale up quickly while minimizing dependence on the owner. [BA34] One business advisor suggested "polling existing customers to inquire what they would like to see in terms of products or services" [BA06] to identify new expansion opportunities. Of course, it is important to evaluate the cost and time to implement in relation to the benefits received.



Value Creation Ideas for Improving Revenue Streams in Advance of a Business Sale

- Analyze concentration by customer, product/service, location
- Compare concentration changes and dependencies over time
- Identify opportunities to reduce risk through diversification
- Consider upselling current clients with other products or services
- Evaluate opportunities to gain or expand revenue streams through new channels
- Develop recurring revenue with customers
- Ensure customer relationships are solidified
- Increase or maintain revenue level so that business is not declining
- Evaluate pricing changes on existing products and services
- Analyze timing and ROI for implementing changes and growth strategies
- Collect customer data through a CRM platform, nurture relationships, and poll for additional needs

Conclusion

Reflecting on the four major parts of a business model—the offering, customers, infrastructure, and financial viability—helps business owners and advisors gain a better understanding of how a company creates and delivers value. By further breaking down these parts into smaller components using the business model canvas, advisors can conduct a more thorough evaluation to identify areas of improvement. As identified in this study, experienced business advisors can help companies improve their financial viability prior to a sale. While this study is not all-encompassing, it serves as a resource and idea starter as business owners and advisors work to build value and ultimately best position a company for sale. Like staging a house for sale, making a business as presentable as possible when it hits the market improves the chances of sparking interest and obtaining maximum value. And, since business owners may receive unsolicited offers at any time, the earlier they start, the better. VE

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