

Center for Private Company Excellence Webinar
**Capital Allocation Strategies
for Private Companies**

Presented by:
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Kreischer Miller

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Agenda & Learning Objectives

Learning Objectives:

- Awareness
- Importance
- Intention
- Limitations
- Mechanics

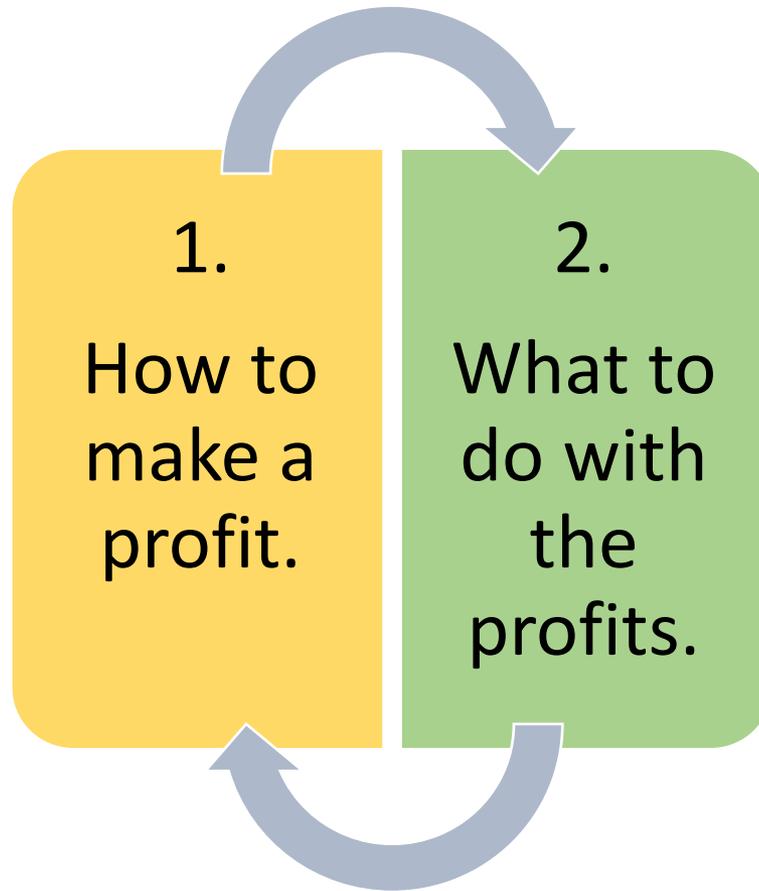
1. Introduction
2. Capital Allocation – The Issues
3. What is Capital Allocation?
4. Capital Allocation Mechanics
5. Return on Invested Capital



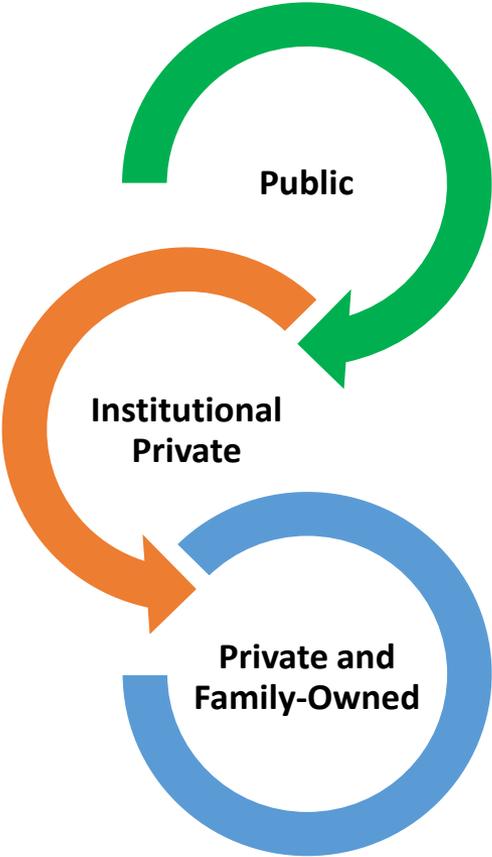
Introduction

High Level Areas of Financial Focus

Separate but Interrelated



Different Discussion for Different Companies



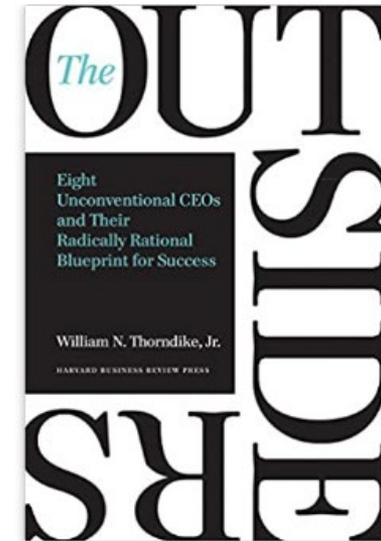
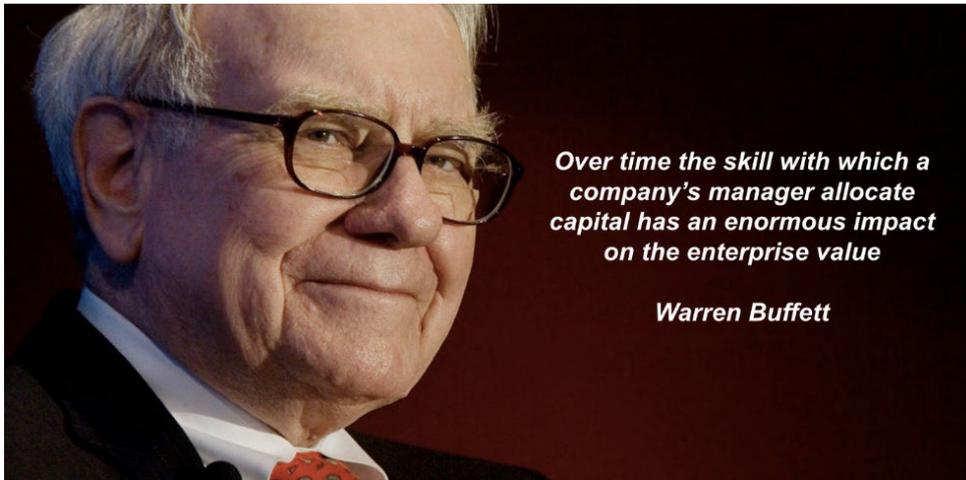
Capital Cost	Capital Access	Capital Availability	Cost of Being Wrong
LOW	EASY	HIGH	LOW
MEDIUM	EASY	HIGH	LOW
HIGH	HARD	LOW	HIGH

Polling Question

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A Master of Capital Allocation

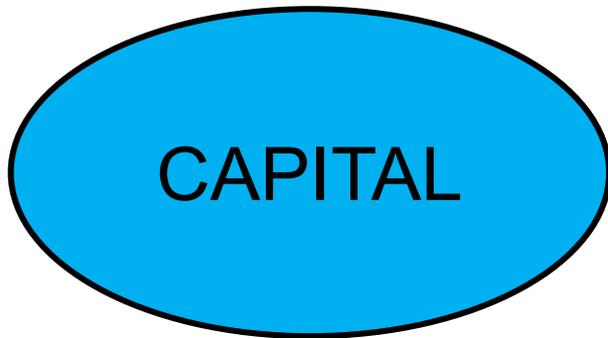


53 years under Buffett

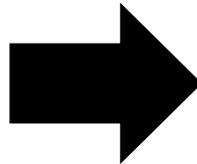


Capital Allocation – The Issues

Key Issue in Common for Most Private Companies



CAPITAL



- ✓ No OPM (other people's money – too many strings attached)
- ✓ Scarce – in short supply
- ✓ Access – hard to get
- ✓ Expensive
- ✓ Takes a long time to develop internally
- ✓ High Cost of Being Wrong

Why not be
THOUGHTFUL and INTENTIONAL
about what you do with it?

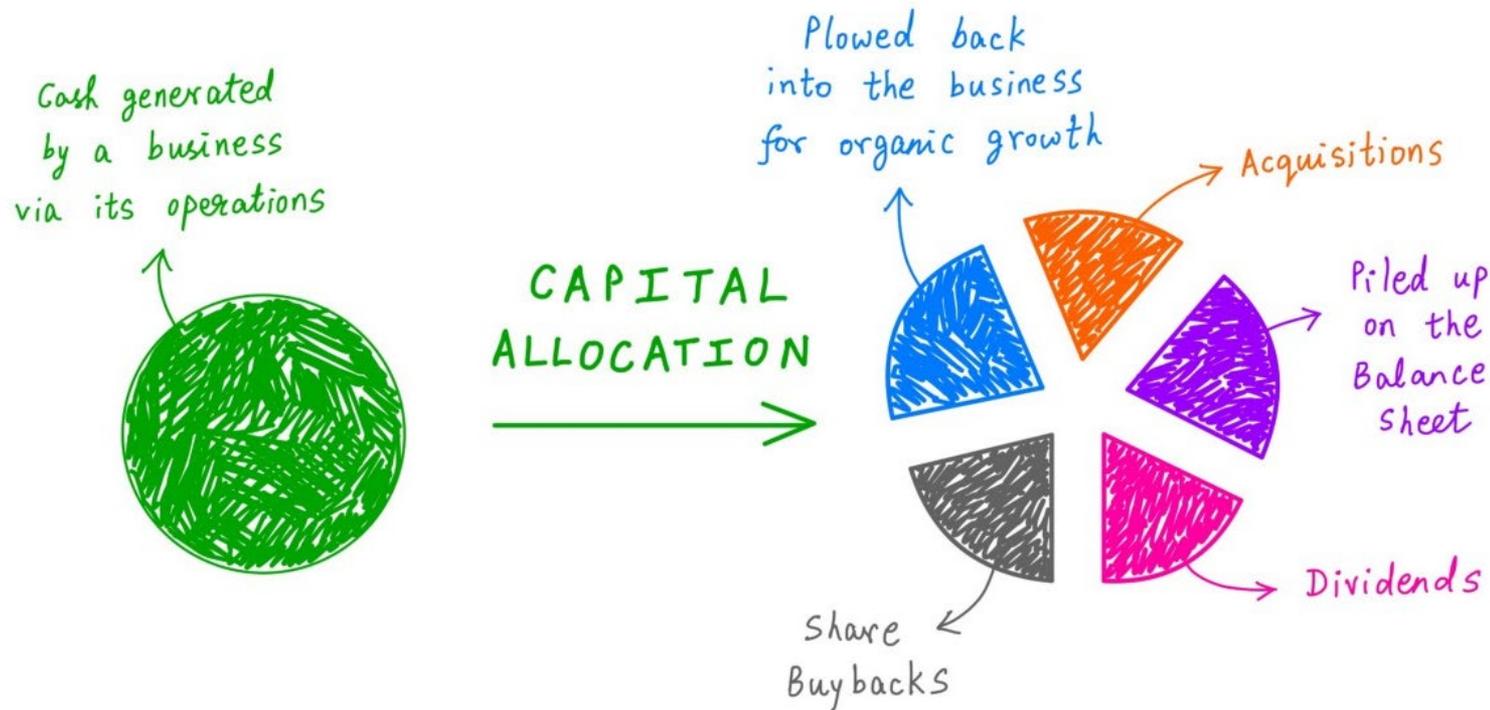
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Capital Allocation – Issues

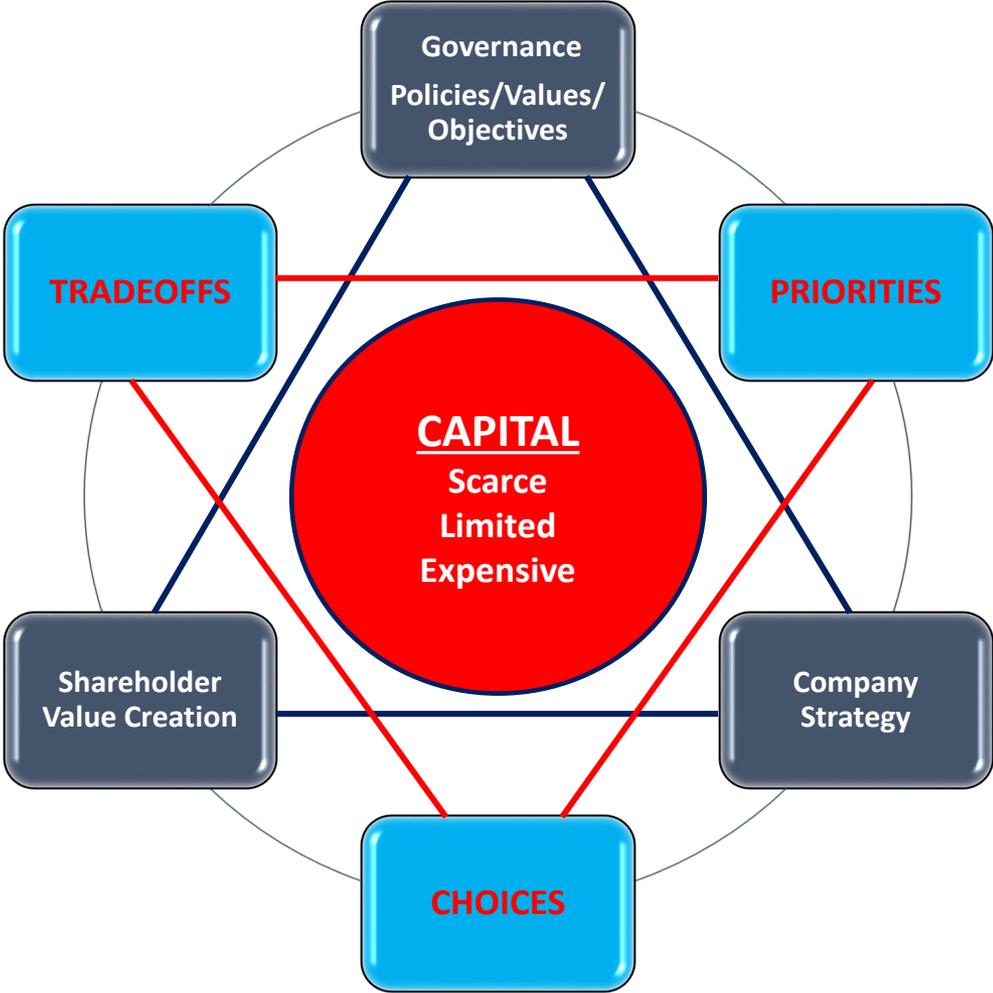
1. Capital gets allocated every year by every company whether intentional or not.
 - How do you know if your capital allocation plan is meeting your governance, strategy and value creation objectives?
2. Typical focus is on growth/profits but not on what to do with the profits.
 - Allocation of cash flow is critical to future growth in profits.
3. Most companies don't focus enough on the balance sheet.
 - Balance sheet management is critical to a company's success.
4. Many private companies don't understand what capital allocation means and why it matters.
 - Capital allocation is one of the most important elements of long-term business success.

Simple But Not Simplistic



Balancing Act With Limited Capital

Competing Priorities & Unlimited Choices Require Tradeoffs



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What is Capital Allocation?

Capital Allocation in a Private Company

Capital Allocation is the intentional decision about how to best utilize the company's resources (existing capital & profits) to:

1. Achieve Governance Policies, Values & Objectives
2. Support the Company's Strategy
3. Create Economic Shareholder Value



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Governance Policies, Values & Objectives

Achieving Shareholder Policies & Values:

1. What do the shareholders value?
2. Why does the business exist?
3. What is our purpose?
4. What goals are important to the shareholders?
5. What are our governance priorities?



Common Objectives:

- ✓ **Team/People** – Profit sharing, gainsharing, ESOP, etc.
- ✓ **Legacy/Community** – Invest in & support the community that the business operates in
- ✓ **Charity** – Support for charitable organizations that are important to the family and business/meet family charitable goals
- ✓ **Dividends/Profit Distributions** – Part of passive / active shareholder governance
- ✓ **Share Redemptions** – Part of governance policies to provide liquidity options to shareholders

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Creating Shareholder Economic Value

Utilization of the company's resources to create a Return on Invested Capital (ROIC) that creates shareholder value:

1. Reinvest in the Business at Appropriate Rates of Return
 - Optimize Utilization of Assets
 - Working Capital Turnover
 - Asset Turnover
 - Use Proper Financial Leverage
 - Balance Risk vs. Return
2. Return Cash to Shareholders
 - Dividends or Profit Distributions
 - Redeem Stock



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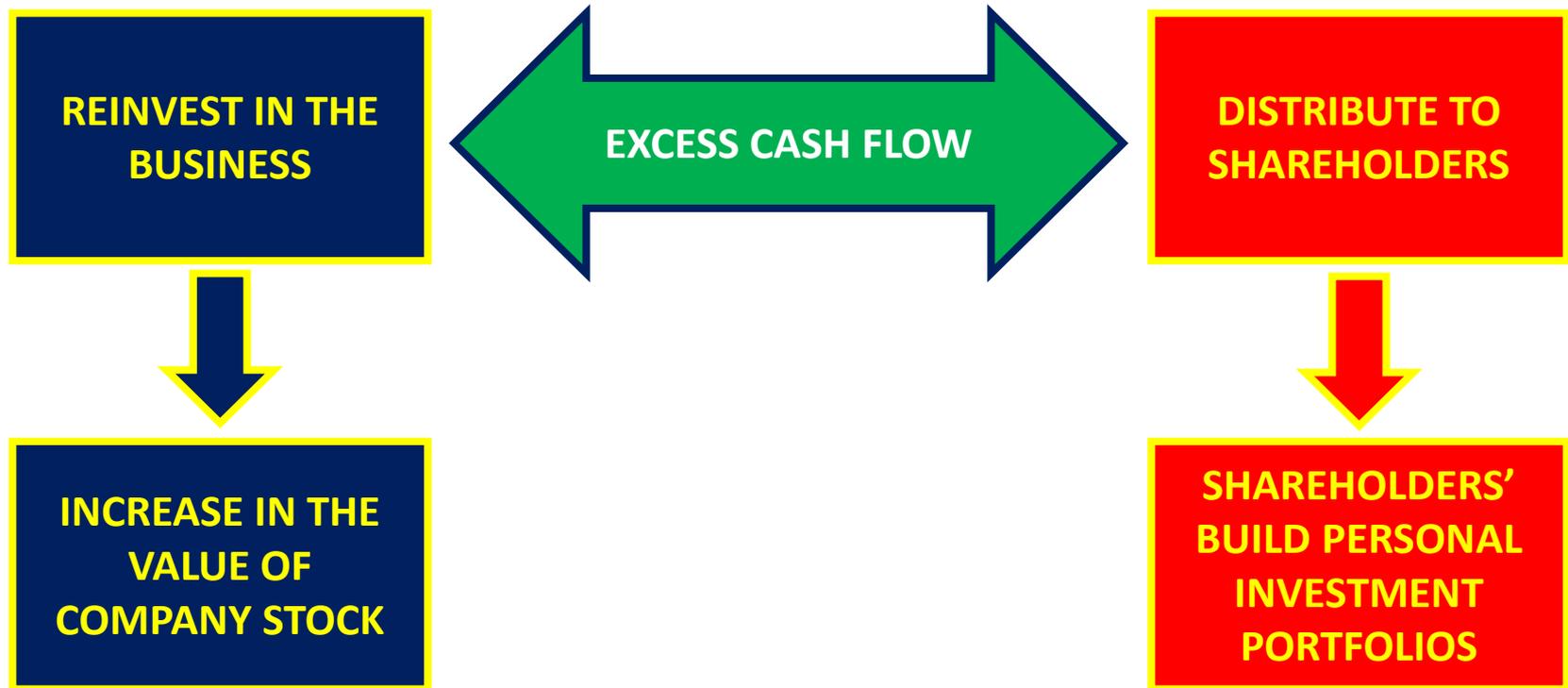
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Shareholder Value Can be Created Differently



Illustration

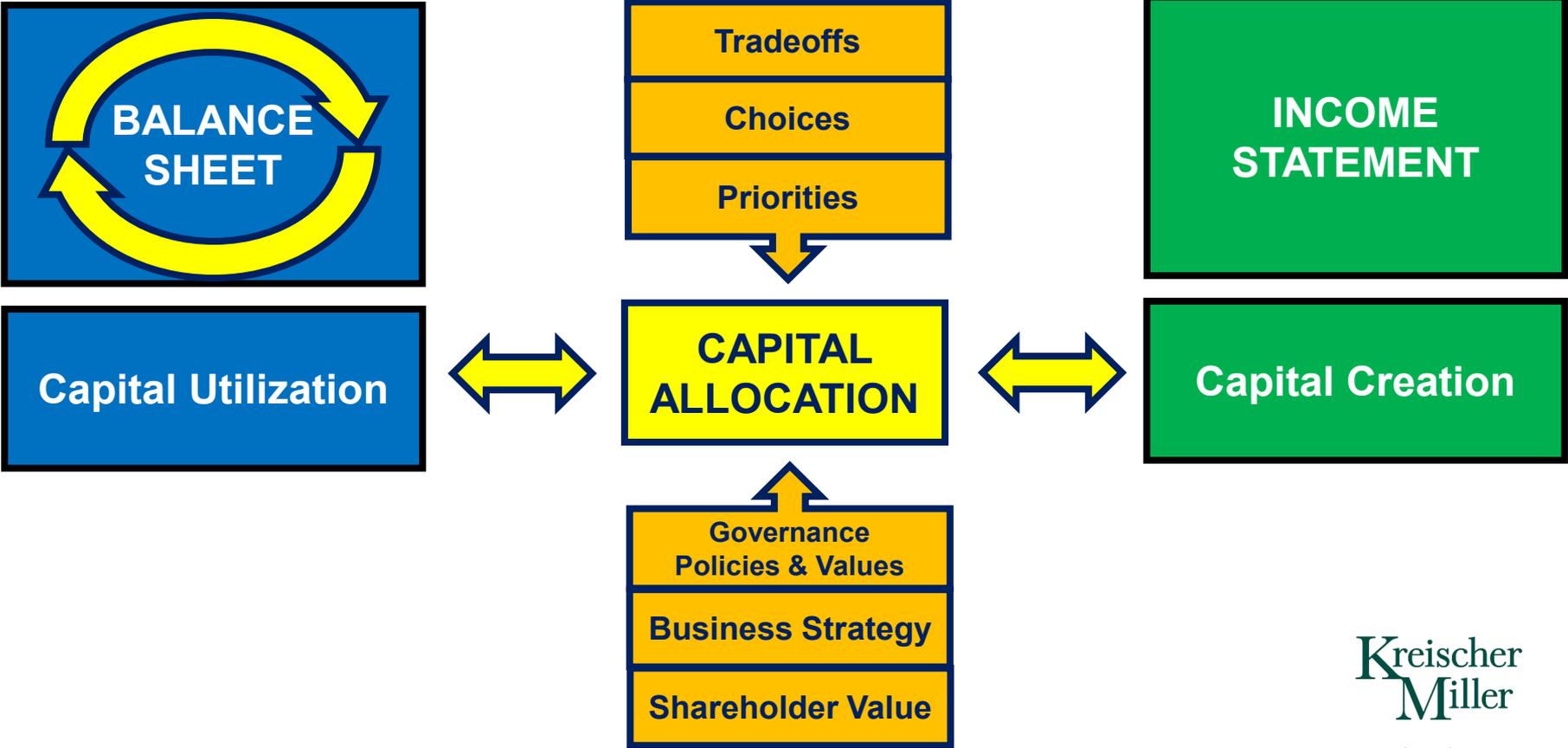
Yr.	Earnings	Dividend	Business		Portfolio	
			Value	Change	Value	Change
1	2,000,000	200,000	13,333,333		220,628	
2	2,080,000	208,000	13,866,667		451,384	
3	2,163,200	216,320	14,421,333		714,260	
4	2,249,728	224,973	14,998,187		1,012,902	
5	2,339,717	233,972	15,598,113	2,264,780	1,351,344	1,351,344
6	2,433,306	243,331	16,222,040		1,734,052	
7	2,530,638	253,064	16,870,920		2,165,966	
8	2,631,864	263,186	17,545,760		2,652,550	
9	2,737,139	273,714	18,247,593		3,199,848	
10	2,846,625	284,663	18,977,500	5,644,167	3,814,543	3,814,543
11	2,960,490	296,049	19,736,600		4,504,024	
12	3,078,910	307,891	20,526,067		5,276,460	
13	3,202,066	320,207	21,347,107		6,140,881	
14	3,330,149	333,015	22,200,993		7,107,266	
15	3,463,355	346,336	23,089,033	9,755,700	8,186,645	8,186,645
16	3,601,889	360,189	24,012,593		9,391,204	
17	3,745,965	374,597	24,973,100		10,734,409	
18	3,895,804	389,580	25,972,027		12,231,136	
19	4,051,636	405,164	27,010,907		13,897,819	
20	4,213,701	421,370	28,091,340	14,758,007	15,752,610	15,752,610

Assumptions:		
Cap Rate	15%	
Multiple	6.7	(1.0/Cap Rate)
Earnings \$	2,000,000	
Growth Rate	4%	
Dividend Rate	10%	
Investment Return	10.314%	(50 Year S&P Return)

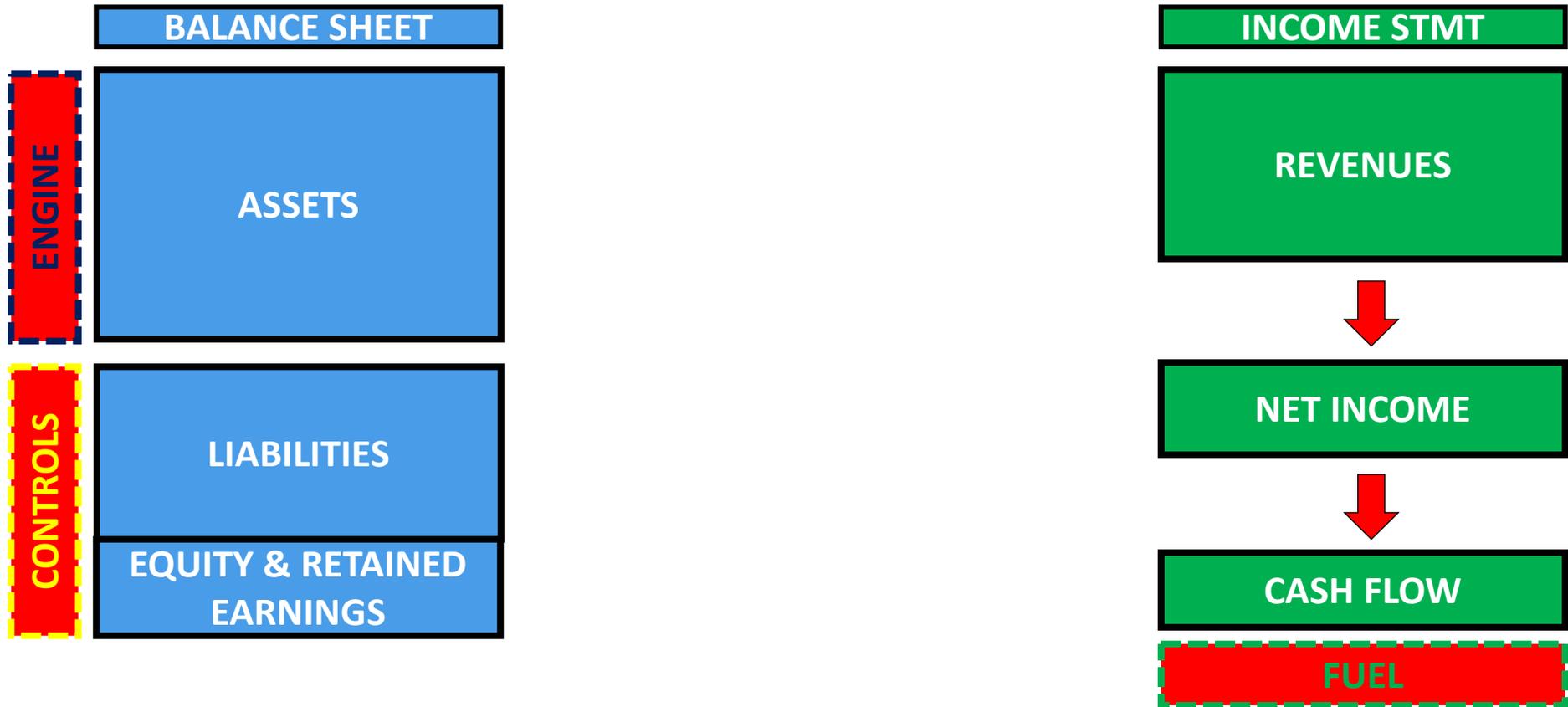


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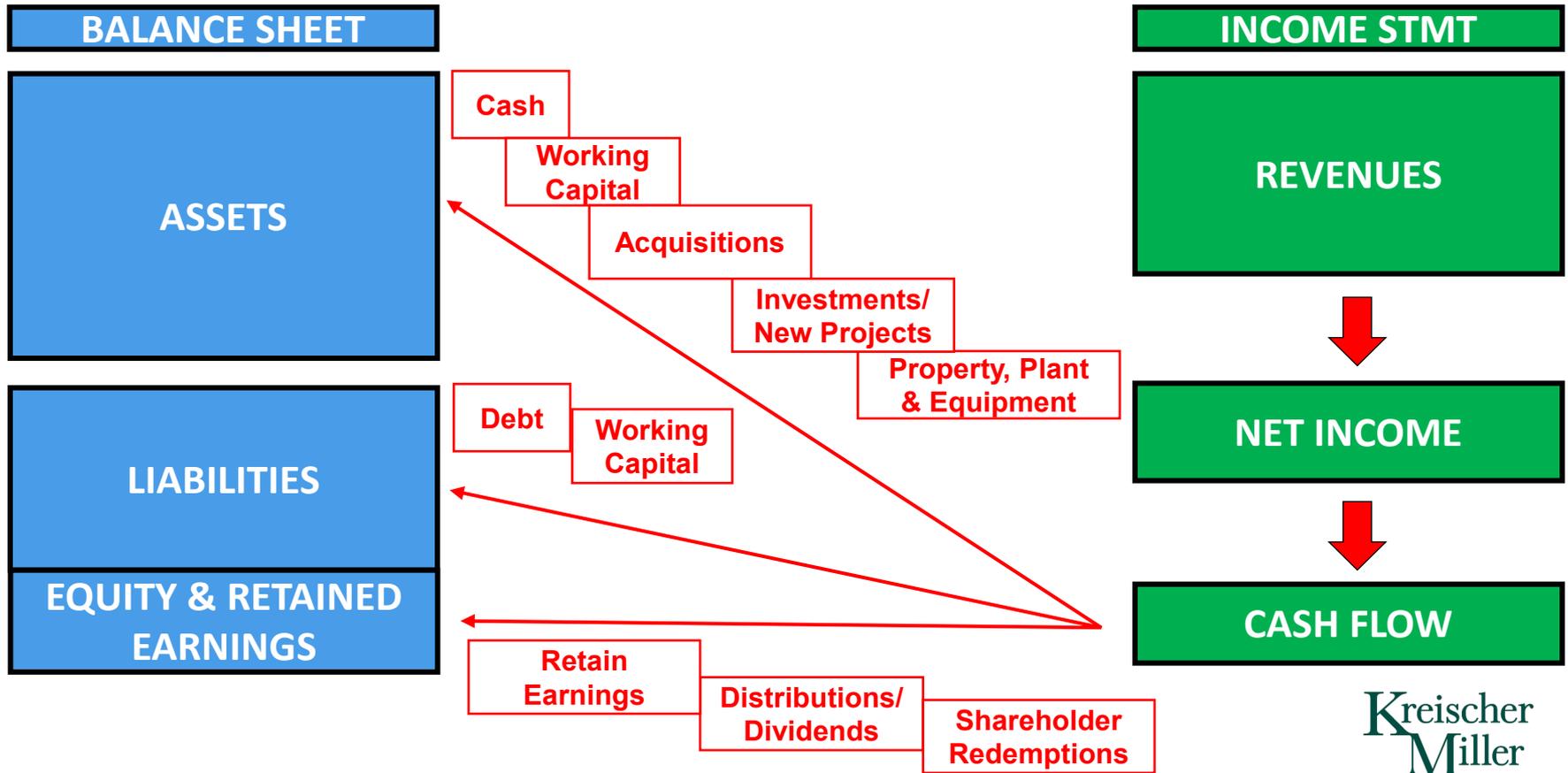
Intersection of Capital Creation and Utilization



Capital Allocation and Your Financial Statements



Where the Balance Sheet and P&L Intersect



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Capital Allocation Mechanics

Mechanics 1 of 2

CAPITAL ALLOCATION MODEL - EXAMPLE

	\$\$	%	\$1.00
OPERATING INCOME	10,000,000	100%	\$1.00
1> PROFIT SHARING WITH TEAM			
Employee Profit/Gain Sharing/ESOP	15% (1,500,000)		
Executive Incentives	3% (300,000)		
TOTAL PROFIT SHARING WITH TEAM	(1,800,000)	-18.0%	(\$0.18)
2> COMMUNITY INVESTMENT & CHARITY			
Charity	8% (800,000)		
Community Investment	2% (200,000)		
TOTAL COMMUNITY INVESTMENT & CHARITY	(1,000,000)	-10.0%	(\$0.10)
PRE-TAX INCOME	7,200,000		
Less: Income Taxes	33% (2,376,000)	-23.8%	(\$0.24)
NET INCOME AFTER TAX	4,824,000		
Add: Depreciation	1,200,000	12.0%	\$0.12
OPERATING CASH FLOW AFTER TAX	6,024,000	60.2%	\$0.60

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Mechanics 2 of 2

3> COMPANY REINVESTMENT

Working Capital Growth		(600,000)	-6.0%	(\$0.06)
Maintenance CapX		(1,500,000)	-15.0%	(\$0.15)
Growth CapX (New Project)	-			
CapX Borrowing	-	-	0.0%	\$0.00
Business Acquisition	(1,500,000)			
Debt Borrowing	-	(1,500,000)	-15.0%	(\$0.15)
TOTAL COMPANY REINVESTMENT		(3,600,000)	-36.0%	(\$0.36)

4> THIRD PARTY DEBT COMMITMENTS

Loan #1 - Principal	(750,000)			
Loan #1 - Interest	(250,000)	(1,000,000)		
Tax Benefit from Interest		82,500		
TOTAL THIRD PARTY DEBT COMMITMENTS		(917,500)	-9.2%	(\$0.09)

5> SHAREHOLDER TRANSACTIONS

Shareholder Redemption - Principal	(350,000)			
Shareholder Redemption - Interest	(100,000)	(450,000)	-4.5%	-4.5%
Tax Savings on Interest		33,000	0.3%	0.3%
Shareholder Dividends/Distributions	5%	(500,000)	-5.0%	-5.0%
TOTAL SHAREHOLDER TRANSACTIONS		(917,000)	-9.2%	(\$0.09)

NET CASH FLOW RETENTION (RESERVE)

589,500	5.9%	\$0.06
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Return On Invested Capital

Key Metric in Shareholder Value Creation



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DuPont Analysis – Drivers of ROE

$$\text{Return on Sales} \times \text{Asset Turnover} = \text{Return on Assets} \times \text{Financial Leverage} = \text{Return on Equity}$$

$$\frac{\text{Net Income}}{\text{Sales}} \times \frac{\text{Sales}}{\text{Assets}} = \frac{\text{Net Income}}{\text{Assets}} \times \frac{\text{Assets}}{\text{Equity}} = \frac{\text{Net Income}}{\text{Equity}}$$

FUEL

CAPITAL CREATION

ENGINE

CAPITAL UTILIZATION

OUTCOME

CONTROLS

CAPITAL MIX

OUTCOME

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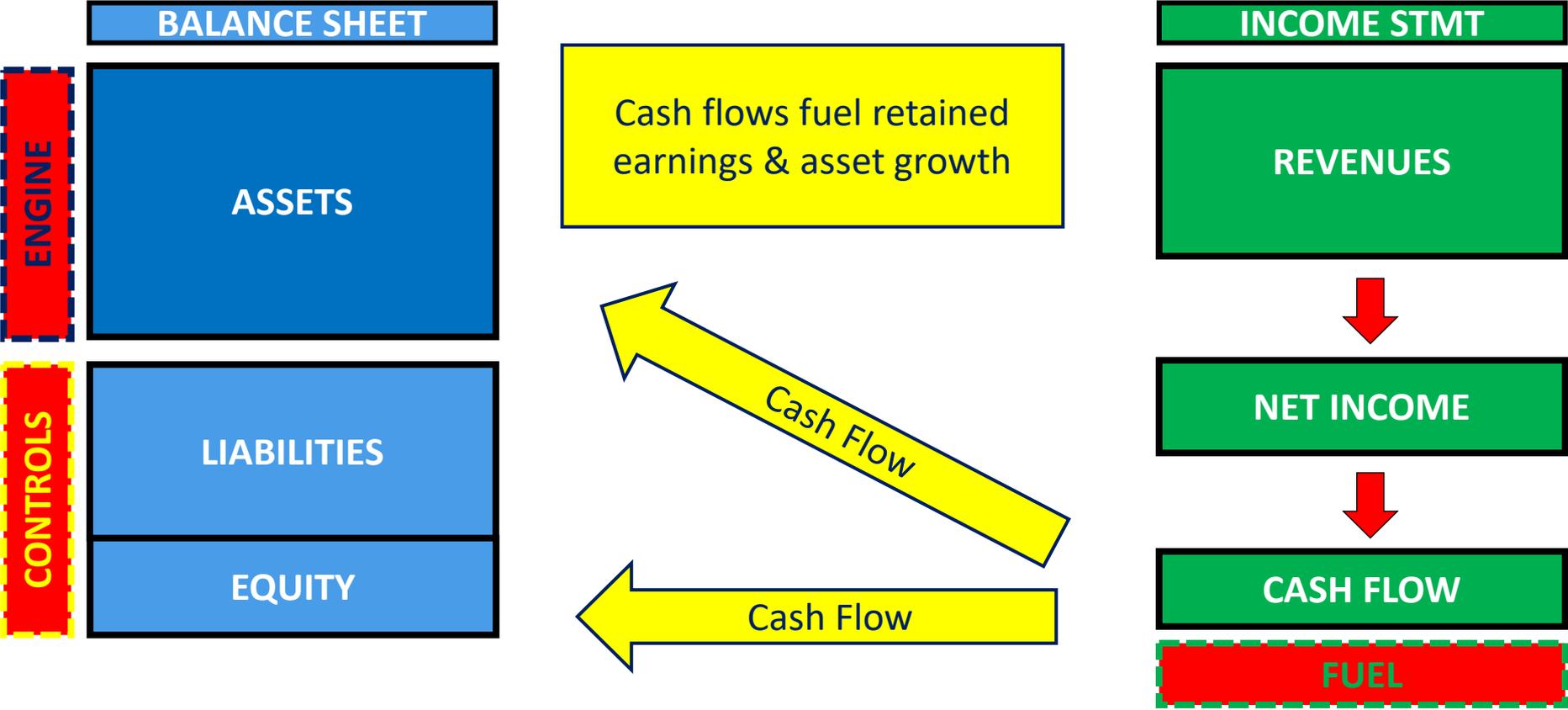
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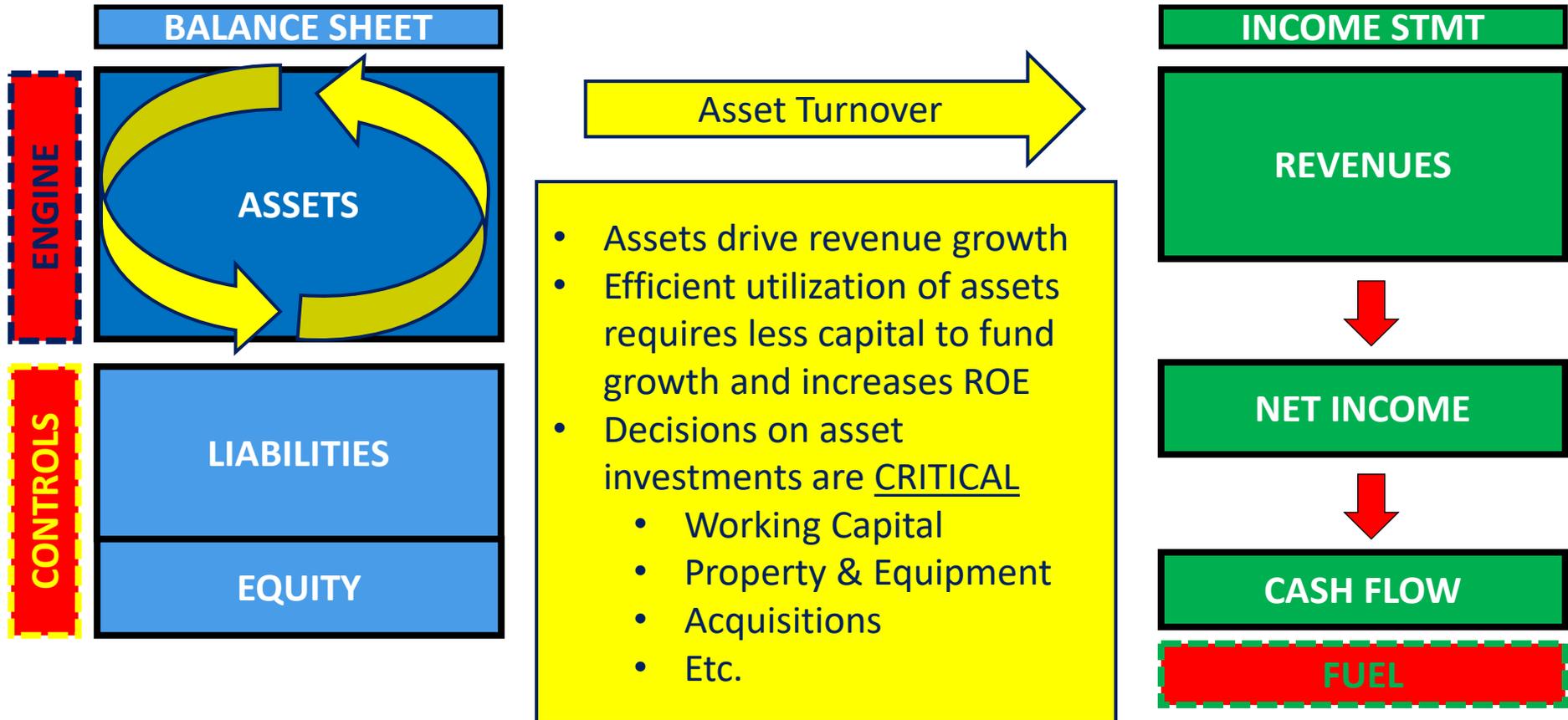
ROE Levers at the Financial Statement Level



ROE Lever – Return on Sales (Capital Creation)



ROE Lever – Asset Turnover (Capital Utilization)



Increasing Asset Turnover (Capital Efficiency)

$$\text{Asset Turnover Ratio} = \frac{\text{Net Sales}}{\text{Average Total Assets}}$$

How many dollars of sales can I drive per dollar invested in assets?
(The higher the better)

Components

1. Working Capital Turnover
 - # Days Sales in A/R
 - # Days Costs in Inventory
2. Fixed Assets (Capital Expenditures)
 - Maintenance CapX
 - Growth CapX
3. Other
 - Acquisitions
 - Other Assets

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Working Capital or Black Hole?

Working Capital is often the most overlooked part of the asset turnover equation and often absorbs a significant amount of the company's capital in an inefficient way.



Assumptions

Sales	200,000
CGS	150,000
Margins	50,000
GP %	25%

		Benchmark	Cash Free Up
Accounts Receivable	36,000		
# Days Sales in AR	66		
Industry Benchmark	53	29,041	6,959
Inventory	52,000		
# Days Costs in Inv	127		
Industry Benchmark	110	45,205	6,795
			13,753
Total	88,000	74,247	13,753

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Capital Budgeting Decisions

1. Capital budgeting is the process to **evaluate potential major new projects and investments**. Which to invest in, which to pass on and how to finance them.
2. Companies **create value by investing capital to generate future cash flows at rates of return higher than their cost of capital** (hurdle rate).
3. The **Hurdle Rate** reflects management's **Minimum Acceptable Rate of Return** based on their:
 - **Opportunity cost of capital**
 - **Risk** associated with the project



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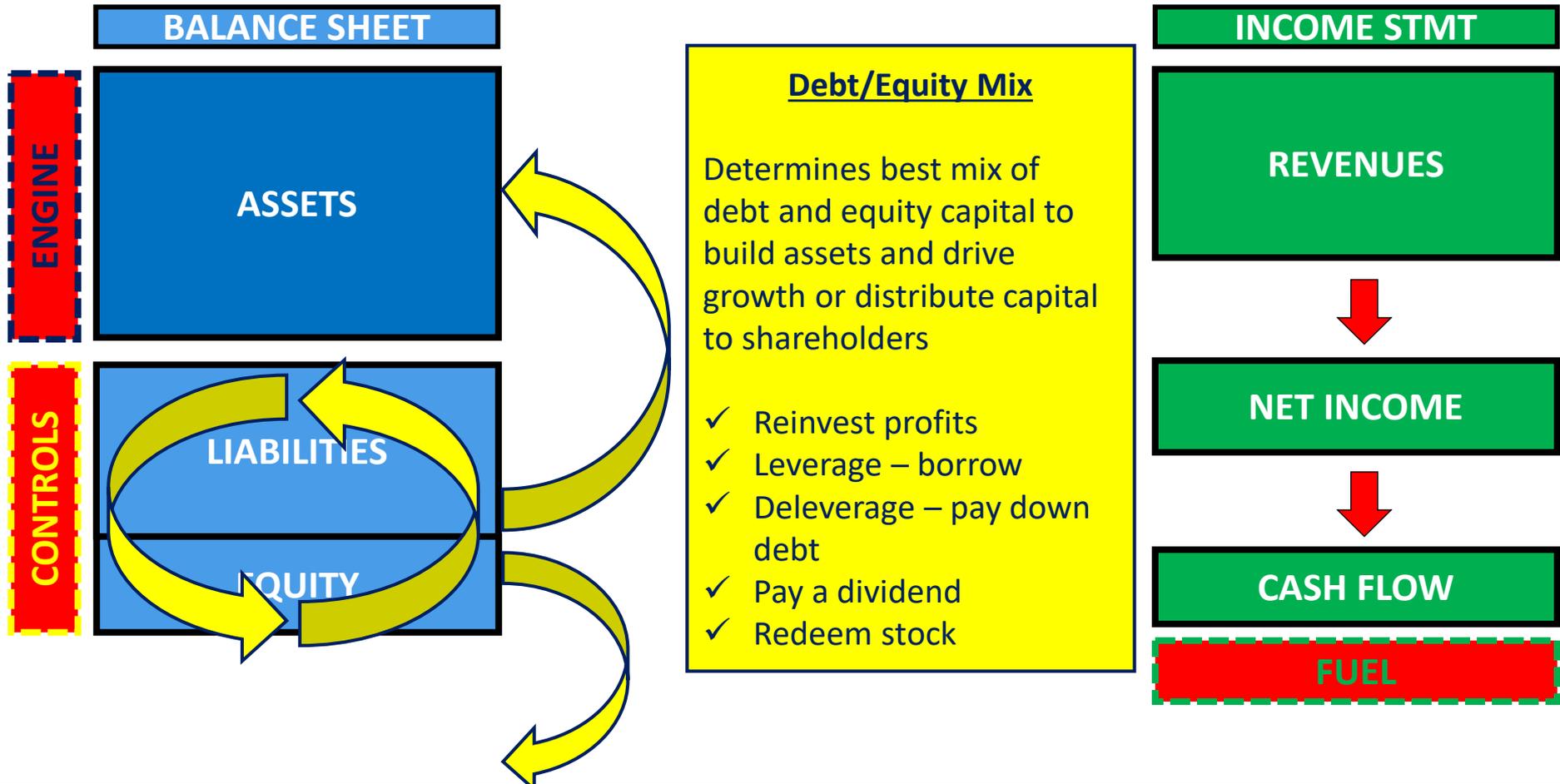
IRR & Hurdle Rate Illustration

	Project A	Project B	Project C
Risk	Low	Med	High
Hurdle Rate	10%	15%	23%
Year	Cash Flows	Cash Flows	Cash Flows
0	(450,000)	(1,500,000)	(800,000)
1	100,000	350,000	220,000
2	100,000	350,000	220,000
3	100,000	350,000	220,000
4	100,000	350,000	220,000
5	100,000	350,000	220,000
6	100,000	350,000	220,000
7	100,000	350,000	220,000
Net Cash Flow	250,000	950,000	740,000
IRR	12%	14%	20%
Payback Yrs.	4.50	4.29	3.64



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ROE Lever – Financial Leverage (Capital Mix)



Proper Use of Leverage

Too much can kill you, and ...

...Too little can lower your returns and eliminate opportunities

Key – Striking the Right Balance

- ✓ % of cash flow committed to debt service
- ✓ Margin of safety
- ✓ Relationship between debt and equity
- ✓ Long-range planning focused on best opportunities
- ✓ Project Risk/IRR
- ✓ Either extreme can hurt you

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Illustration 1/3

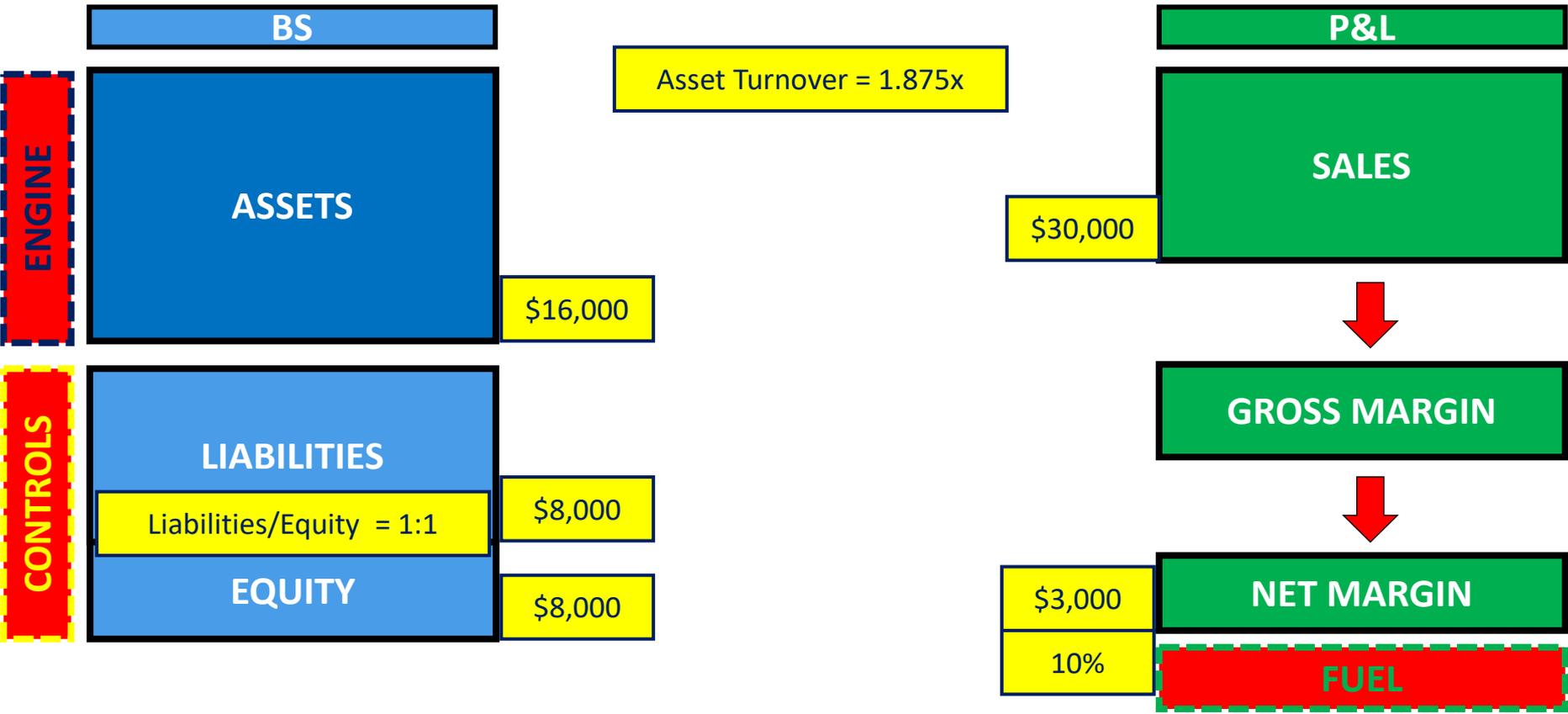


Illustration 2/3

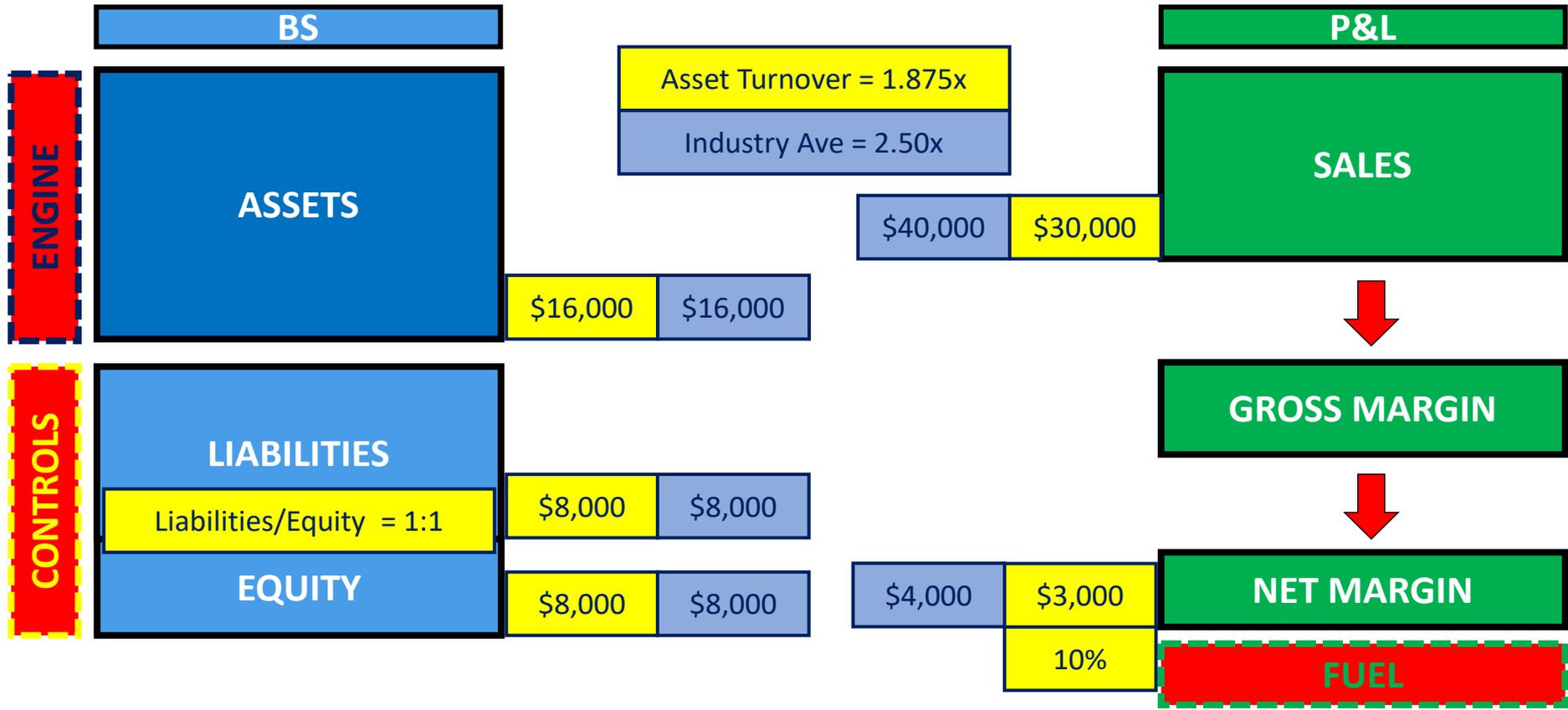
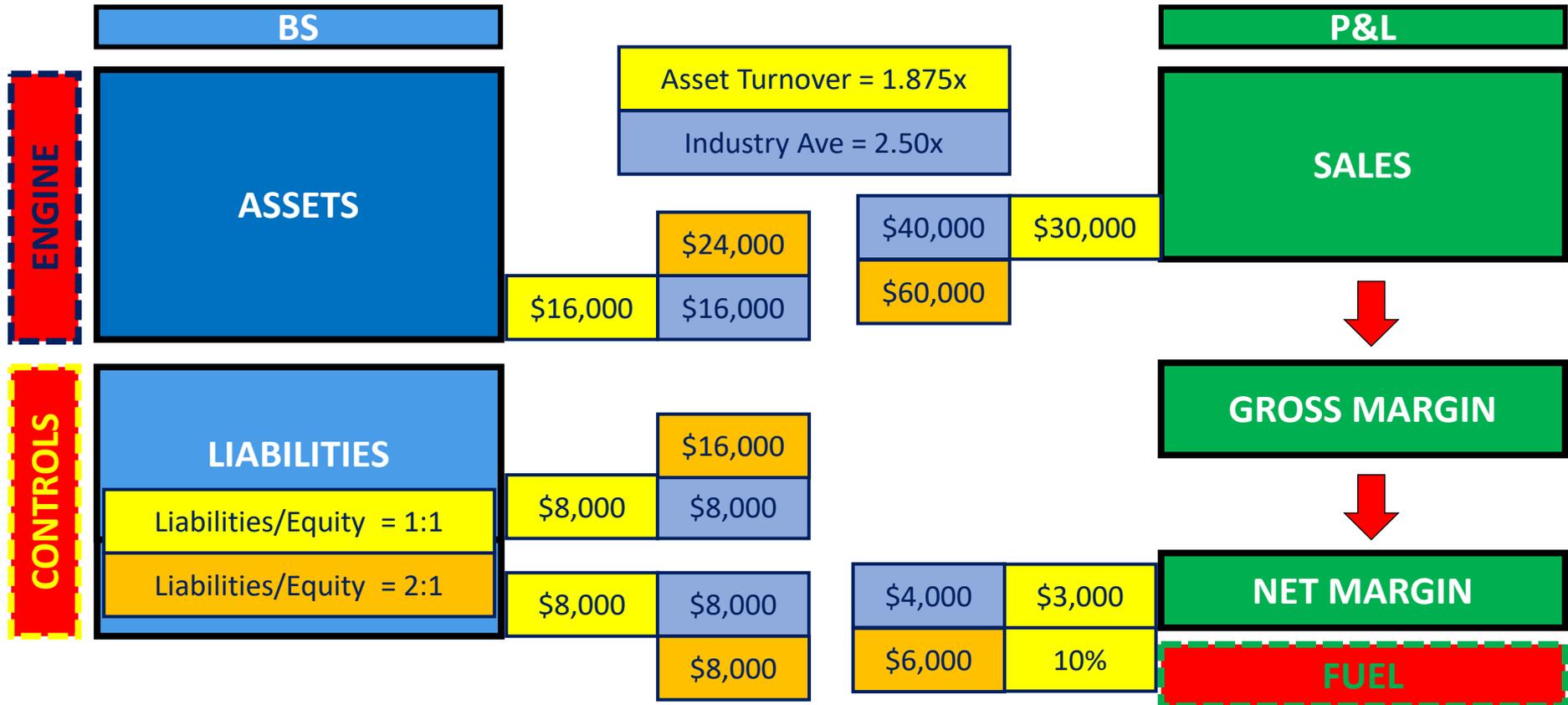


Illustration 3/3



Discussion/Q&A



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Thanks for Attending



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Mario is a business advisor to privately-held companies, helping them to address the unique challenges they face as they grow and to create value for their owners. He has over 30 years of experience working with entrepreneurs and private and family-owned companies in a variety of industries including construction, manufacturing, distribution, and services. His principal focus is on assisting companies in maximizing value for their owners and realizing that value through a clear transfer and exit strategy. Mario is expert in private company transfer strategies and methods, and his work includes a wide range of business advisory services including finance, valuation, strategy, and transaction structure.

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