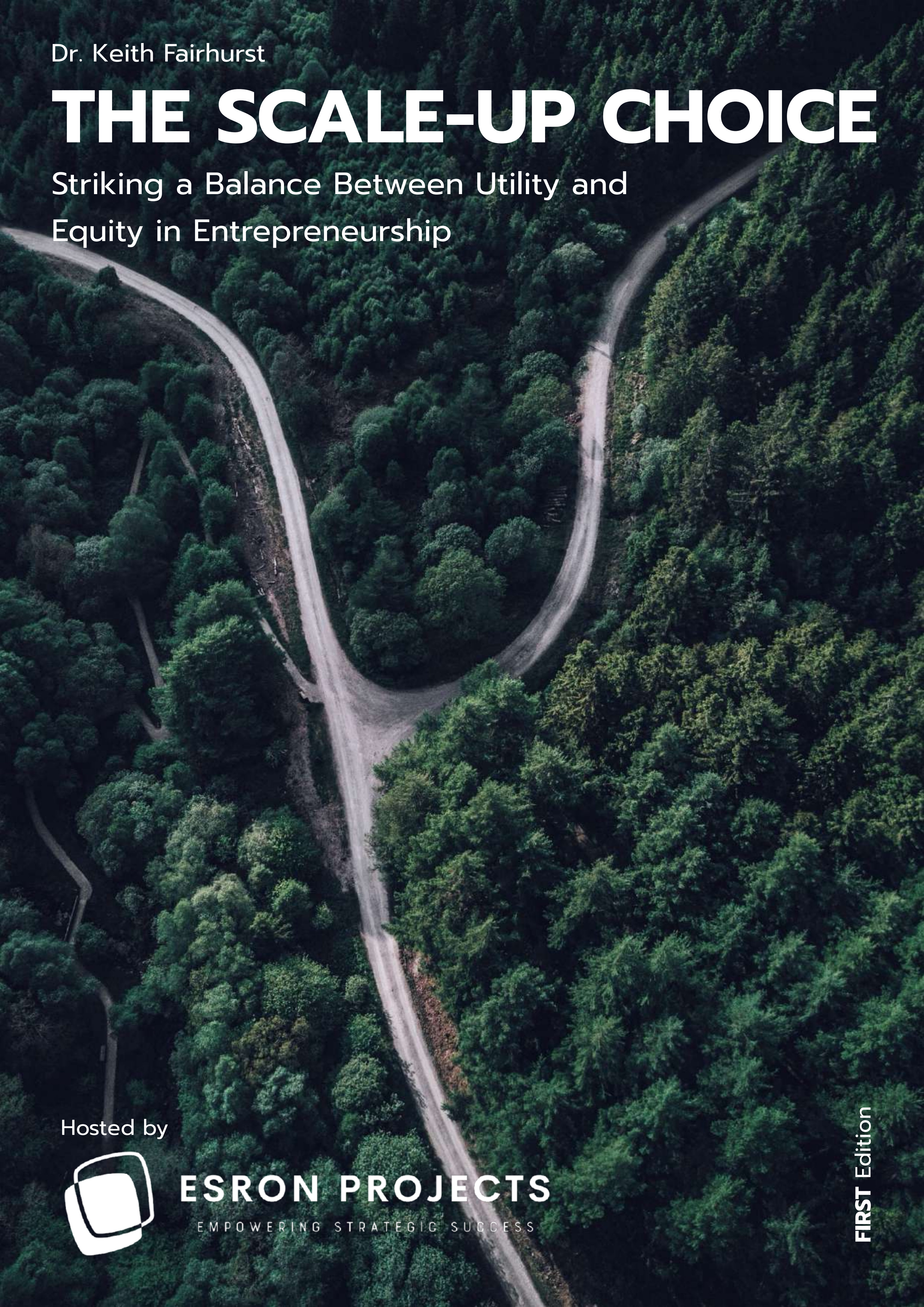
Dr. Keith Fairhurst

THE SCALE-UP CHOICE

Striking a Balance Between Utility and Equity in Entrepreneurship



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Dr. Keith Fairhurst

Dr. Keith Fairhurst, a consultant and leadership coach, focuses on improving company health and individual potential. With a PhD in business management and an MSc in finance, he's an active professional associate of GIBS. Founder of Scale Up Partners, he specialises in scaling businesses, governance, leadership development, and turnarounds. Keith's participative approach and coaching background empower teams and executives. He is also an independent non-executive director for six companies.

THE SCALE-UP CHOICE

Striking a Balance Between Utility and Equity in Entrepreneurship

In the realm of entrepreneurship, business owners often find themselves at a crossroads when deciding the trajectory of their ventures. Are they funding a lifestyle, or are they growing an enterprise? The answer to this simple but difficult question has significant implications for business owners over time.

Many business owners initially set up their businesses to earn a living. The allure of building a lifestyle business that caters to personal lifestyle choices while providing money to fund that lifestyle - its utility value - is undeniable.

However, suppose an owner ultimately wants to sell their business. In that case, the pursuit of personal fulfilment may come at the expense of the business' equity value, which is a critical measure of the economic worth of a business.

Choosing between funding a lifestyle or building equity value forces a frustrating entrepreneurial Catch-22. Understanding the nuances of such a decision is crucial for entrepreneurs. Before making this strategic decision, business owners need clarity on the differences in business styles and to explore the implications of what it means if they choose utility over equity.

The lifestyle business temptation

In economic terms, utility is the total satisfaction or benefit derived from consuming a good or service. Economic theories based on rational choice usually assume that consumers, in this case, business owners, will strive to maximise their utility.

The short-term utility value of a business for an entrepreneur has seen the concept of a lifestyle business - that aligns with the owner's personal preferences and priorities - gaining popularity in entrepreneurial circles.

Business owners are drawn to the idea of creating an enterprise that not only generates financial success but also provides a sense of personal satisfaction and work-life balance. This can range from funding an opulent lifestyle, travelling, sending children to private schools, or creating employment opportunities for family members. The short-term utility value derived from a lifestyle business is immense. It allows entrepreneurs to tailor their work to suit their lifestyles, fostering a sense of fulfilment beyond financial gains.

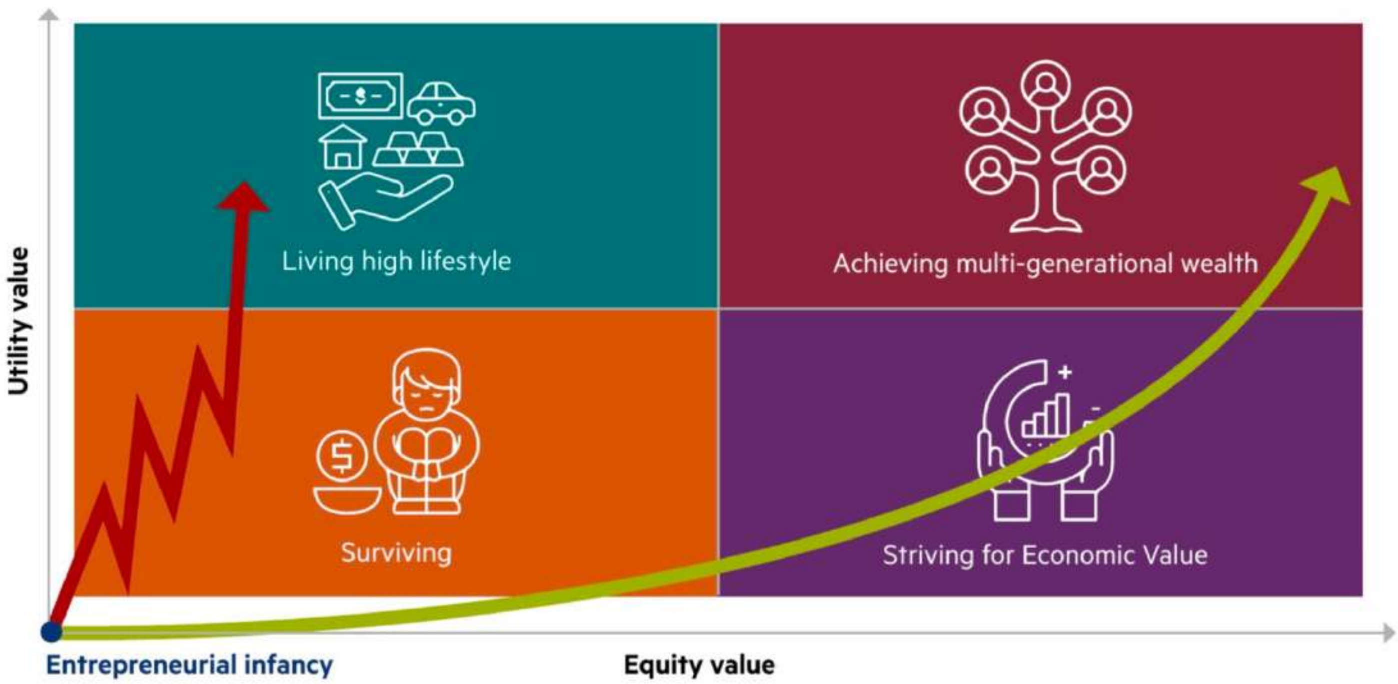
However, the seduction of lifestyle businesses can trap entrepreneurs in a situation that cannot easily be reversed if not approached with strategic foresight. The reason is that the trappings a successful lifestyle business can buy do not allow the entrepreneur to maximise the business' equity value, which is the value of interest to potential acquirors. Equity value plays a pivotal role in determining a business' long-term viability and market standing beyond the work-lifespan of the entrepreneur.

Intentional decision-making

Business owners should approach the choice between utility and equity with intentionality, ideally adopting this thinking from the get-go. However, business owners can also be intentional about the direction they want to take their businesses once they emerge from the initial phase of the business life cycle, which is survival. What is important to note is that this decision needs to be made sooner rather than later.

Figure 1 shows that the initial stage of any business is survival. Moving beyond the survival stage, entrepreneurs choose the path their business takes. Either, the business proceeds fund a lifestyle (the red arrow), or they adopt a more strategic approach and strive for economic value and ultimately achieve lifestyle goals, albeit delayed, while creating a business that will also achieve multigenerational wealth (the green arrow).

Figure 1: The scale-up choice



Understanding the trade-offs involved and making informed decisions that align with long-term goals is crucial. Entrepreneurs must weigh the personal immediate satisfaction derived from a lifestyle business against the benefits of building equity value over time. This means a business can eventually be sold (or listed on a stock exchange) for a healthy sum or scaled further to attract investment capital to fund growth.

I always stress that there is no right or wrong. It's a personal choice for business owners. However, it is important for business owners to be aware of this decision early on ni the life cycle of their business. While pursuing utility value in a lifestyle business is a valid and fulfilling endeavour, entrepreneurs must be cautious not to unthinkingly sacrifice equity value.

Choosing a lifestyle business without considering its long- term implications can be the largest entrepreneurial folly. The myopic focus on immediate gratification may lead to missed opportunities for future growth, expansion, and long-term financial success. The longer business owners wait, the more difficult it will become to transform their business from a lifestyle business to an equity business. This is because it could mean putting the brakes on withdrawals or removing unsuitable family members from their positions within the business, which at a later stage can be almost impossible to do.

There is no right or wrong.

Building equity value in a business

Equity value is the economic worth of a business. It is the valuation of a business for its potential resale, possible listing, or fi a business needs, funding to expand operations. It is a multifaceted metric that encapsulates various factors.

find the equity value of a business, the first step is to use a measure such as earnings before interest, taxes, depreciation, and amortisation (EBITDA), essentially the value of the business looking at what goods or services are being sold, the value of those sales and the strength of a business's customer base.

A multiplier is then applied to the EBITDA. The multiplier represents the non-tangible value of the business. It is a key factor in determining equity value, but is not arbitrary. It is intricately tied to the expertise and maturity of the leadership team as well as the business's governance aspects.

An equation to explain this concept is:

$$Equity\ Value = EBITDA\ \times\ f(Leadership + Governance)$$

$$= EBITDA\ \times\ f[(Vision\ and\ talent) + (risk, sustainability\ and\ cost\ of\ capital)]$$

The multiplier is a critical variable influenced by the expertise and maturity of the organisation's leaders. The people tasked with running the business need to be the best people to do the job. They must have the vision and talent to deliver results, i.e. grow the EBITDA. Experienced and visionary leaders who can navigate the complexities of the business landscape are more likely to command a higher multiplier, thereby increasing the overall enterprise value.

The multiplier also considers governance aspects of running a business, by examining the maturity of governance policies, processes, and practices within the organisation. The multiplier is impacted by firstly, whether the business is compliant across all aspects of the legal frameworks within which it operates, including accounting practices, tax, employment codes, and health and safety, as examples.

Secondly, an assessment of the maturity of governance policies, processes, and practices within an organisation plays a pivotal role, because businesses with robust governance structures are perceived as less risky investments, which attracts investors and contributes a higher multiplier. Therefore, entrepreneurs must invest in developing a sound governance framework to enhance the equity value of their ventures.

The short-term utility value derived from a lifestyle business is immense.

Al too often, the multiplier becomes an emotional ideal for business owners. Many people believe their businesses are worth far more than they are in the eyes of investors. Typically, the multiplier for a privately owned business lies between two and six.

Extremely successful companies will have larger multipliers. By comparison, between 2019 and 2023, Apple achieved a multiplier (PE ratio) of 18 to 34. This means that the company's equity value is worth 18 to 34 times that of its earnings.

As an enterprise adviser, I often see business owners attributing multipliers of 20 or 30 to their businesses. In such cases they need to be realistic and ask, would investors rather invest in their business or in Apple?

Balancing utility and equity

As can be seen in Figure 1, the direction in which a business is taken is not absolute. However, striking a balance between utility and equity requires a nuanced approach.

Entrepreneurs can pursue lifestyle business objectives while simultaneously implementing strategies to bolster equity value. This may involve investing in leadership development – for family members brought in to run the business, for example - or refining governance structures and fostering a culture of innovation and adaptability within the organisation.

Many people believe their businesses are worth far more than they are.

It is essential to explore these aspects with the help of an independent adviser or board member who can see beyond the blind spots that a business owner may have. Board members can assist entrepreneurs to explore opportunities for diversification and scalability within the constraints of a lifestyle business. By identifying avenues for growth and expansion, business owners can increase the equity value thereby increasing the sale value of their enterprise.

What is important is that business owners get help developing a strategy and then implement it diligently without being sidetracked by the allure of enhancing their lifestyle.

The path between lifestyle and equity requires entrepreneurs and business owners to tread carefully. They must recognise the potential consequences of prioritising utility over long- term economic value. While the allure of a lifestyle business is undeniable, the myopic pursuit of immediate gratification can hinder the realisation of a business' full potential.

Intentional decision-making, informed by understanding the factors influencing enterprise value is key to navigating this delicate balance. Embracing a holistic approach that combines personal fulfilment with strategic foresight helps entrepreneurs build businesses that not only enrich their lives but also stand the test of time in the competitive landscape of the business world.

Key Takeaways

- Entrepreneurs can either prioritise utility or equity in their businesses.
- While there is no right or wrong when it comes to utility vs equity, there are long-terrm consequences.
- Lifestyle (utility) businesses fund the lifestyle of entrepreneurs.
- Equity businesses build equity in a business and make it attractive to investors and buyers.
- These two concepts are not mutually exclusive, but to get the balance right requires careful planning.
- Business advisers and board members can help business owners scale up to build equity value.

Notes

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