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Securing the growth of an SME – understanding value creation

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A systematic value creation mindset is often absent in small and medium sized enterprises. Value creation builds on alternative returns. Investing in a business should result in better returns than what is available through other investment vehicles. The target of any company should always be, not maximizing revenues or profits alone, but maximizing profits (cash flow) with as little capital invested as possible.

A systematic value creation mindset is often absent in an SME (small or medium sized enterprise). Text book theory for net present value is hardly helpful for the SME entrepreneur, who typically looks for a safe way to grow profitably. The concept of value builds on alternative returns. To put your money in your business, you should expect better returns from that investment than you could achieve through other investment vehicles. Thus the main target of any company should always be, not maximizing revenues or profits alone, but maximizing profits with as little capital invested as possible. In other words, maximizing the return on invested capital, ROIC, is key.

CEOs of SMEs rarely think of their companies as investments with alternatives, but rather as cash cows. This leads them to focus more on sales than value creation. Sales and profits are easy to understand, while invested capital is more abstract and harder to measure. In our work with SME companies, we see a big need to develop ways for growing both sales and profits without neglecting value. Understanding your invested capital and how it scales with growth (especially working capital) is key to success and often also your best insurance against potential bankruptcy! In our experience, the successful growth journey of an SME requires going through three generic phases which we call *establish*, *create* and *leverage*. These phases are not always sequential, but for each some key questions must be addressed.

Establish the way for growth

As the company grows, eventually the founder/CEO has to delegate responsibility. To make delegation possible, the SME CEO needs to make sure that management practices, structure and reporting systems are in place. Without a proper foundation, effective delegation is not possible and growth is slowed down by the need to handle everyday confusion. Instead of growth the result can easily be decreased customer and employee satisfaction.

A well-designed reporting system forms the structural base. We have found that a comprehensive hierarchy of metrics that covers all the drivers of ROIC works well without the need to formally introduce value as a concept. The main drivers of ROIC are profitability and capital turnover. These can then be broken down and monitored on lower levels. Profitability, for example, can be monitored by customer, supplier, product and sales person. Similarly, capital turnover can be broken down into components such as non-current asset turnover and working capital turnover, which can themselves be broken down into practical subcomponents. Add metrics for revenue growth, which are usually self-evident for SMEs, and you are implicitly monitoring value creation.

Such a dashboard of metrics makes sure that all the plausible drivers of value are covered. However, value should not only be monitored, but it should also influence the development of the business model. Poor working capital management, for example, is one of the most common reasons for value destruction in SMEs. Significant value can be created by setting up payment terms towards both suppliers and customers to minimize working capital, making them as long as possible for suppliers and as short as possible for customers. In service-based businesses, salary payment terms, in addition to customer payment terms, can provide additional leverage to minimize working capital. Salary pay dates are to some extent irrelevant to an individual employee, but from the company's perspective can enable reaching even negative working capital.

With the measurement system in place, focusing on what needs to be done is easier. In a small company, however, everyone is doing a bit of everything. An organization or key process chart defining roles and responsibilities allows everyone to focus on their competence areas and develop their own work. When the roles are clear, they are easier to manage and measure. Targets can be set on a detailed level and development discussions and compensation schemes can then be linked to the targets and results. Note that performance starts from the management team. These individuals affect the company culture significantly, and a lot of effort should be put in systematically and strictly leading the management team and demanding results from them. No organization will commit to working methods that management themselves do not use.

For a small company, support functions such as IT and HR can be handled on the side, but quite soon it becomes crucial to separate support functions from the line organization by handling them through dedicated units (in-house, or outsourced). This improves efficiency and reduces costs by freeing up resources to focus on their core activities of value creation.

Create economies of scale

There are two aspects to growth; the strategy, that is the choices of where to pursue the growth, and the execution. However, growth is risky and requires investments. Thus owners should be ready to sacrifice some dividends (cash today) in favor of investments (that result in more cash tomorrow). In an SME the weight is often in cash today, since analytics to understand what value could be achieved through investments is lacking.

Making a growth strategy may sound more difficult than it actually is. Most start-ups have an inherent growth strategy even if it is not explicitly documented. In its simplest form, growth strategy expresses what, where, how much and to whom you are selling, and how your activities drive increasing returns. A key step is understanding what the customers want, and how the company can address that need in an increasing way.

There are a few common rules to help in choosing the strategy. A small company should usually not grow through mergers and acquisitions before it has clearly smaller companies to buy, a solid business and operating model that allows integration of targets and a sufficient and sustainable cash flow. Geographically, very few companies are born global and have the expertise to conquer the world immediately; it is easier to focus on the near markets such as the Nordics, the Baltic region and Russia. Expansion possibilities in Finland should not be underestimated. From the product perspective, the company can choose to either sell many products to few customers or few products to many customers. Many smaller companies go for the latter, since expertise is often product-centric. However, once your channel starts to stabilize, increasing the offering scope is usually a great value lever.

The growth strategy should always take value creation into account – options should be analyzed via their effect on company value. Revenue growth is not valuable in itself, especially if profitability and capital invested do not scale. Typically the working capital structure of a company limits the growth that can be attained without external financing; if the company grows too fast, it needs to invest more money in working capital than it can afford, and may even go bankrupt.

After the growth strategy is chosen, the execution is mostly about management, measurement and tough decisions. An easy-to-use CRM system and a customer classification help the sales force focus their efforts and time so that they generate more sales. With right measures and incentives, this effect can be enhanced even more. Measurement systems also help in managing the product portfolio; monitoring the profitability of products and being brave enough to end non-profitable products leads to a more focused and profitable portfolio, from which both the company and its customers ultimately benefit with more resources available to develop and support each product.

Leverage economies of scale for sustained value creation

After growing a company to a certain point, the SME entrepreneur is likely thinking of one of two things: plan an exit or expand the company further. In both cases, maximizing the value of the company becomes relevant when considering bringing in external investors or financiers. This requires introducing value creation explicitly into the organization.

Achieving a value creation mindset in the organization requires a new level of maturity from the management team. This is easier than it might seem; as we discussed in the beginning, a high return on invested capital is all you need to drive value creating growth. In other words, the value of the company increases through increasing ROIC and growing revenues/profits. The proper tools set in place to monitor the company's performance in the very first step of the growth journey will facilitate this process and ease the transition into measuring value in an explicit way.

To increase the ROIC of the company at this stage, efficiency and productivity improvements are typical tools of choice. The possibilities (and challenges) lie mostly in optimizing capacity utilization and creating and utilizing synergies. A major pitfall, however, lies in trying to make savings from continuous growth-related investments such as marketing or R&D to achieve short-term profitability. Value comes from the systematic execution of a growth strategy, which addresses both revenue, cost and invested capital. Optimizing capacity utilization can be achieved for example by investing in relevant IT systems such as a tailored ERP or by pooling resources and combining responsibilities. Productivity can be increased by more effectively sharing information through common processes, workspaces or IT systems, rearranging the organization to ensure cross-functional interaction and optimizing the product portfolio. Revenue growth opportunities lie in expansion to new segments, products, markets or services, that is, broadening the offering portfolio. While such efforts require investments, the increased cash flows from the steady and profitable operations will ease the financing of these larger scale investments and allow some risk taking.

To continue the growth journey, and obtain external financing, the management must demonstrate its capability to create value. Having systematically covered the establish, create and leverage phases provides the track record needed.