Human Capital

The missing factor in valuing F&F companies.

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Capital markets have certainly changed since the Great Recession. Bankers are much more conservative with their credit, merger and acquisition (M&A) activity has taken on a different cadence, and new venues of capital have blossomed. Couple that scenario with the trend for baby boomer entrepreneurs to begin devising exit strategies for retirement, and one can see the current landscape, even in the F&F industry, migrating to more intimate deals in which investors want to be more involved and informed.

At the same time, potential investors seek to differentiate between good and bad investment targets, which can be difficult as competition pushes to level the playing field. This results in a growing need to have better tools to measure the value of a company. What is the true value of a flavor and fragrance company? How is it best determined? F&F companies are unique in their intrinsic value in many aspects, although nobody has developed a model to include this in the valuation process.

What follows is a review of the different elements of value in a F&F company, and the tools used to assign a valuation for each.

Top Drawer Valuation Tools: Financial Statements

What does the potential investor look for in an acquisition/investment target? Obviously, the opportunity to substantially increase their return. The leading traditional indicators are sales and EBITDA (earnings before interest, taxes, depreciation and amortization) strength, considered by many to be the true measure of profitability. The strength of the balance sheet is also a major factor, e.g., degree of amounts owed to third parties, efficiency and age of production assets, working capital, etc. Audited financial statements are the basis for determining these key financial ratios.

Two Plus Two Equals How Much?

Standardization of accounting rules has made financial ratios comparable from entity to entity, and therefore reliable for the investor. Note that accounting reports focus on the historical, and provide better lagging indicators than leading indicators. Numbers don't always tell the whole story. Certified public accountants and those with masters degrees in business administration who focus narrowly on those numbers are largely the reason that four out of five acquisitions fail in their objective, especially when ambitions aren't aligned with the economic objective of creating value through the acquisition. If the acquisition/investment is taking place for any reason other than real economic growth, such as ego, status or simply generating brokers' fees, the acquisition will likely fail to meet its initial objectives.

Deeper in the Toolbox: Off-Balance-Sheet Assets

The real skill is involved in evaluating the off-balance-sheet items, which are more indicative of future earnings potential. Investors look to customer relationships, and supply chain sustainability and strength, particularly in raw materials. The formula portfolio offers both significant intellectual property (IP) and serves as a future revenue driver. Technology, when successfully guarded through a sound IP program, offers tremendous value. A well-implemented enterprise resource planning (ERP) system also brings immeasurable value, especially to a process manufacturer such as an F&F company. Off-balance-sheet threats such as looming lawsuits or impending regulatory issues are also considered by industry-savvy investors, as is the ethereal "culture fit." These factors, well-vetted, become a foundation for an offer in the current M&A environment.

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Not in the Toolbox: Measuring the Value of Human Capital

Like flavor regulation harmonization, accounting rules are undergoing global harmonization. Under current practices, GAAP (generally accepted accounting principles) requires valuing assets at the historical value, or what was actually paid to obtain the asset. New international financial reporting standards (IFRS) require assets to be stated at current fair market value. For instance, under GAAP, vanilla plantings of a farmer have zero value if the farmer cultivates them without inducing costs. Under IFRS, the same plantings will increase with value as the vines mature, increase even more when properly pollinated and so forth through the sale of the harvest. While that difference has immediate implications for vertically integrated flavor and fragrance companies, the long-term implication is significant as investors explore other hidden values in companies. The current chatter among some futurists is that human capital will be the next element to be valued on a company's balance sheet.

This will have nearly as large an impact on F&F companies as IFRS has had on vanilla growers. As technology levels the playing field, human capital, especially F&F artisanship, will stand out as the largest driver of transactions in the future in the industry.

The real value in an organization, particularly in an F&F company, is its people. The creativity of the industry sets it apart from most other companies. This industry is a rare exception in the corporate world, which typically depends more on technical innovation instead of pure creativity and collective artisanship.

Many have given accolades to the importance of people within an organization in all sincerity. However, there has not been an attempt to value the human capital of an organization in a defined and standardized way. It is very possible that mergers in the F&F industry have taken place while leaving a lot of money on the table, or while investors overpaid for attractive numbers that were unsustainable given the human capital structure in the post-acquisition organization. There are key areas in human capital strength where measurement mechanisms are needed in order to more effectively determine the value of an equitable deal.

The Individual

Entrepreneurs possess a broad range of talents and an uncanny ability to know every inch of the ship. Seeing an opportunity, developing strategic relationships, and leading a successful execution of an unwritten and dynamic plan in his/her head, creates great wealth for them individually and for all their employees, vendors and customers. The market's true wealth generator, there is a great deal of value in an entrepreneur. Unfortunately, a common acquisition model today includes the entrepreneur looking for an exit plan, with an explicit willingness to sell all or part of an interest in the company he/she has built. Therefore, investors are very sensitive to the need to either retain that talent, or are savvy enough to find the right successive talent either from within the organization or externally to take the newly acquired entity to the next level.

In small to medium F&F houses, that entrepreneur may be the chief technical asset, a perfumer or flavorist perhaps, who has converted his/her own human capital into a strong balance sheet. Certainly, the creative F&F team brings the most unusual human capital element to the table, with little to compare with other industries simply because the flavorist/perfumer must be as much a creative type as a technical type.

While technical can be learned, the creative is arguably partly inherent and becomes remarkably more valuable when paired with a good technical foundation. This is very difficult to value, as the ability to create successful products depends on these key individuals and the way they are managed. This can be evidenced by a successful track record, but it should be noted that, as with any creative type, a sudden change in environment can either initiate a spasmodic bloom of profitable new products or stifle all creative efforts. Assessing the value of R&D capabilities thus becomes as problematic as it is important to a successful investment decision.

This is not to say that those employees in non R&D functions do not bring value. There will likely be a formula in the future to take into account the number of years key employees have been there, the level of cross-functionality they have, and their ability to train and mentor others. This is very important in an industry for which there is no specific academic discipline, but a combination of many.

We, the People

Teamwork is essential to any organization. Great teamwork produces great results. As trite and true as these statements are, it is surprising that this human capital element is not given more weight in a valuation or decision to invest.

It is truly an enjoyable and almost magical experience to observe or even be part of a well-functioning team. Whether on the gridiron, court, concert hall or battlefield, when all elements perform their responsibilities well, understanding their colleagues' activities, being mutually reliant on each other's commitment to perform their best, and being in tune to all others, success is guaranteed. It is not a stretch to say that workers crave being a part of this harmony-in-motion as much or more than the resulting win. There is a primal need to belong to the winning team. A great deal of value should be assessed to the entity in which management effectively provides the leadership to create this environment. Since this overreaching achievement is difficult to value by itself, it is helpful to break down some common elements by determining what is needed for teamwork and how those elements could be worked into valuation models.

Motivation

Motivation varies from employee to employee, but only in how each motivation is weighted. Without attempting to prioritize in any specific order, note that collectively the motivating elements, when matched with each employee's needs, will provide the team motivation for performance. The degree to which these elements motivate would be the basis for a human capital valuation factor.

- Compensation. With the exception of a business owner, nobody works for free. A fair compensation provides the primary motivation to go to work. An entity's human resource procedures need to include an annual evaluation of each employee's base pay and benefits, as well as a fair performance evaluation. The review needs to compare the individual's responsibilities against comparable market salary data, and assure that the individual is earning the market rate for his/her services. This is obvious and basic, yet surprisingly poorly executed more often than not.

- Benefits. ADP, a nationally recognized payroll and benefits services company, notes that 49% of midsize companies rate a competitive healthcare plan as critical to employee retention. Liberal vacation policies, industry-specific perquisites and other benefits, some of which don't require significant outlays by the employer, also bolster motivation.

- Recognition. While some need this more than others, all employees respond well to the sincere recognition of their contribution. Conversely, if the recognition seems contrived or diluted, it will have a net detrimental effect. Note that recognition from peers and even subordinates can be just as motivating as recognition by superiors, primarily because it is not a mandated program and consequently more genuinely received.

- Empowerment. Employees who feel trusted enough to use their own judgment—and why shouldn't they when they are being paid for their competency?—feel like they are contributing. It is this feeling of mutual contribution, and having coworkers' reliance that the individual is executing their responsibilities to the best of his/her abilities, which makes the employee feel they are now part of a winning team. An organization that pays its workers to use judgment and take initiative needs to allow them to do so. The ROI on this investment is high and should be recognized as inherent to the firm's value.

- Retention. Is the company good at keeping its superstars, or even enough of its critical team mass to repeat past performance? Voluntary turnover rate should be scrutinized. If too high, perhaps there are underlying problems that threaten the ongoing performance of the company, and which all the other valuation evidence has failed to reveal. If too low, this could arguably offset the motivation valuation, as it hints that some people who should not be retained may be enjoying a nice ride.

Education: Who's on First?

Employers hire qualified employees for specific positions, and must be satisfied with the candidate's educational and professional qualifications to perform the specific tasks of the posted position. Imagine now that all employees were well-qualified for their own responsibilities but didn't understand the responsibilities of other employees or other departments, but held them to their own core competencies. Forgive the flurry of analogies, but picture now the catcher running about in center field in full gear while trying to catch a fly ball. Or an offensive line that feels entitled to carry the ball instead of protecting the quarterback. (Apologies to our friends around the world for our lack of a football analogy.) Or a quality manager who expects finance to report budget deviations in a Pareto chart. Or a sales person setting the price without knowing the cost or supply chain issues.

The examples could go on forever. The point is that, in a high-functioning team environment, each member knows something about what each other does, and respects them for having proficiency, and trusts they will execute their tasks competently. A key element of that magical team moment is having confidence that each other executes their jobs as well as they themselves are.

Hence, cross-education is key to a human capital structure. Better yet is the case in which an entity has cross-trained middle managers. This has proven to be one of the strengths of Japanese corporations, where even sales staff is trained in flavor development and accountants in the flavor production plants.

This echoes back to the entrepreneur, who out of necessity has had to wear many hats. Remember the human capital value he/she brings? Any worker, whether line worker, middle manager or chief executive, who has experience in two or more relevant areas in the company has not doubled his/her contribution, but has increased it exponentially, and the boost to the human capital valuation should be recognized.

Summing It Up

The flavor and fragrance company that wants to sell, and the investor who wishes to buy, needs to exercise not only the traditional valuation tools they have to determine an equitable deal, but also recognize the value elements unique to an F&F company. More importantly, both parties should focus on building human capital value in the company, so all parties benefit, including investor, seller, employees, customers and vendors.

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