

## **A new challenge ..... Increasing shareholder value in a stagnant market**

**February 2004:** The question we heard when talking to senior management and shareholders with increasing frequency during the past year is: how do we increase shareholder value when revenue is and has been relatively static during the previous two or three years?

Companies have made and implemented operational decisions to reduce cost and to accept the reality that revenue is not going to increase exponentially in the near-term. Although these types of operational actions address the immediate financial needs of the business, they do not address the question of “how can we increase the value of the business?” We often meet shareholders who find it hard to be enthusiastic towards the business, as they no longer see the reward opportunity for their hard work and continued risk. Due to current market valuations, the alternative of an exit via a sale of the business may not appeal to them either.

We work extensively in an advisory role with small and medium size software and IT service companies facing these issues. We have noted that even with the competitive pressures in software and IT services that average selling prices are still sufficient to yield respectable net income and cash flow. Therefore, in most cases the survival of the company is not in doubt, and shareholders actively working in the business can still earn a good living. But, these same working shareholders cannot see the potential for a significant increase in the valuation of the company during the next two to three years. This leaves them feeling that they are in a stagnant position with little chance for significant improvement.

These shareholders often conclude that something must change! The change that is often contemplated is to align with an outsourcing partner. The expectation is that through outsourcing of certain functions that the business will be able to reduce costs and thus be able to remain price competitive in the marketplace. In addition to outsourcing of company functions, we find that many companies are considering or implementing sales channel partnerships. We have noted that many of the most successful companies have developed very strong sales channels using partnership programs. We also have noted that benchmarking performance also provides companies with real insight to what truly adds value in their market sector. In practice we find that few small and medium size software and IT service companies do perform any type of benchmarking.

Our experience in working with clients and prospects is that many roads often lead to discussions of acquisitions and exits. Each of these routes should be expertly analysed and considered for its potential risk and return. For example, for one client we built a financial model to evaluate the potential increase in shareholder of making a strategic acquisition compared to continuing with an organic growth plan for their company.

We find that some shareholders are wary of change because, although it may bring a higher return on their investment, it also involves risk and usually additional investment. Of course this is a personal decision, but if the options are carefully considered, the decision can be made to make a change or to stick with the current approach even if the opportunity for an increase in the valuation of the company is therefore limited.

When they have considered the choices many shareholders have decided not to consider a sale because of their expectation of low valuations as well as of being

viewed as a weak company. There is certainly an element of reality in forming this perception, but the situation is changing. The market is getting better for Sellers as Buyers are becoming active and aggressive. We have active engagements with several well-known US IT companies and contacts from several other large US and European IT companies who are now seeking to acquire small and medium size software and IT service businesses in the US and the UK. It is now certainly respectable to put a business on the market.

In recent weeks we have had several companies approach us seriously considering a sale of their business. Selling a business is fast becoming a viable option for shareholders once again.

###