

Good Business Run Wisely

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A newsletter to help you Maximize Value Creation in your business

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Quote of the Month

The successful businessman is no narrow specialist. He knows and understands all aspects of his business. He can spot a production bottleneck as quickly as he can an accounting error, rectify a weakness in a sales campaign as easily a flaw in personnel procurement methods.

— J. Paul Getty

Building the Situation Analysis: *Part 3, Collaborators*

This month in our continuing series on marketing essentials, we are going to discuss Collaborators. But first, let me tell you a little story:

There are two men in Kansas, and both of them grow wheat and raise chickens. Rancher Sam is able to grow 100 bushels of wheat or raise 50 chickens, yet Farmer Bill is not quite as productive and can grow 100 bushels of wheat but raise only 30 chickens. In this common scenario, Rancher Sam is said to have an **absolute advantage** in raising chickens:

	Rancher Sam	Farmer Bill
Wheat	100	100
<i>or</i>		
Chickens	50	30

And although both men can raise the same quantity of wheat, Farmer Bill has a **comparative advantage** because raising that 100 bushels of wheat only costs him the **opportunity** to raise 30 chickens whereas Rancher Sam would have to forego raising 50 chickens to grow the same 100 bushels.

Both men want to eat chicken and bread. To do so they could each split their time 50/50 between wheat and chickens. If they did this they would have 100 bushels of wheat and 40 chickens to share/trade between them.

	Rancher Sam	Farmer Bill	Total
Wheat	50	50	100
Chickens	25	15	40

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By collaborating through trade, however, they can multiply their wealth by focusing on their respective **comparative advantages**:

	Rancher Sam	Farmer Bill	Total
Wheat	0	100	100
Chickens	50	0	50

In this scenario the wealth of the entire community has grown by 10 chickens versus the previous scenario where both men grew wheat and raised chickens. These extra chickens can be sold and the profits used to buy new boots, add to the 401k, or reinvested in the business.

This story illustrates how trade and collaboration create value. Many companies attempt to maximize profits by increasing their slice of the value pie **relative** to their suppliers, distributors, and potential partners. A more lasting position is to maximize the size of the entire value pie, benefiting as the **absolute** size of your piece grows.

If possible, collaborate with suppliers making them an integral part of your supply chain. By working together you may be able to reduce material costs through customized raw materials, develop innovative new products that lever the strengths of both companies, or increase reliability of your production by linking your computers to theirs.

Similarly, collaborate with distributors. They have much knowledge concerning customer purchasing habits, can help you save costs by showing you how to redesign your packaging so more fits in a truck, and potentially let you know about new competitive threats.

Risks of Collaboration

Beware of collaborating with direct competitors because this puts you at risk of having your customers, proprietary secrets, and top employees stolen.

Also, remember that collaboration does not include collusion. Collusion with competitors to fix prices is illegal.

Related to this are collaborations with professional services such as accountants, lawyers, and even HR consultants such as [Kemmer Consulting Group, LLC](#). Working with such professionals allows you access to their specialized expertise without employing them full time on your staff.

Finally, consider strategic alliances. For instance, if your company makes car washes, consider approaching a chain of gas stations to see if you can work together to design a special car wash that fits into their business or uses their proprietary soaps and waxes. Or if you have started a local microbrewery, consider an alliance with a local pizzeria where they will sell your beer and you will let them deliver their pizza to your bar.

When analyzing collaborators, remember that long-term business success comes from leveraging your core competencies to develop competitive advantage and then focusing on that competitive advantage. Partnering with others will allow you to focus on your competitive advantage. Moreover, together you and a collaborator may have competitive advantages neither had before. Focusing on comparative advantage and collaborating with others, this Maximizing Value Creation through Good Business Run Wisely.

Basic Finance:

Valuing Investment Opportunities Using a Discounted Cash Flow / Net Present Value Model

Financially speaking, a product, project, or acquisition is only as valuable as the cash it provides. (Of course some decisions are made for altruistic means, and many are made out of bravado. Both are value judgments and emotional decisions—we are concerned most with rational decision making.) Nevertheless, not all cash flows are created equal. No, those created first are more valuable than those created later. To illustrate this point and to show how to value most any investment, I will use the simple example of a rental house.

Let's imagine you have the opportunity to buy a rental house, but you're not sure how much it is worth. You expect the house to provide \$7,000 per year in net cash income (rents minus all taxes, maintenance, etc.), and at the end of the ten years you believe you can sell the house for \$100,000. In this scenario, your investment would look like this:

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
Rents	\$7,000	\$7,000	\$7,000	\$7,000	\$7,000	\$7,000	\$7,000	\$7,000	\$7,000	\$7,000
House selling										\$100,000
Net cash flows	\$7,000	\$7,000	\$7,000	\$7,000	\$7,000	\$7,000	\$7,000	\$7,000	\$7,000	\$107,000

Simple logic would seem that this rental house would be worth \$170,000 (\$7,000 x 10 years + \$100,000 final value). But what you must remember is that a \$7,000 free cash flow in year two is worth less than a \$7,000 free cash flow in year one. And a \$7,000 free cash flow in year ten is worth a fraction of the \$7,000 free cash flow in year one. This difference in value is because of the time value of money: A dollar tomorrow is worth less than a dollar today.

To account for the time value of money when valuing projects, assets, and investments we find the “net present value of the discounted cash flows” (NPV) that the opportunity provides. This method of valuation does not concern itself with the value of the asset itself, but the cash creation of that asset, and adjusts the cash flows according to a “discount rate.”

A discount rate is an opportunity cost, meaning if you must borrow money at 10% interest you need to ensure the investment potential exceeds the cost of borrowing the capital. Similarly, even if you have cash ready to invest you want to make sure that the cash from the potential investment exceeds the cash you would receive from other less risky investments. For our house example, we do not have to borrow the money and will thus use a discount rate equal to the 10-year U.S. Treasury note. Unlike our hypothetical rental house, the 10-year Treasury note is considered a risk-free investment since it is backed by the U.S. government. As of March 2008, the 10-year Treasury note provided a historic low return of ~3.5%.

We now have all the information we need to do the valuation, and are ready for the mathematical NPV equation:

$$NPV = \sum_{t=1}^n \frac{C_t}{(1+r)^t}$$

t = the time of the cash flow

r = the discount rate

C_t = the amount of cash made from the investment at time t

Don't be afraid. All this is saying is: The NPV of an investment is equal to the sum of each years' cash (C_t) divided by that years' discount rate $(1+r)^t$. In our example the formula looks like this:

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
Rents	\$7,000	\$7,000	\$7,000	\$7,000	\$7,000	\$7,000	\$7,000	\$7,000	\$7,000	\$7,000
House selling										\$100,000
Net cash flows	\$7,000	\$7,000	\$7,000	\$7,000	\$7,000	\$7,000	\$7,000	\$7,000	\$7,000	\$107,000
Discount	1.035^1	1.035^2	1.035^3	1.035^4	1.035^5	1.035^6	1.035^7	1.035^8	1.035^9	1.035^{10}

And the present value of the free cash flows looks like this:

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
Rents	\$7,000	\$7,000	\$7,000	\$7,000	\$7,000	\$7,000	\$7,000	\$7,000	\$7,000	\$7,000
House selling										\$100,000
Net cash flows	\$7,000	\$7,000	\$7,000	\$7,000	\$7,000	\$7,000	\$7,000	\$7,000	\$7,000	\$107,000
Discount	1.035^1	1.035^2	1.035^3	1.035^4	1.035^5	1.035^6	1.035^7	1.035^8	1.035^9	1.035^{10}
PV of cash	\$6,796	\$6,598	\$6,406	\$6,219	\$6,038	\$5,862	\$5,692	\$5,526	\$5,365	\$79,618

Summing the present value of the cash flows gives us an NPV of \$134,121. This means that the value of the rental house is \$134,121, not the original \$170,000 that we assumed before factoring in the time value of money. And since the NPV of the investment is greater than its cost: $\$134,121 > \$100,000$ it would be a profitable investment (as long as our assumptions for rent and resale value are correct).

The rental house is a straightforward example, but not all investments are. For example, when valuing a business project you have to consider the amount of cash required to operate the business, taxes, various rates of inflation, length of the project, etc. And some investments are more risky than others. So when valuing an investment in Super-High-Tech-Startup corporation, you may need a 25% return on your money to account for this risk opposed to the meager risk-free 3.5% we used for the house.

Regardless of your investment opportunities, remembering that an investment is only worth the cash it produces and that cash today is worth more than cash tomorrow will allow you to make objective, rational financial decisions so that you can Maximize Value Creation through Good Business Run Wisely.



[Inc. magazine](#) is generally a decent magazine for small business people, but you can't always believe everything you read.

One specific case was the article, "[The Definitive Valuation Guide](#)" and the corresponding graphic, "[A Universe of Value](#)" published in the January 2007 issue. In the article and corresponding tables, the good people at Inc. were telling people that a business can be valued by multiplying their revenue by some magic number, which is different depending on the industry.

For example, Inc. said that bowling centers sold at a "premium" of about four times revenue, while manufacturers of plastic products sold at a "discount" of 4:10 of revenue. This is bad information.

Think about it, Molco Lanes in Beulah, ND might be more or less profitable than the AMF Bowling Center in downtown Los Angeles. Perhaps the AMF has economies of scale, or perhaps people in the Dakotas are willing to pay more for bowling. Regardless, what is important is cash from profits, not revenue—many companies lose money with every sale.

Inc. is not alone in spreading this bad practice. Even multi-billion-dollar companies I have worked with have wanted me to value acquisitions using multiples of earnings rather than doing the hard work of discounting cash flows. I don't do it. Instead I stick to the lesson Warren Buffet taught me: discount the cash. To learn this lesson from Buffet, read his [1992 letter to stockholders](#).