MAXIMIZE BUSINESS VALUE PODCAST - EPISODE 86 Transcript

Announcer (5s):
Welcome to the maximize business value podcast. This podcast is brought to you by mastery partners, where our mission is to equip business owners to maximize business value so they can transition their business on their terms. Our mission was born from the lessons we've learned from over 100 business transactions, which feels our desire to share our experiences and wisdom. So you can succeed. Now, here's your host, the CEO of mastery partners, Tom Bronson.

Tom Bronson (35s):
Hi, this is Tom Bronson and welcome to maximize business value. A podcast for business owners who are passionate about building long-term sustainable value in your business for the next few weeks, we're going to present a series of podcast to get your business ready for next year, business planning is something that too often takes a back seat to the day to day running of a business, particularly in small businesses. But in this series, we're going to talk about budgeting, setting up key performance indicators or KPIs, business growth, succession planning, and more.

Tom Bronson (1m 17s):
Now a few weeks ago, we had a great interview with Susan Bryant, principal of the MB group, a CPA firm based here in Dallas. And we talked about year end tax planning. That podcast is a great place to start if you haven't listened to it yet, but that's all about this year. It focused on what to do now. Now I want to go back to the future and really start thinking strategically about next year today, we're going to start with budgeting. Now, if you already have a process in place to budget for the upcoming year, feel free to skip this episode and go back and listen to your favorite episode from this year.

Tom Bronson (1m 59s):
But if you're like most small businesses, you don't have a process in place. And I'm going to give you some solid reasons to develop a budget and then to easy to follow processes to get you started. So let's start with why as Simon Sinek would say, let's start with why, why should you take the time to budget? Taking the time to plan a budget, forces you to think strategically about your business. Now, if you have trouble getting out of the day-to-day running of your business, I encourage you to step back and take a day in the coming month to focus on the future.

Tom Bronson (2m 44s):
You'll thank me a year from now, setting a budget is like setting a target. Imagine if you will running a marathon that has no finish line. That's what it feels like. If you don't have a budget now, budgets help you set goals for revenue and expenses. And we'll give you a measuring stick to monitor your progress. If you're planning to grow your business and you should be because a growing business is always worth more than a flat or declining business, that growth may come with some challenges. And if you can grow your business by 20% or 50% or more, do you have the capacity you'll need to handle that growth?

Tom Bronson (3m 33s):
Is your business scalable, or do you need to add resources to handle the growth? Now we'll talk about growth in a coming in the coming weeks in a different episode. Now the most common resources needed for growth are human capital. And what we call cap ex investments, CapEx is short for capital expenses. The kinds of things you'll need to invest in to be able to handle more business things like new equipment, perhaps vehicles, perhaps more space. It might be software needed to drive higher efficiencies. Whatever those capital investments are, you'll need access to cash to make the investments.

Tom Bronson (4m 18s):
And that's just easier if you have a plan and you've budgeted for them in advance. Now human capital of course is all about your people. Most business owners when asked

what their most important asset is, would almost universally say it's their people. So if your people are in fact, your most valuable asset, then you need to plan not only for business growth, but also for growing your people and giving them the skills they need for that growth. A topic we'll cover in the coming weeks. Okay. Let's recap on the reasons why to step back and budget for next year.

Tom Bronson (5m 3s):
You'll set a target or a goal you'll think strategically about your business. You'll consider growth initiatives. You'll think about your capacity for that growth. And you'll think about the investment you'll need to make in your people and in your physical assets. So now that you understand the why let's talk about the, how, if you've never budgeted before, here are two simple methods you can use to get started. First, let's talk about what I like to call the easy button method. The easy button method takes a very broad view, but does not consider the specifics of your plan.

Tom Bronson (5m 48s):
Well, it's okay to use this method. If you've never budgeted before only use it the first time, once you're more comfortable with the numbers and process, I urge you to consider diving a little bit deeper and taking the harder path. The easy button method sets a budget in four specific categories, revenue gross profit expenses and operating profit. So let's start with revenue. What are your growth expectations for next year? Take your current revenue projection for this year and add a factor for your growth target. Now you'll need to consider your historical growth rates as well, because that will give you some clues regarding your potential growth.

Tom Bronson (6m 37s):
If your business has been flat, as many small businesses are, I suggest that you consider at least a 10% growth rate. If however, your business has been growing, you'll need to match at least your historical growth rate, but try to exceed it a little bit because that will improve business value. Remember a growing business is always more valuable than a flat or declining business. So that's your revenue next. Use your historical gross profit percentage and apply that to as your gross profit target. Now

gross profit margin is usually dependent on revenue, but perhaps you can find ways to shave a percent or two off the cost of goods sold.

Tom Bronson (7m 27s):
If your historical gross profit has been, let's say 70%, then can you try to shave off your cost of goods sold to achieve 72 or 75% gross profit? You see, you see what's happening here. You're starting to think strategically about your financials and ways to reduce your costs and improve the profit percentage. Next break down your expenses into what we call the major categories perhaps by department or by category think sales, marketing, operations, administrative, or perhaps product development or support costs, and figure out the percentage of each category as compared to your current revenue.

Tom Bronson (8m 17s):
Now, this is easy. If your financial statements are aligned in these categories already, for example, if your revenue is $1 million and your sales expenses are $100,000, then your sales expenses are running at 10%. In the same example, a million dollar business. If your administrative costs are $500,000, then your administrative costs are running at 5%. Now it really pays to look back at more than one year. So you can plot your expenses and the percentages of those expenses by revenue and spot the trends.

Tom Bronson (8m 58s):
If your expenses are growing at the same rate as your revenue, or if they're declining or increasing as a percentage, if they're growing at the same rate, your business may not be scalable. The optimum is for the expenses to decline as a percentage of revenue, or at least remain flat. If your expenses are growing faster than your revenue, you may have a problem brewing. Now that you've got the target for each category, add them up. And now you can see your total operating expenses, which we'll also want to express as a percentage of revenue.

Tom Bronson (9m 40s):
Again, optimally, you want this percentage to decline slightly over past periods, showing that you're managing the business well, and that you have some synergies as you scale

the business. Finally, we get to net profitability, take your gross profit, subtract your total expenses. And now you have your net profitability goal. Be sure to express that as a percentage of revenue as well. Again here, what we want that percentage to grow. So think about ways to improve your profitability. Now don't forget that 97% here that again, 97% of all business transactions are based on earnings.

Tom Bronson (10m 28s):
So the value of your business is very likely tied directly to your profitability. So it is definitely worth thinking about, okay, that's the easy button method, those four categories. But if you're up for the challenge and taking a slightly harder path, I strongly encourage you to do that. And here's how that works. You're going to follow the basic same process we did in the easy path, but you're going to get more granular and we're going to add a twist at the end. The harder path has a few more things to do. In addition to revenue, gross profit expenses and operating profit.

Tom Bronson (11m 11s):
We're going to toss in cost of goods, sold and EBITDA earnings before interest taxes, depreciation, or amortization. Okay, let's start with revenue rather than looking at revenue. As a lump sum here, we're going to break it into smaller sections by category, whatever your revenue sources, we want to break out your revenue by source. So for example, if you charge your customers for products or services or support, you'll want to break out each of those categories visibly so that you can see them. You'll also want to segregate.

Tom Bronson (11m 51s):
This is really important. You want segregate your recurring revenue, make sure you break out any recurring revenue, because that is the golden ticket. When it comes to business value, recurring revenue is long-term and predictable. Something every buyer wants to have. Now, now that you broken your revenue down by category, consider your growth plan for each category. Now you may have higher growth in one category than others. One or more of your categories may stay flat or decline depending on your business.

Tom Bronson (12m 31s):
Again, take the historical data into consideration when planning your growth. You might want to think about your VCR or value creation revenue. When you're planning for your revenue growth. If you don't know what VCR is, I recommend you go back and listen to episode 71 with David Weibel or read his guest blog post on, on VCR from August 17th. So once you have your growth by category, add them up and determine if you're satisfied with the overall growth rate. If you're not go back and work on the categories, next we're going to insert here, cost of goods sold, and we're going to treat it just like the revenue categories.

Tom Bronson (13m 23s):
Break down your cost of goods, sold by category, which are almost always tied to your revenue categories. For example, if you sell hardware, you're going to have a hardware revenue line and a hardware cost of goods aligned. The percentage of cost of goods sold is also tied to the revenue, but take scalability into account. For example, if you sell cloud-based software, do you need to increase the cost of goods sold for the cloud infrastructure? Or can you achieve higher growth without increasing your cost of goods sold?

Tom Bronson (14m 4s):
That's the best possible outcome. So once you have your cost of goods broken down by category, add them up and that's your total cost of goods sold, subtract that from revenue. Now you have your gross profit. Does it hit your target? Remember that your gross profit percentage should be the same or higher than your revenue growth. So if you're growing the business by 10%, you, you want, you want your gross profit to be the same percentage as it was last year or slightly higher than it was last year.

Tom Bronson (14m 46s):
That's a nuance. Now, now let's dive into expenses and the harder path you're going to want to really take a hard look at expenses by line item, not just the category here, you can get very granular and think specifically about each line item and whether you can shave some costs or if you need to increase it to achieve your growth targets for this. I really like to take historical data by month for at least one year so that I can see the

trends month over month. It's better. If you look at a longer time period, say 18 months or two years, but I'd be willing to bet that if you haven't done that before, you're in for some surprises, I'd be surprised if you don't start questioning some of the expenses to determine if they're actually needed.

Tom Bronson (15m 45s):
And that's a good thing. Again, it forces you to think strategically about your business. Now there's one more nuance in the expense review. Think about taking all of the expenses related to owner compensation and discretionary expenses and moving them below the operating profit line. Now we do this exercise with our clients to make it easier to see the true operating expenses of the business, as well as understanding the EBITDA discretionary expenses, by the way, are those personal expenses that business owners run through their businesses, but which are not tied to the operation of the business.

Tom Bronson (16m 33s):
For example, personal cell phones, home office expenses, personal cars, country club dues, personal travel, et cetera, et cetera, that any future buyer will eliminate right off the bat. Now you might also think about minimizing those expenses to improve profitability, but that's a discussion perhaps for another day. So now you could add up all your operating expenses so you can see the true operating profitability of your business and depreciation and amortization below the operating expenses, as well as your owner expenses.

Tom Bronson (17m 13s):
And then you'll have your net profit or EBITDA. That's a really important number. It's the EBITDA that make up the earnings for business value. So you see, it's not that hard. Is it breaking these things down, forces you into thinking strategically, and that will lead to maximizing your business value, whichever method you choose, the easy button or the harder path take the time to budget for next year. I promise you'll thank me later. Now, if you need help on these things, just go to our website and click on, on the button to schedule a call directly with me.

Tom Bronson (17m 60s):
I love talking about this stuff with business owners, and I'd be happy to give you a leg up. This is the maximize business value podcast, where we give practical advice to business owners on how to build long-term sustainable value in your business. Be sure to tune in each week and follow us wherever you found this podcast. Give us a comment or a suggestion for future podcasts until next time I'm Tom Bronson reminding you to budget and plan for a great year while you maximize business value.

Announcer (18m 39s):
Thank you for tuning into the maximize business value podcast with Tom Bronson. This podcast is brought to you by mastery partners, where our mission is to equip business owners to maximize business value so they can transition on their terms, learn more on how to build long-term sustainable business value and get free value building tools by visiting our website, www.masterypartners.com that's master with a Y masterypartners.com. Check it out.

Tom Bronson (19m 25s):
That was perfect. I wouldn't make any changes.