RKJ PARTNERS
LOWER MIDDLE-MARKET INVESTMENT BANKING

RKJ Partners, LLC is an Atlanta, Georgia based investment banking firm designed to specifically assist dynamic, lower middle market growth companies in executing transactions less than $100MM.

CYRIL JONES
Managing Partner
cyril@rkjpartners.com

GREGORY FICKLIN
Managing Partner
greg@rkjpartners.com

RKJ PARTNERS, LLC
4514 Chamblee Dunwoody Rd., Suite 170
Atlanta, Georgia 30338
p. 404.827.8605
www.rkjpartners

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All Revenue Is Not Created Equal

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A business owner should always have a realistic understanding of the factors that increase or detract from business value, regardless of their intention and timing of selling the business. A common misconception is that someone can estimate the value of a business based upon a formula that is tied to gross revenue; however, experienced buyers and valuators appreciate that all gross revenue is not created equally and the factors that impact quality of revenue play a significant role in the value of a company. Fact: Business value typically has very little or nothing to do with gross revenue.

Which company would you value higher: 1) A company generating $12 million in revenue and $400,000 in earnings, or 2) A business generating $7 million in revenue with $1.5 million in earnings? With all other factors being equal, the company producing $5 million less revenue but yielding 21.4% return is worth substantially more than its larger counterpart that only yields earnings of 3.3%.

Sophisticated acquirers understand that it is profitability rather than revenue that drives value. Revenue can typically be increased if there is no concern for the profit margin associated with the increased revenue, and customers will do business with you if you are willing to "give your products or services away". Differences in profitability have an unmistakable impact on value and marketability. Factors that lead to differences in predictability and sustainability of revenue are harder to identify and quantify. The more predictable and sustainable the revenue stream, the higher the associated value. Conversely, the greater the uncertainty that particular revenue streams will continue going forward, the lower the value. The following risk factors and value drivers are primary determinants impacting predictability and sustainability of revenue:

- **Customer Concentration:** Revenue concentration is a major factor impacting value. There could be two companies that have identical sales and earnings; however, if one company has three customers that represent over half of the total revenue and the other company

has no client representing greater than ten percent of total revenue, then second company, with a more diversified customer base, will generally command significantly higher value and provide the acquirer with a greater comfort level. When there is revenue concentration, one event that leads to a loss of a major customer can significantly impact a company's earnings overnight.

- **Past Performance Mirroring Anticipated Future Results:** Someone buying or valuing a business will rely on historical financial information only to the extent that they consider historical performance is indicative of what is likely to transpire going forward. For example, if 50% of a company's revenue is tied to a product line that has a questionable future due to changes in technology, little or no weight will be applied to its historical performance. This would be the case for a company such as a compact disc manufacturer that may have had substantial historical earnings; however, changes in technology and electronic media cast doubt on future demand for these products.

- **Legislative Changes:** Government policy and regulation are other elements that impact various industries. A good example is companies that rely on third party reimbursement such as health care companies who depend on Medicare and Medicaid reimbursement educational companies who need federal and state student funding; or businesses impacted by international trade regulations and restrictions. The less reliant a company is on third party influences, the less they are subject to being impacted by changes in areas that are out of the company's control.

- **Repeat Customer Base:** There is a considerable difference in revenue quality between a company that generates the majority of its revenue from repeat business with established customers compared to "one and done" type of companies with few repeat orders. Repeat business creates predictability and stability. Even if the end users are different, cases whereby a company's sales originate from relationships with established referral sources, lead to the ability to accurately forecast future revenue streams and ultimately earnings. The more these repeat relationships are likely to impact future revenue, the greater the associated goodwill value. Furthermore, the greater the barriers of exit that exists for customers to make a change, the more predictable the revenue stream. For example, in manufacturing and pharmaceutical packaging, if changing vendors requires that a company incur significant costs and delay in new tooling or government agency approval, it will deter changing suppliers.

- **Bidding vs. Direct Purchase:** As a general rule, less value is placed on a company whose revenue is heavily reliant on a bidding process. Many think of this as only acquiring a company's reputation and its right to bid on future business. Construction companies face challenges in this area impacting value and marketability since most of their revenue is obtained on a bid basis and is therefore not predictable. It follows that the more you can differentiate your offering and offer proprietary based products or services, the greater the perceived value. Bidding can also be mitigated by longevity on contracts and number of historical contract renewals.

- **Customer Relationships:** Relationships can play a major role in predictability of revenue and ultimately earnings. If the business owner controls or is the key point of contact for critical customer relationships, then there is an inherent dependency on the Shareholder's active involvement and management of the customer. The ability to transition these relationships and create multiple points of contact within an organization to manage and retain the relationship, all increase comfort level, the ability of an owner to exit in a timely fashion post-sale, and ultimately overall value received. An acquirer will be wary if the sustainability of a revenue stream is completely dependent upon an existing owner. Relationships with key employees hold the same risk. For instance, a company who has a salesperson that controls 80% of the revenue is highly susceptible to the risk of them leaving with these customer relationships. Ideally a company should strive to have multiple points of contacts within its own organization as well within the customer's organization. If there is one key player in the company that the business channels through and that one person was to leave, it is likely that the business would follow. This can be mitigated by the seller incentivizing the employee in the sale and/or paying them a retention bonus at the end of each of the first two or three years that they remain with an acquirer.

The aforementioned factors have a major impact on the value that potential acquirers place on a company's revenue stream. Whether your intent is to pursue a sale of your company in the near future on hold onto your business for the long term, paying attention to the factors discussed above will enhance your company's value, decrease risk, and provide increased options and opportunity.

ABOUT RKJ PARTNERS, LLC

RKJ Partners, formed in 2008, is an established advisor to leading lower middle-market growth companies. We provide our clients with experienced-based solutions and unbiased advice. Our comprehensive array of strategic advisory and execution capabilities allows us to meet the needs of our clients and provide an outstanding level of service in connection with a variety of transaction processes, including:

- **CAPITAL ADVISORY**: RKJ possesses substantial expertise in assisting lower middle-market clients raise capital to fund growth strategies. Whether the capital source is senior debt, mezzanine/subordinated debt, private equity, or venture capital, RKJ has both extensive and relevant relationships within the capital community to enable the deployment of optimal solutions for our clients.

- **MERGERS & ACQUISITIONS**: RKJ serves as a trusted advisor in executing merger and acquisition transactions for lower middle-market clients. In addition to our significant investment banking transactional experience, RKJ's bankers have owned businesses and have served in interim CFO roles for clients. As a result of our experiences as business owners and senior level managers, RKJ's bankers are able to bring a unique perspective to the mergers and acquisitions process. RKJ's mergers and acquisitions services include:

  - Buy-side and Sell-side Advisory
  - Divestitures
  - Leveraged & Management Buyouts

- **STRATEGIC ADVISORY**: RKJ provides financial advisory services to owners, management, shareholders and their boards to assist in the evaluation strategic alternatives and options for extending and/or maximizing shareholder value. RKJ's advisory services include:

  - Business Valuations
  - Capital Structuring & Planning
  - Negotiating Joint Ventures
  - Strategic Business Development