Twelve Months to Maximum Business Performance

By Michael Emerald, CFA

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About the Author

Comment [ME1]: m3 4/16/18 Revised: 2/8/17

I have an undergraduate degree in physics from Boston University and an MBA in Finance from the University of North Carolina at Kenan Flagler (Chapel Hill). After working for two multi-national engineering firms I worked for an investment banking firm, Boston Financial Technology Group, packaging real estate syndications as a financial analyst. Later, I served in a Boston real estate development firm, The Finch Group, as a financial analyst, analyzing multi-dwelling-unit acquisitions. From there, I co-founded Longfellow Investment Management Company, a multi-billion dollar institutional investment management firm in downtown Boston, where I spent most of my career as a Wall Street securities analyst. My specialty was general equities and Mergers & Acquisitions.

> The one thing the successful businesses have in common is this: <u>performance</u>. And the one thing those doomed to failure have in common is: <u>underperformance</u>.

More important than my experience as a securities analyst I learned how to start a business from start-up, to what it is when I left it, a multi-billion dollar firm with a dozen employees and growing. In addition, from speaking to companies every day, I learned what makes a company move into the tier of a publicly held corporation and what causes a fledgling company to fail.

Today I head Performance Business Design, a business strategy consulting firm I started in 2010. Throughout my career as a securities analyst, portfolio manager and investment banking analyst, I have met about twice a week (and still do) with the heads of publicly held corporations and those about to go public. I listen to CEOs describe all aspects of their company and answer probing and often difficult questions put forth by myself and my peers. Afterwards, I help those corporations boost the value of their stock price by providing feedback on what can be improved. By doing so I provide feedback to such corporations by letting them know how securities analysts are evaluating them.

What does this have to do with you, you may ask? Over time, I came to understand what makes businesses reach the level of success that the corporations enjoy today. Meeting with and evaluating everything from start-ups, to Mom & Pops, IPOs, publicly held corporations and everything in between I found that the one thing the successful businesses have in common is this: <u>performance</u>. And the one thing those doomed to failure have in common is: <u>underperformance</u>. It's easy to disagree with this one-sentence definition of success, and I myself would disagree with it as well. But when you read further on what I mean by performance you'll see that it includes everything that is critical to business success. And then you'll hopefully understand and agree with this one sentence definition.

When I began evaluating smaller businesses, which I define as ranging from Mom & Pops up to those with market values of $10 million, I found something dramatic. I found that 62% of the businesses I analyzed weren't performing above *half* their potential. Knowing that 70% of small businesses fail within 10 years, and that corporations I evaluate typically score between 70% and 90% lead me to form the hypothesis that the secret to smaller business longevity was business performance. What this performance entails, as well as how to plan for and implement it, is the subject of this book.

Today, my firm Performance Business Design collaborates with businesses of less than $10 million in value, including start-ups, with the goal to increase business performance to the levels achieved by large corporations. By doing so, our clients enjoy the higher profits that accrue, and as well the esprit de corps that comes from working in a well-performing organization. Our hope is to see client profits increase 10% per year and for each of them to be in the 30% of businesses that last a long, long time.

Michael Emerald, CFA

Wall Street Analyst and Owner, Performance Business Design

Note: Anyone interested in information on how we work with clients can visit our website www.PerformanceBusinessDesign.com or send an email to higherprofits@performancebusinessdesign.com. Include your mailing address and we will send you information by US mail.

How to Use This Book

Comment [ME2]: m2 2/12/18 Revised: 12/18/17

This is the section which I usually skim when I read a book. So, for your sake, I'll keep it brief. My objective is to help improve your business profits by improving your performance. As your performance rises, your organization will become like a sailboat getting wind in its sails. The sailboat turns with the wind, filling its sails. You feel the boat heel sideways and begin to gain speed. The sound of water splashing grows louder as your boat cuts through the waves, moving ever faster and ever closer to your destination.

> Most underperforming businesses think they are performing well. It's only when a trained independent eye evaluates their businesses do they find, and usually agree, that there is much room for improvement.

So it is with your business. As performance increases, momentum increases. Employees become energized, the pace quickens yet stress is reduced as feelings of security plus the hope for a nice year-end bonus rises. New products roll out, and your sales and marketing departments become like fighter pilots ready for each new mission. Marketing material released to the public shows increased activity and customers become more interested, resulting in shorter sales cycles. Ultimately, as performance rises so do revenues and with it, profits.

We recommend that you do as our clients do. Listen to (read) how we measure performance and about the Business Performance Report. Next, read each of the chapters on how to improve specific areas of your business. If you think you are already strong in an area, read it anyway, because each chapter also includes the items we look for. Most underperforming businesses think they are performing well. It's only when a trained independent eye evaluates their businesses do they find, and usually agree with, that there is much room for improvement. In other words, if you think you are strong in an area, read the chapter anyway, and on a hunch we might agree there's room for improvement.

Once you have read what we look for in evaluating each area, and made notes about your own business, prioritize those areas needing attention. Then plan to improve each, one by one, as described below.

When we work with clients to improve an area we set aside 90 minutes a week for 6 to 8 weeks for planning. The exact number of meetings depends upon the area under consideration. You'll find recommendations for that in each chapter. Once planning for a particular area is complete, we leave the implementation to them (though we are available to help with that as well). So, when you decide to improve an area of your business, set aside a month or two to plan for the change as described in this book, and then the ensuing 3-6 months to implementing that change. To be clear, the implementation is within the normal course of business.

Chapter 1

The 12 Area Performance Check

Comment [ME3]: m3 3/2/18 Revised: 12/18

I'm going to explain what the CFA designation is all about so that you understand more about my background and more importantly how I assess a company's prospects for success.

The Chartered Financial Analyst designation ("CFA") is the highest designation awarded to financial analysts, typically securities analysts. Attaining it entails understanding and being tested on every aspect of a business. The primary objective is to be able to assess the value of a company and its stock. Not, though, as an accountant would value the company, although certainly book value is always taken into consideration. Rather, the CFA goes beyond the accounting statements in making their [1] evaluation.

> Evaluating a company is about 20% art, 50% experience and only 30% science.

A CFA evaluates business value by analyzing the company's prospects for growth. This is done with consideration given to its business strategy, marketing, financial strength, management, its suppliers, the marketplace, competition, the economy, market trends, and any other factor which might enter into a company's prospect for success. Evaluating a company is about 20% art, 50% experience and only 30% science, in my opinion. It is only by experience and having met with and evaluated hundreds of companies that the CFA learns what is relevant to the evaluation…and what is not. It is by experience that you learn that projects don't always get carried out, competitors can arise if barriers to entry are low, lack of financing can kill even the most promising projects, and other unexpected outcomes. It would not be hard to name two dozen factors beyond the financial statements that a CFA uses in assessing value.

There are three tests required, spaced a year apart, in order to attain a CFA, each with a pass rate of about 40%. They require that the examinee be employed by, and recommended by, an investment management, insurance, bank or other financial institution. The first test (CFA I) covers factual areas of accounting and finance. The second test (CFA II) examines more subtle areas of accounting, investments and financial analysis, such as accounting for cross-border acquisitions. And the third phase, almost entirely essay, goes into the qualitative aspects of business strategy, in addition to a plethora of investment theory.

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[1] Note that this book uses the now grammatically accepted singular their

While CFAs deal primarily with publicly held corporations, this book omits specifics of investing, finance, and stock price. Our clients are privately held and while going public is always a consideration, in most cases stock price is not a consideration.

Subjective Bias in Evaluating a Company

Comment [ME4]: m2 2/9/18 Revised: 12/19

While studying for the Chartered Financial Analyst designation, I learned that security analysts make irrational decisions. They tend to "fall in love" with a company, then find reasons for justifying their love. (I once read that men evaluating romantic relationships often do the same). The result is that at best they over-estimate a company's prospects for success and at worst overlook a red flag indicating a problem.

> Example: A charismatic CEO leads an analyst to believe her company is more valuable than is presently indicated by its stock price. She touts its talented staff, opportunities for developing new products, and a large cash position from a recent financing. But the analyst overlooks the company's lacking marketing department. The company would be a small fish in an enormous pond and getting the word out and making the brand known will require more resources than the fledgling company is capable of.

Another bias is not evaluating all areas of the business. Being swayed by the wonders of a biotech's drug, for example, while overlooking its other departments, is a source of bias. One could argue that sometimes certain areas aren't pertinent. For example, a natural resources company doesn't care about its marketing department. This is true, but is unusual. Most of the time all areas of a business come into play.

Example: A fantastic new biotech product leads an analyst to believe that a company has outstanding growth prospects. This product will cure lung cancer. This is a phenomenal company, the analyst concludes. Still, financing the clinical trials will cost many more millions than the laid-back CEO would be capable of raising[2]. Furthermore, such a small company trying to gather sufficient patients to conduct clinical trials in a sea of major biotech companies also competing for those same patients will take time. In all, the company would be better off targeting a smaller indication, such as a rare cancer. Doing so would grant it orphan drug status, resulting in an expedited FDA trial at far cheaper cost. But they aren't. So the company's prospects for success are less wonderful than the analyst concluded.

Having both read and experienced that we make irrational decisions, I decided that rather than qualitatively assess the *overall* value of a company I would instead evaluate, as objectively as possible, *each of 12 specific areas* of the business. I would evaluate each by assigning a numeric score from 1 to 10 on how well each of its areas performed.

Example: A company with a well-trained and decently-sized marketing staff might score a 10 in marketing. But that same company with only enough cash on its balance sheet to last a few months before needing external financing might score a 3 in financial position.

And so, after talking to management, asking the right questions, kicking the tires and crossing the T's and dotting the I's I score 12 areas, each from 1 to 10.

Once I score each of those 12 areas, I average those areas to assign an overall performance rating, measured from 0%-100%. For example, a company which scored an average of 5 in each of the 10 areas would be assigned a performance rating of 50%. A detail, not relevant to this book, is that the areas are weighted according to the importance of each of the 12 areas. For example, a start-up scoring 10 because it does a great job on social media but a 1 in marketing because it lacks a website is not going to score 50% (yes, I've seen plenty of businesses with just these attributes!). Rather, the 1 in marketing is going to weigh heavily towards the final score.

Another detail is why 12 areas? Why not 20? Why not 5? We'll get more into this later, when hopefully you'll agree that 12, while being a manageable number is also the

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[2] Publicly held companies of less than $100 million in market value depend upon a charismatic CEO to appeal to investors. Moreover there are some wonderful companies unable to raise financing and, contrarily, some not-so-wonderful companies with charismatic CEOs able to keep it afloat for a long time.

number of areas critical to business success. In other words, when you see the 12 areas you'll probably agree that they encompass a lot but not too much.

Are High-Scoring Companies More Profitable?

Comment [ME5]: m2 2/14/18 Revised: 12/28/17

To summarize what we've talked about so far, I evaluate each of 12 areas individually, weight the score for each of the areas, and the total becomes the Business Performance Rating, which ranges from 0% to 100%. That score is what I use to decide how successful a company will be[3]. <u>Never do I ask myself whether I *like* a company or rate the business overall.</u>

Putting this method to use, I immediately found that companies which seemed stellar in the eyes of my peers appeared not so stellar when several of the 12 areas I evaluated were weak. Contrarily, companies which were deemed dull to my peers often scored highly because they were well-balanced across all areas. In other words, companies scoring decently in every aspect of their business, although stellar in none, often receive high performance scores. Translated to your business, this means that if you do a decent job everywhere, that's not a bad thing. As you read the rest of this book, however, you'll find that doing well in all areas isn't as easy as it sounds. Moreover, our objective is for you to do *very* well in *all* areas of your business. But, truth be known, most smaller businesses I evaluate would improve by even being *mediocre* in all areas. Indeed, most are deficient in several areas.

Doing well in all areas isn't as easy as it sounds. Moreover, our objective is for you to do *very* well in *all* areas of your business.

I'll bring up a few examples of what I mean by the well balanced company doing well, but first a digression is in order. I said earlier in this book that the Business Performance Report (discussed later) is not concerned with predicting stock price; rather, it is concerned with identifying companies which will grow in profits. Were one to predict which company *stocks* will do well, rather than the company itself, a different analysis would be necessary since stocks contain the element of public opinion, while my analysis does not. A company with great prospects by my standards may have a stock price which is overvalued. Thus, while being a successful company, it would be a bad investment because the general public deems this company multiples more valuable than fundamental analysis suggests.

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[3] Instead of the word "success" I'd prefer to substitute "grow according to its owners' wishes", but that is a topic reserved for later, when we define success for the smaller business.