THE Business Owner®

Expertise for the business owner since 1977

The Business owner®

Growing the Value of Your Business

The financial markets are very efficient. Money flows in and out of investments with incredible speed as investors constantly seek to place their money where it will earn the highest yield. All investors are not right all the time, but as James Surowiecki compellingly argued in *The Wisdom of Crowds*, the "crowd" is almost always right as a group.

What is it that investors value most? Predictability of earnings. Investors pay handsomely for investments that deliver predictable earnings. Add exceptional growth of those predictable profits to the equation and there's a feeding frenzy. Value skyrockets.

What relevance does this have to you, the owner of a private business far removed from the public markets? Nothing — unless you want to build the value of your business or your personal wealth.

The main differences between your company and a publicly traded one are size, public disclosure of financial performance, a mechanism for efficiently trading equity units, and separation of management and ownership. But just because the world isn't looking and the shares aren't trading doesn't mean that building business value doesn't matter. It just means that the only shareholder you have to please is yourself — and possibly a few others close to you.

So, here's the big question. What do you, the shareholder, demand of yourself, the manager? Anything at all?

Do you set standards for financial performance and demand they be met? Rationally allocate your capital to investments that will provide the highest return? Use your influence to push for changes in management in an effort to get a team in place that will deliver results? Prudently move your money out of investments that are underperforming and into investments that offer higher returns?

Neil Schaffer of Longview Consulting Group (www.longview-cg.com) has spent his career building value in private companies. He has diligently studied the art and science of private company value

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The Business Owner 1977–2007 Celebrates 30 Years

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From the Editor

David L. Perkins, Jr.

Building the value of a business is largely the task of stabilizing and growing the profit.

Stabilizing the profit means making the profit stream more predictable and consistent, which makes your business less risky and thereby more valuable. This involves diversifying your line of products and services, customer base, industries served and employee base.

Growing profit incrementally can be done in a similar manner — by continuing to diversify and grow your product offerings, customer base, industries served, talent pool, etc.

Growing profit radically is a different game altogether. It demands much more of the business owner, and the first step requires no experience, schooling, consultants, strategy or money. It is simply you coming to grips with the inescapable reality that if it is to happen, it must begin with you. After all, you are the origin of all energy and direction from which your organization feeds. You're the lead pilot of the rocket ship — manning the controls, setting the course and firing the rocket boosters to propel the ship to its exciting destination.

However much you wish to bite off, this issue will be useful in your efforts. And when you find success, don't forget to let us know about it so we can share what you did with others.

Sincerely,

David L. Perkins, Jr.
Publisher and Editor

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VALUE ENHANCEMENT

How to Enhance the Value of Your Business

Enhancing the value of your business is primarily the process of stabilizing and growing your earnings stream. The investment world calls this "quality of earnings," which simply means that the earnings are stable and predictable, i.e., devoid of large fluctuation from year to year. Earnings of this type are less risky for investors, will support higher levels of debt (if and when such are needed or desired), will put more money in investors' pockets over time, and therefore will garner much higher valuation. Add consistent growth to the equation and value increases exponentially.

Whether you and your family continue to own your business for the next 100 years or plan to sell it in a few years, you'll reap considerable financial benefits from enhancing the quality of the earnings stream. Doing so is not easy, of course, but by breaking down the task into project-size initiatives and tackling them one at a time, before you know it you'll have strengthened your business considerably and raised value substantially.

Here are some value-enhancing strategies to consider:

Sell Value, Not Price: If you are competing for customers based on price, you're likely not making much money. You must find a way to add more value, real or perceived, and charge a premium that garners far higher profit. One way to accomplish this is to develop your own proprietary products. If they have value to customers and nobody offers them but you, you should be able to charge a healthy price.

Price Strategically to Maximize Profit: There's a strategy to getting the most profit from a product and product family. There's also a strategy to pricing quantity orders. Read the case study "Use Cost-Volume-Price Analysis to Increase Profit" in this issue and "Strategies for Maximizing Profit Throughout the Product Life Cycle" in the next issue of *The Business Owner Journal*.

Diversify Your Customer Base: What would happen to profit if you lost your largest customer? If the answer is anything but "not much," then you have a customer concentration problem that adds risk and volatility to your earnings. You need to work on bringing in new customers and building existing ones. Many customers purposely turn away the big boys and focus on the little guys. Big guys have lots of power and everyone competes for their business. That means lower profit margins. Add to this the diversification risk, and you may be better off being less of a lemming.

Diversify by Industry: The economy as a whole is cyclical, but individual industries swing more wildly than the overall economy. To stabilize your earnings stream, you need to serve multiple industries. To achieve growth, penetrate growing industries.

Diversify by Geography: The global economy is also cyclical, but individual locations don't move in lockstep. In fact, they ebb and flow at different rates and times. If you serve a single geographic area, your earnings stream will depend entirely on the fortunes of that single economy. By penetrating other locations, you will insulate yourself a bit from local swings and smooth out your earnings stream.

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Where to Find Breakthrough Growth

If it's breakthrough growth you are looking for, you'll need to take aggressive measures. Here are tactics used by the best to build substantial value, and fast.

Build a Brand: Brand is your company's personality, or your product's. It's who you are and what you stand for. Just as people remember and want to associate with people who have real personality, customers patronize companies that have style and stand for something. They like the comfort of knowing what to expect. Companies with a strong, unique brand get noticed, attract new and loyal customers, and get more traction for each marketing dollar.

Innovate, Don't Emulate: "Me too" never gets you much. Nobody's willing to pay a premium for commodity products or services. But develop new products, services, and solutions, and introduce them with excitement and you'll enjoy the spoils that only leaders and innovators get.

Penetrate New Markets: You've built a business serving a niche market. The easiest way to supercharge revenue is to take those same products and adapt them for a new, larger market. You'll have to work hard on devising a smart marketing plan, and might have to make changes to tailor them for the new audience, but most of your development costs will already have been covered, so when sales start to take off, the lion's share of gross profit will fall to the bottom line.

Invest: Growing rapidly soaks up cash. In fact, growth is impossible without either re-investing profits or obtaining capital from other sources. If you're not prepared to take the risk of doubling down on your investment, you're not ready for breakthrough growth.

If you're not prepared to take the risk of doubling down on your investment, you're not ready for breakthrough growth.

Experiment: Andy Grove, founder of Intel, says, "Business is just one great big experiment." Great new discoveries aren't found by playing it safe. The only way to find new, superior methods is by trying new things and being willing to fail. And as Roger Von Oech says in *Whack on the Side of the Head*, the best way to get a great idea is to get a lot of ideas.

Learn from Others: The world is full of examples of breakthrough success. Spend your time learning about what others have done to achieve it, and consider how those ideas might be applied in your business. Attending your industry trade show is a must, but innovations that sweep through one industry might take a while to jump to others. Why not periodically go to lunch with a leader in another industry and pick his or her brain about innovations? You could even attend the trade conference of another industry.

Hire Thinkers, Visionaries, Dreamers: Some people are born with a mind for innovation. Some are born with a need to put the pedal to the metal. Hire these people. Listen to their ideas and give them opportunities to explore and experiment. Develop a culture of innovation, risk tolerance and rejection of the status quo.

Quality Control: Customers must know what they're going to get from you. And as you know, disgruntled customers talk and tell with much greater verve than happy ones. That is why great companies work hard to standardize and control the customer experience. Look at Starbucks. Every store looks the same. A cup in Chicago tastes the same as a cup in London.

Focus: Determine what you do best and stick to it. Don't create confusion among your customers and employees by offering products or services not in your core area of expertise. Domino's Pizza is a great example. They deliver fast. They don't sell quality or price but "deliver in 30 minutes or less." Home Depot is another great example. They could sell just about anything in their huge, well-located warehouses. But they sell only home and garden supplies. When you need home and garden supplies, you know exactly where to go.

On the other hand, Sears tries to be everything to everybody, an approach that simply does not work today. Stake your claim on a niche, stick to it and focus on getting better at it every day.

Go After Large Groups of Customers: If you're going for breakthrough growth, go after a large target group of customers. It's just common sense.

Go Where There Is Less Price Sensitivity: Less price sensitivity means higher margins and in most cases faster sales cycles. You can achieve this by developing products that are unique and that deliver value well in excess of the price, or by going after customer groups more interested in values such as convenience, safety, or status, than in price.

Scalability: When your sales start taking off, will you be able to deliver the goods in a timely manner? The ultimate in scalability is software delivered by Internet. So long as you have a server that can handle high volumes of orders and downloads, volume can explode and nearly all the profit will fall to the bottom line. This is what you want. Hourly consulting by a respected expert is not very scalable. Put the expertise in a book or software package and now the expertise of the consultant is scalable. The ultimate example of lack of scalability comes from my uncle. During the crazy dotcom days he excitedly shared that he had worked out a deal to sell via Amazon the hand-crafted duck calls of a renowned duck-call whittler. My uncle would pocket about $20 each. After a moment I asked my uncle, "How fast can this guy whittle?"

Master the Art of Alternative Marketing: Few small businesses can afford to drive growth using traditional marketing such as television, radio and print ads. The good news is that there are, and always have been, alternatives. At least for those that can think out of the box. And today there are more alternatives than ever with the rise of the multitude of new forms of electronic communication. Yes, small companies seeking high growth can

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Diversify Your Talent Pool: People drive businesses. In your case, you hope that more than one or two people drive your business. What would be the impact if you fell ill? If your partner or personal assistant went to work for a competitor? The prudent business owner will address risks such as these and work to diversify his or her productive talent pool and/or mitigate risk associated with a particular employee. After all, the inevitable will happen — it's just a matter of time.

Product Mix and Diversification of Gross Profit: Individual products and services will have good months and bad months, good years and bad years. They also have a life cycle that, as with every life cycle, eventually leads to the pasture. To smooth earnings and always have fresh horses ready to carry the load, develop a diversified line of products and services that includes a steady flow of new entries.

Off-Balance Sheet Risks/Contingent Risks: Risk and uncertainty will lower the value of any business because eventually the inevitable will hit and earnings will suffer. So whether the contingent risk is a lawsuit (which can be mitigated by insurance), a real estate lease (which can be mitigated by buying the property or moving locations in advance of the inevitable), or a key supplier deciding to "go direct," it will serve you well to address the issue today by working to lower your exposure rather than hoping Murphy's Law will give you a pass.

Go for Less Cyclical or Countercyclical: The general economy rolls through periods of high and low growth in cycles that average eight years. Some industries are more sensitive to cycles than others. Generally, construction and capital equipment industries and those that depend on them are the most volatile. Companies that rely on these industries will experience earnings volatility and receive lower valuations. Other highly cyclical industries include: personnel supply (e.g., employment agencies); computer services (e.g., custom software creation); agricultural services (because of the landscaping and horticultural component), automotive services (such as car rentals and repairs); miscellaneous repairs; luxury goods; travel and lodging industries; personal services such as laundry, cleaning, and garment services; and motion pictures. Health care services are the most countercyclical, gaining jobs rapidly during an economic downturn. Other industries generally believed to be countercyclical, or at least far less sensitive to general economic downturns, are private education, child day care, amusements and recreation. Expand into these industries and your earnings will be less volatile and the value of your business will increase.

Lower Costs: Obviously, every business must continually wring out cost. Every dollar saved is another dollar earned. Develop a lower cost base than your competitors, and you can run 'em out of business or enjoy more profit than they do on every sale.

> **"Americans want to pay more, you just have to give them a good story."**
>
> *Sidney Frank*
> *Built Jägermeister and Grey Goose into billion dollar brands*

Reduce Fixed Cost in Favor of Variable Cost: All things being equal, in a world of uncertainty, variable costs are much more suitable than fixed costs. Variable costs are much lower risk and generally offer lower variability of earnings. So look for ways to economically trade fixed costs for variable, such as finding independent contractors to do certain tasks when needed and that will only charge for when they are used. This, of course, instead of hiring a full time employee (for example) to do the job and running the risk of not being able to keep that person productive and 100% utilized. ❑

"OK, it's not growing on a tree, but we're on the right track."

GROWTH

Where to Find Breakthrough Growth, continued from previous page

find it, and in most cases have no choice but to find it, through smart and savvy forms of alternative, bootstrapped, niche marketing that can produce great bang for the buck.

For example, many companies are finding success in direct-response type advertising using Google or Yahoo, which can be very cost-effective because one pays only for action (i.e. per 'click'). As Neil Schaffer explains, demonstrations and free tasting — in stores or at trade shows — can also be a good way to showcase a new product or even a prototype. If one can couple the demo with press coverage, testimonials, focus group type feedback, coupons or even purchase orders, then by killing more than one bird with one stone can make the 'free' activity very cost-effective. Finally, legendary liquor entrepreneur Sidney Frank built both Jägermeister and then Grey Goose into billion dollar brands by shunning traditional marketing and going directly to the college campus (Jägermeister) and high-end bars and fashionable parties (Grey Goose) and "demonstrating" the product to consumers and bartenders.

To achieve radical growth, you have to try many of the above ideas, but the main thing is to be innovative, imaginative and different. And when you think you have it, back it with enthusiasm, energy, a great catchy marketing plan, and a good bit of capital. It's done every day in the world. You might as well do it, too. ❑

Q&A: Neil Schaffer on Accelerating Company Growth

Neil Schaffer is CEO of Longview Consulting Group. He founded the firm in 2005 to bring senior executive and entrepreneurial experience, perspective and creativity to emerging and middle-market companies seeking to accelerate their growth.

Schaffer has served in executive management roles across a number of industries. He served as EVP & CFO of the MediaPort consortium ('01 – 02) and AudioAudit ('02 – '05), both innovative technology companies in the advertising and media business. Along with several former senior executives from Citigroup and several Ivy League university professors, he founded iPrivacy, LLC, a software and services company focused on Internet privacy and security.

Growth is hard and leadership commitment is essential, and the entire team must be able to set aside ulterior motives and personal agendas to cooperate in pursuit of goals.

He previously served as CFO of several industrial, distribution and technology companies, including Horizon Paper Company, a leading paper brokerage firm; The Carson Group, Inc., an investor relations consulting and information services company (sold to Thomson Financial); and The Hain Celestial Group (NASDAQ: HAIN), the largest natural-products manufacturing company in the U.S.

Schaffer began his career as a certified public accountant with the middle-market practice group of Price Waterhouse in New York.

Question: Assuming that ownership is committed to growth and a skilled team is in place, what are the keys to driving company growth? In other words, what are the essential elements of an achievable growth plan?

Answer: Knowing your destination is absolutely crucial. Airplanes are off course 90% of the time, but through a large array of corrections they land safely at their destinations. There are so many elements to executing a strategic plan, and the devil is in the details. But your question was: "What are the essential elements?"

It is critical to have a clear and realistic vision and mission, starting with the CEO and shared by the entire organization. That means having a few very specific and quantifiable goals for the products or services at the center of the growth strategy. The CEO and senior management team must be fully committed and involved. Growth is hard and leadership commitment is essential, and the entire team must be able to set aside ulterior motives and personal agendas to cooperate in pursuit of goals.

Another essential element is rapid decision-making based on hard deadlines, and on feedback from customers and from all functions within the organization. This decision-making process should be facilitated in part by a free sharing of information. Whether by using a "war room" environment or a formal knowledge base such as an intranet, true collaboration is an essential element of the culture of successful growth.

Question: The word scalability is thrown around a lot. Could you define scalability in your own words?

Answer: The classical notion of economies of scale is that unit cost declines with increasing volume. Volume purchasing reduce the cost of material inputs, and machinery and mass production drive down labor costs. Today, technology offers productivity to all, but in exchange for shorter product life cycles and greater value ascribed to the services/service components that now accompany products. So scalability is more a function of building a foundation of repeatable methodologies and processes so that new product development occurs faster and margin expansion occurs earlier in the life cycle on relatively small volumes.

Question: What's the biggest misstep that a company can make when trying to expand?

Answer: Loss of customer focus. Most companies begin with a zeal for serving the customer. It serves them well and the business gets on its feet, but as it grows it becomes more bureaucratic, and product development, production efficiency and financial performance take precedence. The company loses its intense focus on meeting customers' needs and having meaningful two-way dialogue with them. Marketing devolves into a bunch of scattered and unfocused tactics designed solely to feed revenue growth.

Question: So what is the key to growth?

Answer: Assuming the business has the talent and the capital necessary to support growth, the key is an actionable, achievable and measurable plan. Building sustainable advantage is a long-term commitment, and small first steps and "quick wins" do wonders to build a team's confidence to take larger steps and make bolder moves. Business plans must be developed from, and supported by, thorough and accurate customer and market research.

Question: Where can a business owner look to find avenues for growth?

Answer: Avenues of growth are found by better serving and further penetrating existing customer groups with established offerings, improving and also broadening the offerings to existing target markets, and identifying new markets and/or customer groups. In each case, success will be found only by a smart and savvy selection of the proper mix of marketing and communications tactics.

Question: Most businesses have real limits on the dollars they can spend on marketing. What are their options, if any?

Answer: Traditional advertising can be incredibly expensive and relatively useless. Identifying alternative means for cost-effectively reaching target markets may be the #1 challenge for a small business. The old "build it and they will come" just doesn't happen in real life. Finding the right mix of cost-effective marketing tactics will require lots of thought, discussion, brainstorming, learning from others and a good bit of trial and error.

Question: Can you give us some real-life examples of companies that found a cost-effective means for reaching their target market and, by doing so, achieving rapid growth?

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Q&A: *Neil Schaffer on Accelerating Company Growth,* continued from previous page

Answer: We have found that public relations campaigns can be very cost-effective. Having industry thought leaders and editors focus on a problem, or on a problem and a company's solution, is a good way to gain credibility and awareness, especially when followed by a direct campaign to "push" the press material to the target customer base.

Demonstrations and free tastings — in stores or at trade shows — are good ways to showcase a new product or even a prototype. If one can couple the demo with press coverage, testimonials, focus-group-type feedback, coupons or, imagine, purchase orders, then killing more than one bird with one stone can make the "free sampling" activity very cost-effective.

Question: How can companies make sure they remain focused on the customer?

Answer: The short answer is that the business owner or CEO must remain committed to marketing as a strategic imperative. The corner office sets the tone for the entire organization. If the unifying theme is to put the customer first and **really** listen to them and serve them with integrity — and all the necessary carrots and sticks are properly installed — then the organization will get into and remain in alignment.

Far too often the top brass conjures up ideas, jots them down, recites it all in company meetings, and calls the exercise "marketing planning," but it's little more than a wish list. Specific, discrete individual activities and measurable objectives are neither considered nor implemented.

Instead, senior management must define, mandate and drive proactive marketing initiatives. This involves identifying specific target market segments, potential customers, potential channel partners, influential analysts, etc., and developing and positioning targeted messaging with clearly defined rationales and goals for each activity or investment. True marketing plans must deliver specific messages to specific audiences (i.e., developing unique talking points for all constituencies: employees, investors, customers, channel partners, analysts, press, competitors, etc.). The essential theme may be the same, but one size does not fit all. These are niche audiences, each needing specialized treatment.

It is also critical to develop, communicate and support clearly articulated sales and pricing strategies, and to assign team/department budgets, timelines and milestones, and hold managers accountable for effective execution.

Question: What are some of the negative repercussions of a poorly defined marketing plan, and how can companies ensure that their strategies are clearly mapped out?

Answer: Marketing tactics manifest themselves in public exhibitions and dialogues. The greatest negative effect is that poorly defined plans will expose the company publicly before all of its stakeholders, customers, prospects and competitors as unclear, uncertain, bumbling, selfish or weak.

Question: Every business owner starts out each year with a plan to grow. Why do so few achieve growth consistently?

Answer: Despite the best of management's intentions, in many cases, strategic plans become a victim of the "busyness" of doing business. Consumed by the daily pressures of running their companies, CEOs and management teams become distracted and make reactive or opportunistic decisions about disjointed ideas and concepts that "could result in good growth impact."

Some classic examples of misguided thinking include:

- Marketing plans and tactics that are formed wholly from the minds of the owner or managers. Unfortunately, company heads often do not accurately represent target audiences, and thus many marketing campaigns do not generate the required enthusiasm and response in the marketplace.
- Plans for products or for marketing that struggle to become actionable because they are based on ill-defined, nebulous goals such as becoming the "best of breed" or "most desired."
- "Dollar-oriented" plans driven by budgets rather than goals, where executives proclaim, "I spend money on ads and sales collateral, so I don't have the budget to do anything else." This approach is so prioritized at getting the best deal that it often foregoes achieving the best results.

The business owner or CEO must remain committed to marketing as a strategic imperative. The corner office sets the tone for the entire organization.

Question: What other relevant issues are involved in mapping out growth strategies?

Answer: Companies can work toward ensuring that their strategies are clearly mapped out by establishing and sticking to some basic concepts. They are simple, but they are not easy.

One basic concept is to create a meaningful brand identity. The brand is an embodiment of vision and mission. Everyone inside and outside the company should know that the company can be trusted to do a very specific thing. It is important to develop and maintain an evolving "singular company message" that will ensure harmony of the methods and tools the company uses to present itself to its customers, competitors, investors, the media, analysts and all other constituents.

Another concept is to create awareness of the company as the singular source for its unique products and services. Shine a bright light on what makes you special to get recognized and become known.

Management must enhance the company's image as being most responsive to clients' requirements through actions and results, not simply through chatter, ambiguous colorful brochures and vacant tag lines. One of the tough questions always worth asking about any planned action is: "To what end?"

And finally, it is critical to measure your marketing as you would any other business activity, and invest marketing dollars as efficiently as possible for maximum return on investment. ❑

CASE STUDY: Use Cost-Volume-Price Analysis to Increase Profit

To show the importance of pricing decisions, this advisory will show how you can make money by selling a product for $15 when your average cost to produce that product is also $15.

Setting prices on your company's products is tricky business. Set prices too high and you may never get the market share you're after. Set them too low and sacrifice profit.

Compared to larger companies, smaller businesses are much more vulnerable to pricing mistakes because they're usually concentrating their efforts — and building their business — on fewer products. A larger company spreads its risks over many product lines, so a mistake on one product's pricing won't impact its bottom line as much.

One way the smaller company can lessen the risk of a pricing mistake is by doing more extensive analysis before setting price. Here are the important initial questions:

- What is my breakeven on each product?
- Can I sell more products by lowering the price, or should I increase the price and sell fewer units?
- Given a set price, should I lower the price for quantity orders, and how low can I go and still make a profit?
- Do I have enough cushion in my pricing to give my salespeople or reps an additional 5% commission as incentive for more sales?
- If I'm going to spend $20,000 on advertising, how many additional units must be sold to get back my investment?

These questions are critical: Most smaller businesses don't have the capital that enable a larger corporation to ride out the consequences of a flawed pricing decision. That's why knowledge of the cost-volume-price relationship of your products is essential for greater profitability and, at times, survival itself. Here's a case study on **Carbondale Corporation** that will help you better understand how to analyze your pricing and evaluate bulk orders.

Step 1: Prepare the Data

Carbondale Corporation is a manufacturer of converters sold on a private-label basis to large discount chains. The company has capacity to produce 45,000 converters a year. Planned production for the current year is 20,000 units and involves working the plant for a single shift. An analysis of the company's cost records reveals the following information for the 20,000-unit production level:

Note: Variable costs fluctuate with volume changes while fixed costs don't. They reflect more of a company's capacity to produce.

Variable Cost per Converter:

Manufacturing Cost per Unit	$8
Selling and Administrative Cost per Unit	$2
Total Variable Costs per Unit	$10

Fixed Costs Allocated to This Product Line:

Manufacturing Costs	$60,000
Selling and Administrative Costs	$40,000
Total Fixed Costs for Carbondale	$100,000

Current Selling Price per Unit: $18

Based on the above data, the average cost per converter for a quantity of 20,000 units is $15, computed as follows:

$$\text{Average Cost} = \frac{\text{Fixed Costs + Variable Costs}}{\text{Number of Units}}$$

$$= \frac{\$100{,}000 + (\$10 \times 20{,}000)}{20{,}000 \text{ Units}}$$

$$= \frac{\$100{,}000 + \$200{,}000}{20{,}000 \text{ Units}}$$

$$= \$15 \text{ per Unit}$$

So, the average cost per unit is $15 at the 20,0000-unit sales and production level, fully burdened for all costs — variable and fixed. **Note:** In the case of fixed costs, they're burdened by the **portion** of fixed costs allocated to this product.

At a selling price of $18 and volume of 20,000 units, the profit per unit is $3 and the total annual profit is $60,000, calculated as follows:

Sales (20,000 Units X $18)	$ 360,000
Less: Fixed Costs	($100,000)
Less: Variable Costs ($10 per Unit)	($200,000)
Operating Profit	**$60,000**

Note: The input data for your particular company and product should be easy for you to obtain. Talk to your accountant or treasurer.

Step 2: Analyze the New Order (hypothetical or real)

Let's say Carbondale's sales manager just received a large order from a **new customer** for 10,000 converters, but at a price of $15 each. **Important:** The $15 price being requested is **Carbondale's** current average cost per unit. But before you reject the large order on this basis, let's do a little analysis.

Question 1: Is there any scenario under which Carbondale should accept the new order? On the surface it would seem futile (devoid of profit).

Answer: The fixed costs associated with the converter product are already fully absorbed by the 20,000 units already being sold. The new large order, therefore, will not have to absorb any of those fixed costs. Through a little investigating, you determined that you'll need to spend another $10,000 on equipment (a fixed expense) and that you should be able to produce the additional 10,000 units at the same variable cost of $10 each. The next step then is to calculate the new cost-volume-price data **on the new order only.**

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CASE STUDY: Use Cost-Volume-Price Analysis to Increase Profit, **continued from previous page**

If the result is positive (a profit), the order should be considered. If it is a negative number or near breakeven, the order should be turned down.

Note: In making the calculation, **only incremental revenues and costs** are considered — those that are added by this particular order. Again, that's because the fixed costs absorbed by the original 20,000 units are already taken care of. Now let's do the analysis:

Analysis of New Order:	
Incremental Revenues	
(10,000 Units at $15)	$150,000
Incremental Costs	
Manufacturing	($10,000)
Variable Costs ($10 per Unit X 10,000)	($100,000)
Profit on New Order	**$40,000**

As computed, the new order generates an **additional** profit of $40,000. Now let's look at the total picture — the effect of the new order on **Carbondale's** total sales and operating profit. Here is a condensed income statement:

	Without New Order	With New Order
Sales	$360,000	$510,000
Less: Fixed Costs	(100,000)	(110,000)
Less: Variable Costs	(200,000)	(300,000)
Operating Profit	$60,000	$100,000
Operating Profit Margin	16.7%	19.6%

Step 3: Look at the Results

If you accept the new bulk order for 10,000 units at $15 per (a 16.7% discount from list price), which is your fully burdened cost for the initial 20,000 you expect to run through your plant, you'll actually add $40,000 to your bottom line and raise your operating profit from 16.7% to 19.6%.

Question 2: Just how low a price would it make sense to accept? The calculations are simple: Divide the total **incremental** costs of $110,000 by the number of additional units (10,000) to obtain your breakeven price per unit of $11.

But should you sell the product at $12, if that were the best you could do to get the order, resulting in a profit of $1 per unit for a total added profit of $10,000? It would appear so, but let's look at the new profit margin. Your new sales would be $480,000 ($360,000 plus $120,000 with the new order) and your operating profit would be $70,000 ($60,000 plus $10,000 profit from the new order).

The result. Your operating profit margin drops to 14.6% ($70,000 profit divided by sales of $480,000), compared to 16.7% **without** the order.

You can accept the new order at the $15 price — even though your average cost per unit is also $15. **Reason:** Your profit margin increases to 19.6%, from 16.7%

This is the essence of what is meant by "having more sales but enjoying it less." The trade-off is the increase in the absolute profit of $10,000 versus the decrease in our overall profit margin. The choice is yours. But with these calculations, you at least have the data to make a more informed decision and you may decide to take the new order just to add another customer whose business could increase in the future.

Remember: Exact costs may be hard to determine, and the line between fixed costs and variable costs can be hazy. But all businesses, especially smaller businesses where a mistake in pricing can mean the difference between survival and failure, should use breakeven and contribution margin analysis. It's easy to compute and it can give you the necessary data to maximize your long-term sales and profits.

Other Applications

The analysis used here also can be used for:

- Pricing a new product.
- Justifying additional salespeople.
- Increasing your fixed costs to handle projected or increased sales.
- Considering the make-or-buy decision.
- Determining the minimum price of your products and the profit contribution of each product.
- Assessing a new marketing initiative, e.g., adding a new sales office or territory.

Buying a business. In addition, this type of analysis can be used to evaluate the purchase of a product line, a division of another company or another company altogether.

In these cases, certain fixed costs will be reduced because you will be operating under one umbrella. These reduced costs are referred to as the **synergistic** benefits and can substantially add to the overall profitability of the combined entity. ❑

Steps to Pricing an Order

Step 1: Obtain all relevant pricing data, including your company's current fixed and variable costs.

Step 2: Analyze the new order. Include incremental (additional) costs associated with the order. Be sure to adjust for any additional fixed costs. Will it make a profit?

Step 3: Prepare two proforma annual condensed profit-and-loss statements for your company. In the first, assume that you reject the order. In the second, assume that you accept it. Now, calculate the operating profit margin for each. Which is higher?

"The thing you resist is the thing you need to hear the most."

Dr. Robert Anthony

Test Yourself

Using the original cost data presented for **Carbondale Corporation** and the breakeven data below, see if you can answer the following questions. The answers are on the following page.

Note: The formula for determining **Carbondale Corporation**'s breakeven (in terms of units) is as follows:

$$\text{Breakeven} = \frac{\text{Fixed Costs}}{\text{Selling Price} - \text{Variable Costs}}$$

$$\text{Breakeven} = \frac{\$100{,}000}{\$18 - \$10} = 12{,}500 \text{ Units}$$

Q1. What is the **minimum** selling price to break even on the additional 10,000-unit order if fixed manufacturing costs increase by $25,000?

Q2. If your salespeople want 2,000 special product brochures for a direct mail campaign with follow-up calls, what is your breakeven in number of units? Assume that the brochures, mailing, follow-up phone calls and other costs will total $8,000.

Q3. Your goal next year is to sell 40,000 units at $18 per unit (double your current level of 20,000 units). Fixed costs will increase by $75,000 (to a total of $175,000). Variable costs will remain the same: $10 per unit. Prepare a projected operating profit.

Q4. After you prepare the answer to Q3, compute your operating profit margin and contribution profit margin.

Q5. What is the new average cost per unit based on the projected volume level of 40,000 units?

Definitions

Breakeven in sales (revenue) is determined by the following formula:

$$\text{Breakeven} = \frac{\text{Fixed Costs} + \text{Zero Profit}}{\text{Contribution Margin}}$$

Fixed Costs: Costs of operations that remain the same in dollar amount even though the number of units produced may change. *Example:* Rent.

Variable Costs: Costs that change in total dollar amount as quantity (units) increases and decreases. *Example:* Materials used in the manufacture of each unit and sales commissions.

Operating Profit: Your profit after cost of sales and general, selling and administrative expenses. It is your profit **before** interest expense and other income and expense items, including taxes.

Operating Profit Margin: Your operating profit divided by your sales (e.g., $60,000 operating profit divided by $360,000 sales equals 16.7% operating profit margin).

Contribution Margin: Percentage of sales dollar that is needed to cover fixed costs, or sales dollars less variable costs divided by sales. *Example:* $18 selling price less $10 variable cost equals $8 contribution profit (or 44% contribution margin, $8 divided by $18).

Note: With breakeven **and** contribution analysis, you will be able to show how much in **incremental** sales is needed to cover **incremental** costs. Then you can determine what you can expect as profit if you increase sales **or** the number of units produced. ❑

"The best way to predict your future is to create it."

Dr. Robert Anthony

About the Publisher

David L. Perkins, Jr. owns, writes, edits and publishes *The Business Owner*, the newsletter of choice for more than 35,000 business owners who are serious about building wealth through successful private business ownership.

Perkins draws editorial ideas and inspiration from his own life as a business owner and investor, and his daily work as a merger and acquisitions consultant, where he has advised on more than 100 purchase/sale transactions involving both private and public companies. His M&A consulting firm is Acquisition Advisors, which he founded in 1997 and specializes in transactions valued between $5 million and $75 million. Visit www.AcquisitionAdvisors.com to learn more.

Perkins holds a BA in psychology from the University of Oklahoma and an MBA from the University of Notre Dame. He has formal training in business valuation. He also pulls editorially from prior experience in commercial real estate leasing and brokerage, commercial bank lending and private company financial management.

Perkins is the author of *A Concise Overview of Business Valuation* and co-author of *The Business Sale, An Owner's Most Perilous Expedition*. You can buy both at www.TheBusinessOwner.com.

Perkins is a professionally trained, content-rich platform speaker available for both keynote and breakout sessions. He is a Certified Toastmaster and a member of the National Speakers Association.

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***Growing the Value of Your Business,* continued from cover**

creation. He has worked seven days a week for as long as he can remember in various leadership roles for a varied string of small, medium and large private companies. His vantage points have been that of chief financial officer, president, chief executive officer, investor and owner. He has learned from trial and error, success and failure. He now consults full time on this very narrow subject — helping companies grow value rapidly, even radically.

From my experience, for every 1,000 people who say they consult on areas such as these, there's maybe one who really knows what he or she is talking about and can drive results. After all, building a company is not easy, as you know. That's why the wealthiest 1% of the population controls nearly 40% of all the wealth.

My point is, Schaffer is the real deal. I talked with Schaffer extensively. And here's what he says about radically growing the value of a private company:

> *The most important thing is the people, and the most important of all is the business owner himself. We see many dozens of companies each year — from start-ups with a great idea seeking capital to mature companies preparing to charge up the next hill — and we always give great weight to the vision and commitment of the founder/entrepreneur/CEO and to the quality of the management team.*
>
> *There are many obstacles to building a high-performance (and thus valuable) enterprise — technology risks, financial risks, regulatory risks, etc. But most business risk is what we call 'execution risk.' The successful teams are those that develop a first-class playbook and can run their plays against the tough and unpredictable defenses of global markets and competitors, and Murphy's Law.*
>
> *Sure, a company needs good products or services that the marketplace values, but superior results and sustainable advantages are driven by what the competitors can't see and can't easily copy ... an excellent and committed senior team with vision and values that spark the entire organization to high performance.*
>
> *The good news is, talent can be hired. But attracting and hiring top talent will only occur if the controlling equity holder rejects the status quo and has the vision and the commitment to really building something special.*

The light definitely shines on you, the business owner.

So whether your desire is to slowly enhance the value of your business while maintaining a healthy and balanced life, or to radically grow your business and create something significant, the first and most important step is for you to make up your mind. Establish a vision. Then, when you're ready to turn vision into reality, this issue of *The Business Owner* offers strategic and tactical suggestions you can use. ❑

Answers to "Test Yourself"

(Questions are on the previous page)

1. The minimum selling price to break even on the 10,000-unit additional order is computed as follows:

Additional Fixed Costs	$25,000
Variable Costs ($10 per Unit)	$100,000
Total Incremental Costs	$125,000
Divided by Number of Units	10,000
Minimum Seling Price per Unit	$12.50

2. The breakeven in units for the direct mail campaign is calculated by using the following formula:

$$\text{Breakeven} = \frac{\text{Additional Costs}}{\underset{\text{(per unit)}}{\text{Selling Price}} - \underset{\text{(per unit)}}{\text{Variable Costs}}}$$

$$\text{Breakeven} = \frac{\$8{,}000}{\$18 - \$10} = 1{,}000 \text{ Units}$$

3. Your projected income statement and operating profit is as follows:

Sales (40,000 X $18)	$720,000
Fixed Costs	($175,000)
Variable Costs (40K X $10)	($400,000)
Operating Profit	$145,000

4. Your operating profit margin is 20.1% ($145,000 operating profit divided by $720,000 in total sales). Your contribution profit margin is 44.4% ($18 selling price less the $10 variable cost per unit equals $8, which is then divided by your $18 selling price).

5. Your new average cost per unit is $14.375 ($575,000 total fixed and variable cost divided by 40,000 units).

Federal Minimum Wage Raised to $5.85 on July 24. More to Come.

Effective July 24, 2007, the federal minimum wage for covered non-exempt employees was raised to $5.85 per hour. The minimum wage increases to $6.55 per hour effective July 24, 2008, and to $7.25 per hour effective July 24, 2009. Many states' minimum wage tracks the federal minimum wage. The chart below shows changes in the minimum wage since 1978.

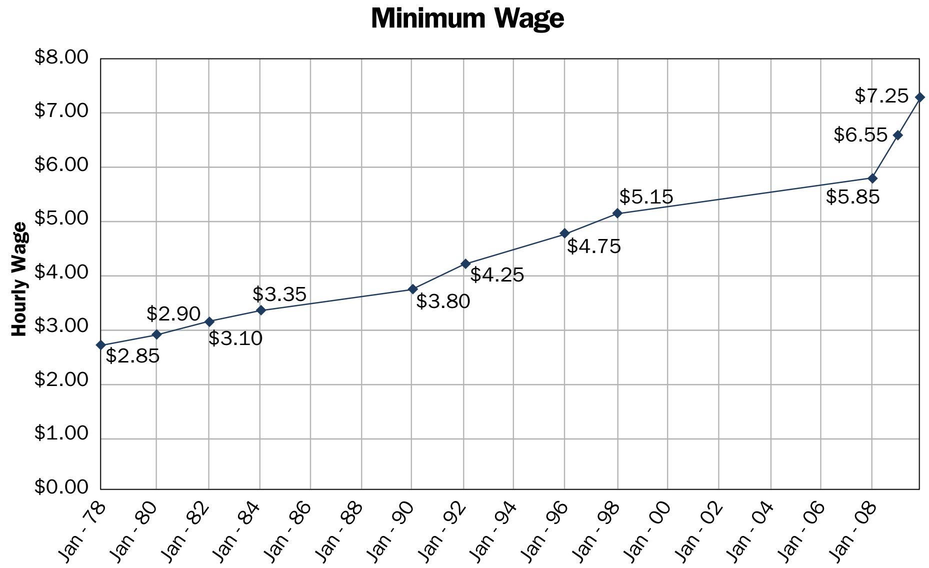
We started 2007 with a minimum wage of $5.15. By this time next year there will be nearly a 25% increase when the $6.55 minimum wage goes into effect. By July 2009, when it goes to $7.25, it'll be up 41% since the start of 2007

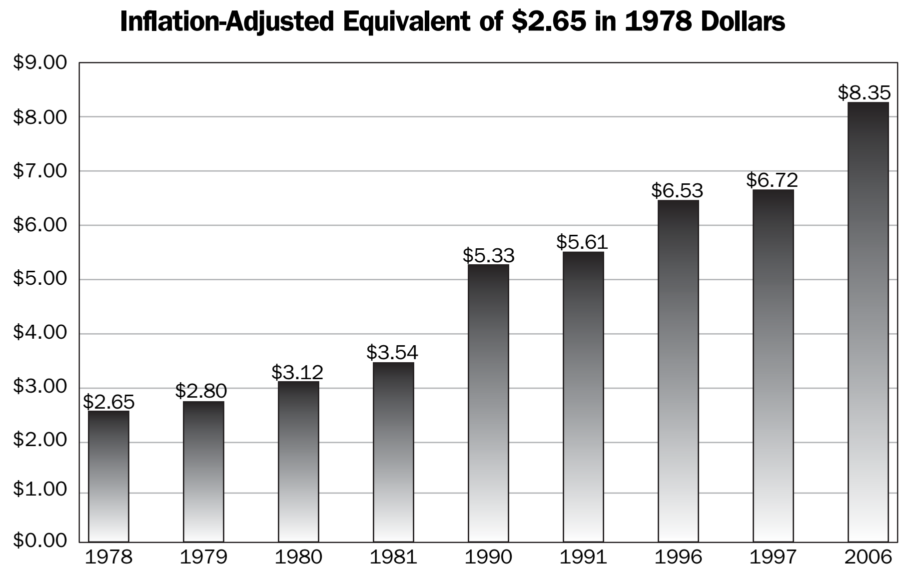
Those making minimum wage have consistently lost ground in the real value of their wages.

Of course, few of us can get the employees we need at minimum wage. The market itself, not the law, dictates what we must pay. On the other hand, some businesses no doubt will be affected by the change. The rise depicted in the above chart does appear alarming. But the real question is whether minimum wage has increased in REAL dollars. The second table shows the increase in NOMINAL dollars. Real dollars are adjusted for inflation. So, to put the new increases in perspective, one important question is whether we really pay more than we did in 1978 in REAL dollars. The answer to that question is found simply by adjusting the $2.65 minimum wage in 1978 to today's dollars. That is adjusting for inflation. And the answer is that $2.65 in 1978 dollars is equal to $8.35 today. So, in REAL dollars, we actually pay less today than we did in 1978.

The chart above shows the inflation-adjusted value of $2.65 on each date that the minimum wage was increased. By comparing this to the first table, you can see that those making minimum wage have consistently lost ground in the real value of their wages.

A revised federal minimum-wage poster is available from the Department of Labor website at http://www.dol.gov/esa/regs/compliance/posters/flsa.htm. ❑





> **"It's all about brand differentiation. If you're going to charge twice as much for a vodka, you need to give people a reason."**
>
> *Sidney Frank*
> *Built Jägermeister and Grey Goose into billion dollar brands*

Regular Price Increases are Essential to Keep Pace with Inflation

A dollar is not a dollar. It is completely relative to what it will buy for us, referred to as purchasing power. And what it will buy for us (i.e., its purchasing power) changes over time. Most of the time it declines. The following chart shows the change in the purchasing power of a dollar since 1914.

A decline in the purchasing power of a dollar is called inflation. Maybe it should be called deflation, because the value of a dollar falls, but it is called inflation because the cost of goods – the things we buy – rises. As the above chart shows, the purchasing power of a dollar rose during the period from 1920 to 1934. During this time, the cost of goods and services fell as we faced the Great Depression, and the purchasing power of the dollar increased. This is deflation (prices fall).

From the chart, you can see that the dollar today has the same purchasing power as about 5 cents in 1914. That's an erosion of 95% of the value of a dollar.

Some simple examples of the steady rise in the cost of goods: In 1950 a gallon of gas was 20 cents, a first-class stamp was 3 cents, a McDonald's shake was 20 cents (today it's $1.79) and a typical house went for around $17,000.

The government expends considerable effort to measure inflation. It regularly assesses the prices of goods and services, like those above, and publishes the rate of inflation. The most common measure of inflation is the Consumer Price Index. The following chart shows the annual rate of change in consumer prices, as measured by the Consumer Price Index, since 1948. As you can see, the annual rate of inflation has hovered around 3% since 1983.

What's the point here? You must raise prices every year. Your costs, no doubt, are going up — roughly at the rate of inflation. If you buy large amounts of certain materials, such as fuel, lumber or even such things as cheese, your costs may fluctuate more wildly.

Keep track of your overall costs and raise your prices every year. If you raise them

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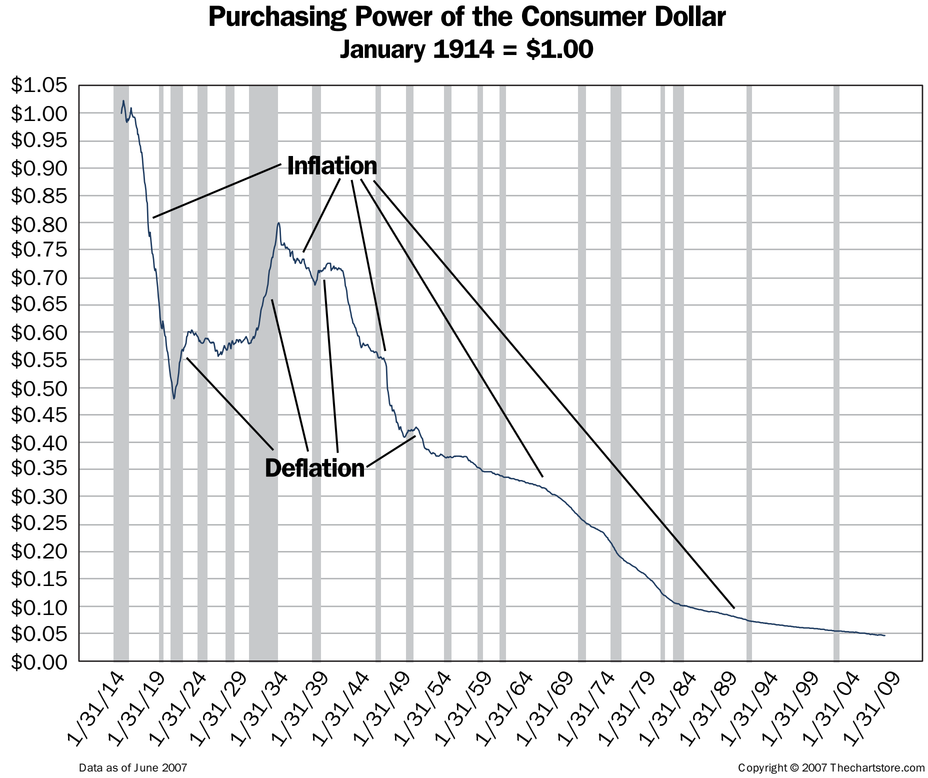

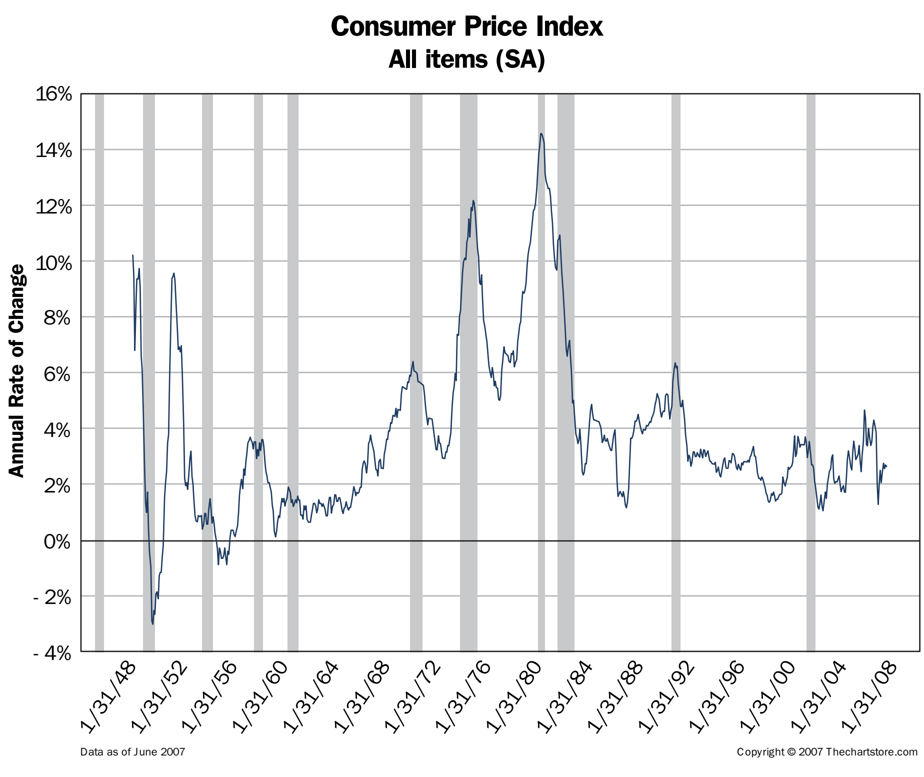

Charts sponsored by THE CHART STORE

Holidays: Enemy of Progress?

If you're like me, you work a lot. That's because you're dedicated to your work. Heck, you NEED to work. You have goals to reach and, ah, a lot of fires to put out.

You work a lot of holidays. Certainly, most of the second-tier holidays that seem to come around every other week. I don't even pay attention to the second-tier holidays. But maybe I should — because they're a nuisance. Even more, they're the enemy of every business owner who wants and needs to get the most for his labor dollar; who wants and needs to get the work out the door.

So when I show up at work and ask where everyone is, I get a little uptight when the answer is "It's Washington's Birthday." To be sure, I delegate personnel management to a talented, longtime employee who is much better at this stuff than I am (her name is Renae Williams and, no, she's not available). But I look like the bad guy when I grumble, "Didn't we just have a holiday?"

So then I ask Renae, "How did you decide which holidays we'd honor, just take all of 'em?"

After a few years of this, I decided I needed a new approach. I needed to get this monkey off my back. As is almost always the case, my "hangups" stem from my own ignorance. In other words, I'm the problem. And, as usual, the path to recovery begins with research. Research is the path to enlightenment.

Here is what I found. There are 10 federal holidays:

New Year's Day — January 1
Martin Luther King, Jr. Day — Third Monday in January
Presidents' Day (aka Washington's Birthday) — Third Monday in February
Memorial Day — Last Monday in May
Independence Day — July 4
Labor Day — First Monday in September
Columbus Day — Second Monday in October
Veterans' Day — November 11
Thanksgiving Day — Fourth Thursday in November
Christmas Day — December 25

The pertinent information here, for me, is that there is nearly one a month. So I need to get used to it. And as quickly as the weeks go by, it's no wonder that it feels like every other week.

My next question is, "Are we required to let people off on these holidays — and pay them?" After all, the word "federal" sounds pretty doggone serious.

Turns out that few people know the answer to this. So I called an employment law attorney, Mike Lissau of Hall Estill, and asked him the question. Of course, he said, "I'll get back with you on that."

He did. There is not room in this publication to print all the facts and related conditions and disclaimers that he provided (just kidding), but the summary is that the federal government "does not require private employers to provide employees with paid holidays off."

Well now. We may be uncovering something useful here.

Next, I called a friend who owns a staffing business, who has been successful, and who has a lot of common sense. I asked, "Federal law does not require employers to give their employees ANY holidays, so what do most employers do and what is the minimum that I could get away with in my business?"

Blayne Frieden said that most businesses give their exempt (salaried) employees eight paid holidays per year, six of which are the biggies:

New Year's Day — January 1
Memorial Day — Last Monday in May
Independence Day — July 4
Labor Day — First Monday in September
Thanksgiving Day — Fourth Thursday in November
Christmas Day — December 25

The additional two days are picked by the employer based on his or her own beliefs or preferences, generally from the following:

Martin Luther King, Jr. Day — Third Monday in January
Presidents' Day (aka Washington's Birthday) — Third Monday in February
Good Friday — The Friday before Easter Sunday
Columbus Day — Second Monday in October
Veterans' Day — November 11
Friday after Thanksgiving Day — Fourth Thursday in November
Day after Christmas — December 26

If the above listed holiday lands on a weekend, then the day off is the Friday before the holiday. In addition, some employers will give half days off, with the total equaling eight full paid holidays.

Blayne said that some employers try to give fewer days off, but employees expect to get the major holidays. He said that if employees feel their boss is "cheap," then most of them will get what they want one way or another. For example, they'll call in sick. And when this kind of thing starts happening, he said, it begins to erode the employer-worker relationship and undermine morale. So most smart business owners are not stingy with holidays — and they get a payback in the form of better relationships with employees and a more productive workforce.

And so my journey of enlightenment has reached its natural end. The employment market dictates what employers must do, not the federal government. Employees expect eight paid holidays per year, and I can either give it to them or they'll take it from me one way or another. So I might as well give it to them and get something in return. I'll do so by providing it with all good wishes to enjoy their days off. After all, they do deserve it.

End note: You have no obligation to give any employee a paid day off, but before you refuse to give any employee an unpaid day off for any reason, such as to allow them to observe a religious holiday, contact legal counsel. ❑

E~~Id~~entity Crisis: Choosing the Right Legal Entity

Selecting the most appropriate legal entity for your business can be a confusing task. However, picking the one that strikes a comfortable balance between cost, complexity, liability protection and taxation can give you peace of mind at a time when you have much on your mind. Use this overview to see the big picture and begin to ascertain which will suit you best.

Sole Proprietorship: The sole proprietorship is the most common business type in the United States because of its simplicity and because it is the legal form that is automatically assigned to any business that is started by an individual who does not proactively organize in some other form. No formal registration is required and a sole proprietorship may change to one of the other entity types at any time. Sole proprietorships have only one owner, referred to as a sole proprietor, and all business income and expense is reported on the business owner's individual income tax return via Schedule C. A disadvantage includes the fact that there is no mechanism for sharing ownership, and liabilities of the business are all personal obligations of the owner.

Partnership: The partnership is a very old form of business association that may be formed when two or more persons (partnerships, corporations or other legal entities may also be partners in a partnership) wish to jointly enter into a business for profit. There are two common types of partnerships – general and limited. In a general partnership, all of the owners have full management power and are held personally liable for the actions and omissions of the other partners, and for the indebtedness of the partnership. In a limited partnership, partners are divided into two classes – general and limited. General partners are as described above. Limited partners are essentially passive investors, and are not active in the management of the company. They are not held personally liable for the obligations of the partnership.

Partnerships, like sole proprietorships, are easy to form, require little ongoing paperwork, and are only taxed at the individual (partner) level. Use of the partnership has been in decline, however, as the S-corporation and limited liability company now offer attractive advantages in terms of flexibility and in insulating the owners from the liabilities of the business.

C-corporation: The C-corporation is the classic for-profit legal entity in the United States. It is unique in that it is taxed as an entity in itself, separate and distinct from its shareholders, and it may have its ownership interests (shares) trade on public exchanges. Forming a C-corporation is much more complex, however. The incorporation process requires that the shareholders adopt bylaws, distribute shares and elect officers who oversee corporate functions. There are ongoing requirements as well, such as annual meetings, disclosures and shareholder approval of certain types of actions. In exchange for these burdens, shareholders enjoy fairly significant protection from personal liability for company obligations, and ownership interests can be easily transferred. Moreover, at lower annual income levels, income tax rates are lower for C-corporations than they are for individuals. Dividends, however, are the only means for distributing company profits to non-employee shareholders and are subject to double taxation. Double taxation means that company distributions (dividends) are paid out of the corporation in after-tax dollars (i.e. dividends are not a deductible expense of the business), and then, the shareholder who receives the dividend will owe taxes on the amount received as the IRS requires that such receipts be included as taxable ordinary income to the shareholder.

S-corporation: The S-corporation has similarities to its C-corporation cousin, such as ease of ownership transfer and shielding of shareholders from the liabilities of the company. However, it has many differences as well. Significant ones include the fact that the number of shareholders it may have is limited, shareholders may only be United States citizens and it is taxed as a partnership (i.e. there is no tax paid at the corporate level). Benefits, such as life and health insurance and housing cost reimbursements, are treated as tax-deductible expenses in a C-corporation and are considered taxable compensation for shareholders who own more than a two percent share in the S-corporation.

Limited Liability Company: Coming into vogue in the 1990s, the Limited Liability Company (LLC) often appeals to businesses and professional groups that formerly formed partnerships. Similar to the S-corporation, the LLC is a hybrid creature, combining the beneficial tax treatment of a partnership with many of the owner-liability protections of a corporation. It also permits easy changes in ownership. Different from the S-corporation, however, the LLC can have unlimited shareholders (called members), who do not have to be U.S. citizens.

The above is meant to provide a very brief overview of the different types of legal entities. For the very small business, the sole proprietorship remains the most common. For larger, multi-owner businesses, the S-corporation and Limited Liability Company are the common choice today for reasons discussed above. If you need to select an entity type for a new or existing business, take this summary and visit further with your tax advisor about the characteristics and merits of each. Continue to research until you find the one that is right for you. ❑

STRATEGY

Regular Price Increases are Essential to Keep Pace with Inflation, **continued from page 13**

regularly, in small increments, along with the steady rise in your costs (inflation), your customers will hardly notice. But if you miss several years and then have to raise more steeply, you not only have needlessly lost profit for a few years but you'll likely give a few of your customers just enough reason to try a competitor.

Worried about raising prices? Listen, everyone knows that inflation is persistent. Your customers will understand when you raise prices to keep up with inflation — so long as you do it every year. And think about it: The reason inflation exists is because everyone else is raising their prices. Your vendors are, and so are your customers (unless you sell to consumers). Raising your prices will not make you money, it'll just keep you from losing. ❑

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