Determining Valuation Loss in Small Classical Knowledge Intensive Firms Due To Owner-Dependence

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Abstract

Many businesses founded are aimed to be sold at certain time in the future. It is a natural desire of any single business owner to be able to sell his business at the highest possible value. There are lots of resources, consulting firms, etc. dedicated to helping business owners to properly value and sell their businesses. Numerous factors affect market value of a business. In the professional services industry one of the major problems affecting perceived value of a classical knowledge intensive firm is the degree of dependence of the firm on its owner.

In this master thesis, I will review academic literature on small knowledge intensive businesses in order to have comprehensive study of owner-dependence concept with all relevant elements and aspects and eventually visualize it in a logically structured framework which later will be exploited in a qualitative valuation of a firm. Thereby, insight will be gained into negative valuation gap between value of the firm today with the owner and value without the owner and potential value gain in the future in terms of progress towards owner-independence. To preserve and increase the perceived value of the firm to potential buyers, owner of the firm should approach the problem from both sides by improving negative and positive aspects and adopting non-existent aspects of owner-dependence.

Keywords: *owner-dependence, framework, owner-redundancy, knowledge intensive firm, small business valuation*

Preface

This thesis is a vital and central part of my two years exceptional master studies at the University of Twente. It signifies the concluding steps to an important phase in my life: the alteration from being a student to being a hired man.

First of all, I would like to express my special appreciation to Henk Kroon for his invaluable insights, ideas and his great deal of exertion that helped me to have this thesis completed. With his assistance, commitment, eagerness, academic and practical intuitions, he led me from a very comprehensive thesis issue to the master thesis as how it is now. Besides, I would like to offer my gratitude to Berend Roorda for his respected feedback, remarks and recommendations during thesis route. Additionally, I am inclined to thank all the respondents of the involved organization who gave their valuable time and shared resources accessible for this research and offer my countless appreciations for their readiness and interest to collaborate during this work. I am indebted that they pooled their interesting thoughts and that they delivered supplementary information and perceptions on the thesis topic.

Last but certainly not least I would like to thank my family and friends, especially Samir Hasanov, for their support during my studies, graduation period and bringing this thesis work up.

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Chapter 1

Introduction

1.1 Background

Past decades have witnessed immense number of merger and acquisition (M&A) of small businesses, particularly professional service firms in knowledge intensive businesses such as accounting, consulting, law etc. There is vast amount of literature related to knowledge intensive firms; however there doesn't seem to be a systematic research on M&A of small knowledge intensive firms.

In this thesis, focus will be given to one of the major problems affecting perceived value of a classical knowledge intensive firm which is the degree of dependence of the firm on its owner. All the relevant aspects of owner-dependence will be pointed out and a comprehensive framework will be developed which will later be used for qualitative business valuation purpose in terms of owner-dependence. Thereby, insight will be gained into negative valuation gap between value of the firm today with the owner and without the owner and potential valuation gain in the future in terms of progress towards total owner-independence.

There is almost no literature specifically dedicated to this topic on small knowledge intensive businesses. However distinct academic and non-academic researches over M&A market on small businesses point out that owner-dependence is one of the important elements in valuation and marketability of these businesses. This thesis was written with the purpose of opening an easy path in small business valuation from owner-dependence perspective in qualitative terms.

Idea to write this thesis came into existence after several discussions over small business valuation issues with my thesis advisor, Ir. Henk Kroon. Despite the fact that many consulting businesses emphasize substantial negative effect of owner-dependence on small businesses, academic literature doesn't seem to be reflecting this problem properly. This thesis is inspired by the desire to develop a clear and comprehensive framework for owner-dependence which will later be used as an input to a qualitative business valuation for small classical knowledge intensive firms.

1.2 Relevance of research

As mentioned before academic research on this particular topic is roughly new and there is almost no literature particularly dedicated to this perspective of small business valuation. Literature review mainly indicates some important factors to be taken in small business valuation which also includes owner-dependence and returns vast amount of literature on business valuation using bare financial techniques. Though owner-dependence is being perceived by some academic authors and field professionals as one of the most important factors in small business valuation, there has not been done any single comprehensive work to elaborate on this topic except some short white papers of some business consulting firms.

The work done in this thesis and the framework developed as part of it is directly relevant for use by owners of classical small knowledge firms who look for a clear and structured way to determine probable valuation gap between the going concern value and the value of the firm under sale circumstance from owner-dependence perspective, and except for immediate sale action, to preserve and increase perceived value of it by covering lacking and non-existent aspects. It is inevitable problem of many small business owners that the value of the firm is destroyed substantially when they are kept totally out of the business or when they decide to sell the firm. Having a comprehensive framework at hand with all the relevant aspects of owner-dependence allows owners to see their weaknesses and embark upon improving or preventing loss of value systematically by focusing on problematic points and improving them depending on the exit planning.

1.3 Research objectives

In this thesis, owner-dependence is perceived as a risk which may cause substantial value loss to a small firm preparing to sell, and in the worst case even destroy most of the value. Therefore, a comprehensive framework of aspects for owner-dependence will be developed; each element of the framework will be elaborated and ultimately incorporated in a qualitative valuation case of a small knowledge firm.

Motivation for this thesis is born completely from the need to offer small business owners from distinct education backgrounds a structured and systematic way to identify and gain insight into main problem areas leading to owner-dependence which causes negative valuation gap and hides potential for future gain. Main reason for choosing classical knowledge intensive businesses central to the thesis objective stems from the fact that owner-dependence plays much greater role in these businesses because major proportion of the market value in these businesses comes from intangibles.

1.4 Outline

To make a smooth entry to the main central topic of this thesis, first of all in chapter 2, information will be provided on knowledge intensive businesses, their taxonomy and a big challenge they face during sale process. Besides, owner-dependence will be explained and compared with a close and confusing term, owner-redundancy. In chapter 3, description of knowledge, value construction and value components in a small knowledge intensive firm and a general approach to valuation of such a firm will take place. In chapter 4, framework for owner-dependence will be developed and designed and all the elements and aspects of it will be explained. After we have comprehensive framework of owner-dependence ready for use, in the final chapter, it will be incorporated in a valuation case of a small knowledge firm. With this study, the process and outcomes of valuation and the role of the framework to find valuation gap due to owner-dependence will be discussed, after which concluding remarks will take place.

Chapter 2

Classical Knowledge Intensive Firms (KIFs) and a Big Challenge during Acquisition

2.1 What do we know about KIFs?

During the last two decades knowledge intensive firms (KIFs) or simply knowledge firms have received rapidly increasing interest. Alvesson (1993) explains this tendency in several ways, while the most common reason he cites is emphasized by actual changes in society, work and organizations as knowledge becomes more important that is reflected in the increasing number and significance of KIFs.

Environment of KIFs is distinctive and different management theories apply to them. Firms from wide range of industries are considered knowledge intensive and it is not an easy task to define them. Popular examples of KIFs that we often hear in our everyday life include accounting, law, consulting, research and development, etc. In KIFs most of the focus is given to human capital as opposed to financial and physical capital, and competitive advantage is gained by converting the knowledge and skills of their human capital into intellectual capital (Swart and Kinnie 2003). According to Miles, Kastrinos et al. (1995) there are three principal characteristics of knowledge intensive business services (KIBS) provided by KIFs:

1. They are based heavily on professional knowledge;
2. They either are themselves major sources of information and knowledge or they exploit knowledge to generate intermediate services for their clients' production processes;
3. They are of competitive significance and provided primarily to businesses.

Some popular definitions of KIFs found in the academic literature are provided below. KIFs

Definition	➔ Author
provide services that involve economic activities which are intended to result in the creation, accumulation or dissemination of knowledge	➔ Miles, Kastrinos et al. (1995)
are expert companies that provide services to other companies and organizations	➔ Toivonen (2006)
are private companies or organizations who rely heavily on professional knowledge, i.e. knowledge or expertise related to a specific (technical) discipline or (technical) functional-domain to supply intermediate products and services that are knowledge based	➔ Hertog (2000)
are enterprises whose primary value-added activities consist of the accumulation, creation, or dissemination of knowledge for the purpose of developing a customized service or product solution to satisfy the client's needs	➔ Bettencourt, Ostrom et al. (2005)
are companies where most work can be said to be of an intellectual nature and where well-educated, qualified employees form the major part of the workforce	➔ Alvesson (2000)

Table 1 Some definitions of KIFs

Hence, three principal elements may be resulting from these definitions. First, the term "business services" is associated to those focused services required by firms and public organizations and not shaped for private consumption. Second, the expression "knowledge intensive" can be inferred either in terms of employment qualification or in terms of the circumstances for the business between the service supplier and the service receiver. Third, the term "knowledge intensive firms" denotes to firms that are responsible for complex processes of intellectual nature where human capital is the leading aspect.

Human capital, constituted of highly qualified workers, is the main value element in a knowledge firm. It is generally accepted that the collective expertise of this workforce is the primary asset of a KIF. Because most of the work of these employees requires the application of knowledge, they may also be considered as ‘knowledge workers’. Generally, related to the nature of individuals themselves and the nature of the tasks they perform, these workers require and expect significant degrees of autonomy. One of the main uncertainties faced in a KIF environment is that time and resources needed for a successful project work is inherently unpredictable. Thus, establishing and monitoring efficiency criteria becomes problematic. Management that is addressing and mediating tensions between autonomy and control and efficiency and uncertainty in the best possible manner should be ahead of others in sustaining its competitive position over time (Robertson and Swan 2003).

2.2 Taxonomy of KIFs

Von Nordenflycht (2010) provides taxonomy of knowledge intensive firms which includes four categories labeled as:

1. Technology Developers (e.g. biotech and R&D labs)
2. Neo-PSFs (e.g. consulting and advertising)
3. Professional Campuses (e.g. hospitals)
4. Classic PSFs (e.g. law and accounting)

For each category the predicted intensity of challenges, opportunities, and organizational features are varying. Classic PFSs are categorized by knowledge concentration, low capital force, professionalized workforce, much higher sovereignty and informality equated with others.

Miles, Kastrinos et al. (1995) differentiate between new technology based services and traditional professional services. New technology based services are linked to new technology and provide services related to information and communication technologies as well as technical activities (IT related services, engineering, R&D consulting, etc.) whereas old-fashioned professional services such as accountancy and legal services depend mainly on specialized knowledge.

There is no regular methodology and recognized explanation of KIBS (Muller and Doloreux 2007). The statistical arrangement of economic actions in the European Community, shortened as NACE, is the terminology of economic activities in the European Union. In this representation, the term KIBS has been used to point out to service firms that are branded by their high knowledge concentration and the positioning of their services to other firms and organizations, services that are largely non-routine. However, some sub-sectors of activities matching to services and exposing similar features (high ranks of skilled labor and the use of new technologies) are usually not deliberated as KIBS. For instance, services such as health care-related services and dedicated services linked to resourced-based segments (agriculture, forestry, mining and gas extraction) are not identified as KIBS:

NACE	Description
72	Computer and related activities
721	Hardware consultancy
722	Software consultancy and supply
723	Data processing
724	Database activities
725	Maintenance and repair of office, accounting and computing machinery
726	Other computer related activities
73	Research and development
7310	Research and experimental development in natural sciences and engineering
7320	Research and experimental development in social sciences and humanities
74	Other business activities
741	Legal, accounting, book-keeping and auditing activities; tax consultancy; market research and public opinion polling; business and management consultancy
7411	Legal activities
7412	Accounting, book-keeping and auditing activities; tax consultancy
7413	Market research and public opinion polling
7414	Business and management consultancy activities
742	Architectural and engineering activities and related technical consultancy
743	Technical testing and analysis
744	Advertising
7484	Other business activities

Table 2 KIBS sectors and sub-sectors[1]

[1] NACE Rev. 2, Statistical classification of economic activities in the European Community http://epp.eurostat.ec.europa.eu/cache/ITY_OFFPUB/KS-RA-07-015/EN/KS-RA-07-015-EN.PDF

2.3 Owner-dependence as a big challenge

There are many businesses around today that if you consider them without their owners, value of these businesses would dip instantly. Therefore, it is also one of the greatest concerns of the buyer to be certain that the value stays there after the owner leaves. Unfortunately, due to many negative factors many small businesses have huge dependence on their owners. In this thesis, owner-dependence should be understood as a risk which has a destructing effect on the value of the business.

While discussing dependence it is important that one distinguishes between owner-redundancy and owner-independence clearly. It is possible to face certain misconceptions in the internet pages of some consulting, business advisory, etc. over these two terms which are sometimes used interchangeably. However, owner-redundancy refers to the situation where the owner has already delegated all of his tasks and is free from daily work. Literally speaking owner makes himself redundant which is a substantial step toward owner-independence. Consequently, it should be understood that the term owner-redundancy doesn’t reflect the problem of owner-dependence in totality, while it only stresses part of the problem which is an important advantage in case of valuation.

Becoming redundant is very beneficial in terms of speeding up the process of taking the firm to owner-independence. As the owner-manager becomes redundant he is free from constant pressure of daily work and extra working hours, as a result of which he can achieve more balanced lifestyle and better health. This gives the owner very good chance to focus on more strategic and long-term goals and simultaneously to work on smooth exit plan for the ultimate goal of sale value maximization.

Most of the small businesses begin operating as privately owned enterprises where ownership and management are often held by the same person. From the first day owner becomes so much involved in most of the activities that as the business growths, this tendency starts to put heavy reliance on the owner. As a result, this situation evolves into a structural problem through years and business ends up in a place where it becomes totally dependent on its owner. Speech of a typical owner that Zheng (2012) cites in his work explains the situation: “I keep direct control on every procedure to make sure each step is done properly so that the final result meets my expectations. I always believe that if the procedures are right, the outcome will be right. Sometimes I really feel very exhausted, because everything depends upon me."

While discussing the owner-dependence issue, Rigby (2012) approaches the reason of this particular problem from an interesting perspective. Main reason he indicates is related to the emotional connection of the owner to his firm. Evidence from practical works on owner-manager relevance supports significant impact of the owner's capabilities on the success of the new firm. Decisions made by the owner are also linked to an emotional element, not based on fact and rationale alone (Wiedenfels 2009).

Behavioral shift of the owner towards starting to put firm independent of himself is particularly difficult due to the human nature. Another similar and supporting statement comes from Barrow (2011) that many of the business owners actually like to be dependent upon which basically makes them ever needed and valued. Rigby (2012) suggests that an owner who business is dependent upon resembles a chief firefighter who spends most of his time to fighting fires as everybody comes to him as the main point of contact. In this self-perpetuating role, as the owner tackles with the increasing number of problems, the more he becomes indispensable for the rest. At certain points, owners should understand that most of the tasks can be delegated.

As it is obvious that from many perspectives owner-dependence has a destructive effect on the firm performance and consequently on the firm value, Rigby (2012) makes a statement that "a business that can't run without its owner is a business with a deadline". So, the main question that should be asked is how you can move your business from owner-dependent state to – independent state and develop a more corporatized business model.

Chapter 3

Valuation of a Small Knowledge Firm

3.1 Knowledge and value creation in KIFs

Løwendahl, Revang et al. (2001) lists three particularly important factors that are crucial for the understanding of value creation in professional service firms, e.g. engineering, consulting, accounting, law firms, etc.: (1) the domain choice, i.e. strategies concerning prioritization of clients and projects; (2) the resource base of the firm, with particular emphasis on knowledge; and (3) the value creating processes.

Domain choice

Domain choice affects both the type of professionals the firm can hire and the type of learning that takes place within the firm. Projects and work that professionals do as part of their daily tasks in KIFs play important role in determining what and how much they learn from the clients and the projects which improves and enhances the knowledge base. Therefore, as part of value creation of the firm, it is absolutely critical for these firms to target and win the right kinds of projects and clients.

The selection of domain is possible at more general level such as industrial context which is typically constrained by the professional context; for instance, accounting firms operate in the accounting business, law firms operate in the law business and so on. However, these firms also face some other choices within the professional context. In the example of law firms, they may choose to provide services within different segments such as criminal law, contract law, tax law, labour legislation, etc. And subsequently the firm may choose to work with the most demanding business clients or target small businesses or individuals.

Resource base

It is important to distinguish between information and knowledge before moving into valuation of a knowledge firm. Peter Drucker defines information as data that make a difference and as data with attributes of relevance and purpose. Usually, information is comprehended as a message, generally containing the layout of a paper or visual and/or perceptible message. Knowledge is linked to the capacity for action. It is intuitive, for that reason complex to delineate. It is connected to the user's principles and practice, being powerfully connected to model acknowledgment, similarities and embedded rules. Generally, knowledge inside a business is to be found both inside employees' heads (tacit knowledge) and in papers (explicit knowledge). This clarifies why such uncertainty has arisen between document administration and knowledge management (Joia 2000):

In the literature several dimensions are proposed for knowledge, such as explicit versus tacit knowledge, embodied versus embedded knowledge, and knowledge as intrinsically versus instrumentally valuable. In the context of classical KIFs, knowledge is viewed as a very broad term which includes both tacit and explicit knowledge, and both knowledge at the individual and at the collective levels. Løwendahl, Revang et al. (2001) distinguish between the characteristics of knowledge and the level of analysis supported by numerous different authors in the literature.

At the *individual level*, three types of knowledge matter in value creation:

- Information-based, objective, task-related, 'know-what'
- Experience-based, tacit, subjective knowledge, 'know-how'
- Personal knowledge, including talent, aptitudes, artistic abilities, creativity, intuition, etc.

At the *collective level*, Løwendahl, Revang et al. (2001) defines knowledge as "the combination of skills, routines, norms and values developed and shared by at least two employees working together, each employee's individual knowledge, and the information available to them."

Value creating processes

Value creating processes benefit clients, firm members and owner. Owners gain both from financial returns and knowledge development, as the latter, to the extent that new knowledge is retained within the firm, is in many ways similar to retained earnings. Both increase the value of the firm, as they enable more revenue enhancement. Hence, a comparison of KIFs results in terms of return on equity, or other traditional stockholder measures, does not always make sense since earnings deliberately retained or forsaken for the purpose of undertaking projects with a higher learning potential can easily be confused with lower profits as a result of lack of success in the marketplace.

3.2 Value constituents of a small knowledge firm

Once strategic management of physical and financial resources was always in the front line, however, in the information age that we live, strategic importance of knowledge has increased dramatically, reflected in the increased importance and emergence of the professional services industry and many new knowledge-based firms. Despite its huge importance and increased focus, true value of knowledge with its intangible nature, can never be fully evaluated in the financial terms that we are currently accustomed to (Bontis 1998).

According to the literature, in general terms market value of a knowledge firm can be separated into three main constituents: physical capital, financial capital and intellectual capital. In figure 1 Johnson (1999) provides a basic framework of intellectual capital as a component of market value where intellectual capital is defined as a system (of elements and processes) that utilizes human intellect and innovation to create wealth:

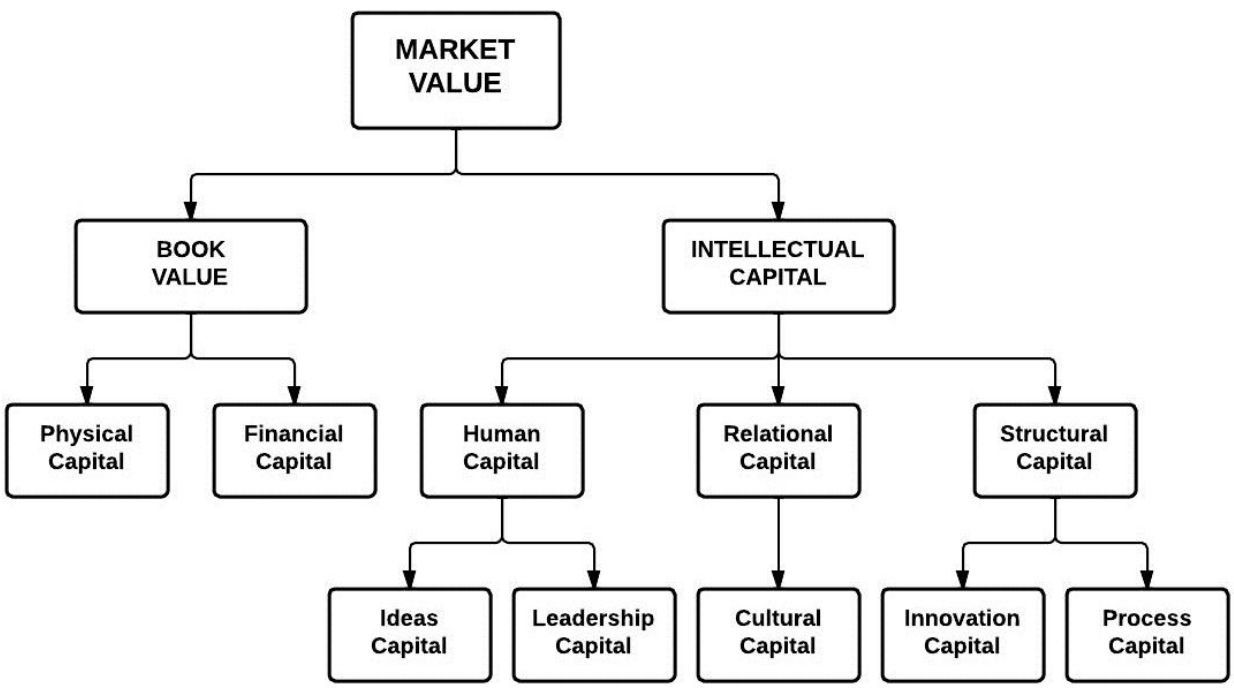


Figure 1 Intellectual capital framework: its relationship to market value (Johnson 1999)

Below in figure 2, Bontis (1998) illustrates conceptualization of intellectual capital in terms of essence, scope, parameters and codification of each constituent. According to the model, intellectual capital is classified into three parts: human capital, structural capital and customer capital (relational capital). The model of Bontis (1998) given below and the framework of Johnson (1999) will be taken as a basis to understand the structure of market value and intellectual capital of small KIFs and later will be used for the purpose of valuation in the case study:

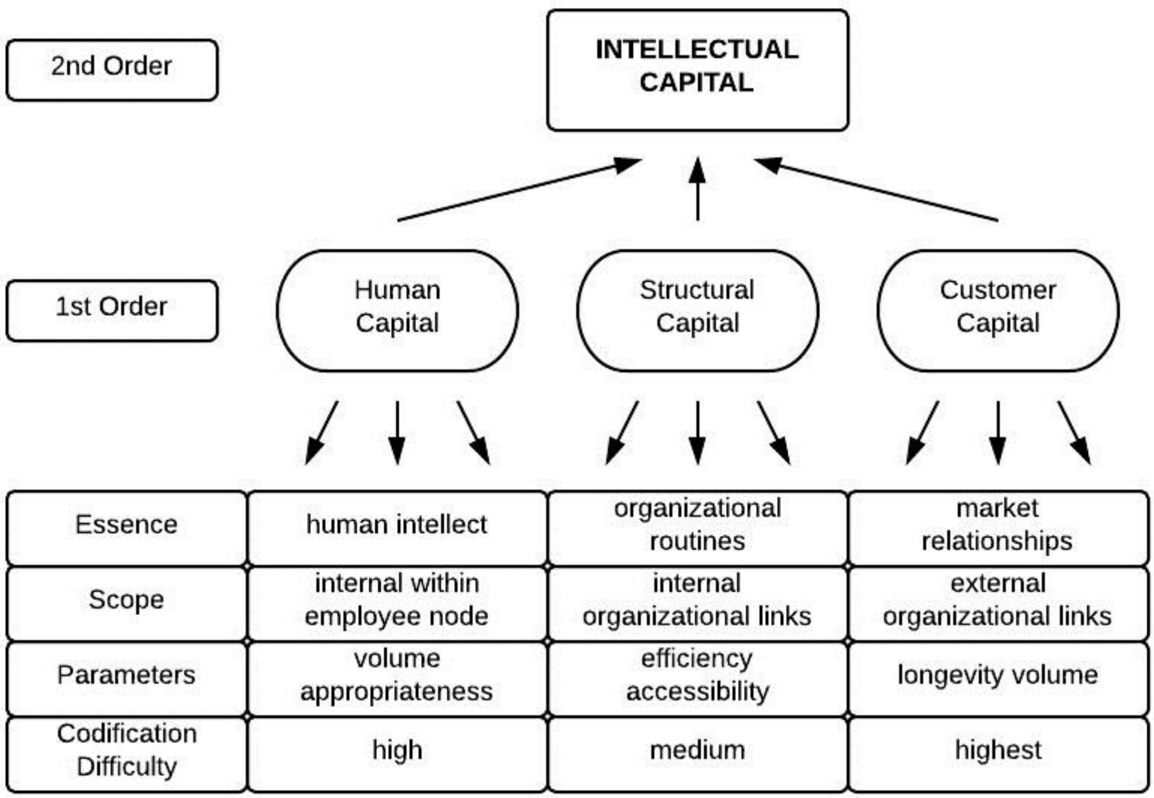


Figure 2 Conceptualization of intellectual capital (Bontis 1998)

Human Capital

Edvinsson and Sullivan (1996) define human resources of the firm simply as the collective capabilities of employees to solve customer problems. Value by human resources is created either directly or indirectly. For example, in consulting business consultants are the providers of service, while in software development value created by programmers is indirect. Once the program is codified it becomes intellectual asset of the firm which is later reproduced and sold. Thus, as far as classical knowledge intensive businesses are concerned, value creation by human resources will be treated as direct.

Structural Capital

Maddocks and Beaney (2002) define structural capital as one of the three essential components of intellectual capital which covers the supportive infrastructure, processes, and databases of the organization that enable human capital to function. This part of the intellectual capital plays enormous role in supporting employees in their search for optimal intellectual performance with the mechanisms and structures of the organization, which on the other hand enhances total business performance. This basically implies that if an organization possesses unsophisticated systems and procedures to track employee actions, despite high intellectual level of an individual, the overall intellectual capital will not reach its maximum attainable potential.

Customer Capital

Customer capital, also known as relational capital or complementary business assets, is exploited to add value to intellectual capital which otherwise would have little commercial value (Edvinsson and Sullivan 1996). Bontis (1998) characterizes customer capital as one of the most difficult subdomains of intellectual capital to codify. According to Teece (1986) complementary business assets are assets, infrastructure or capabilities needed to support the successful commercialization and marketing of a technological innovation, besides the assets fundamentally associated with that innovation. Customer capital has special focus on knowledge of marketing channels and customer relationships. Therefore, the essence of customer capital is knowledge embedded in relationships external to the firm.

3.3 Theory of knowledge intensive business valuation

In KIFs intellectual capital is the main source of value and knowledge is the central focus in this capital. But knowledge, as a strategic asset, makes several problems for the potential buyer. Due to some important reasons, Coff (1999) is convinced that knowledge-based assets pose threats for potential buyers, however, he mentions that little research has been done exploring these reasons more deeply and how buyers cope with them.

Knowledge can be maintained at the group, organization, and network levels – this bundling, along with tacitness, makes knowledge difficult to acquire in traditional factor markets. Variations in knowledge are harder to observe than tangible asset – information dilemma, risk of overbidding.

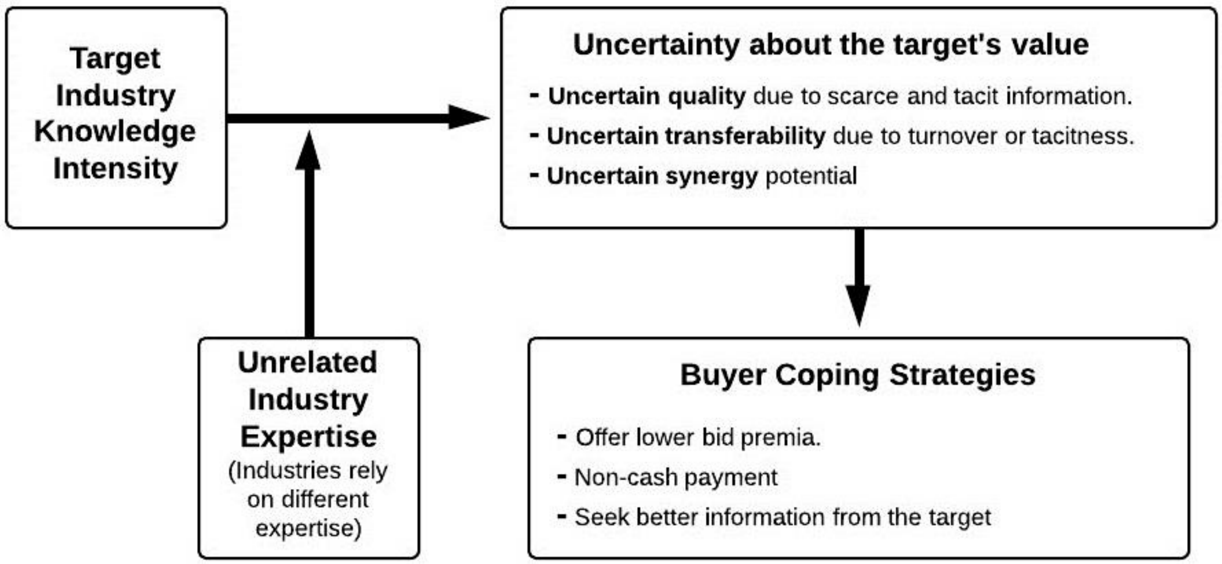


Figure 3 Coping with knowledge intensity in acquisitions Coff (1999)

Potential buyers have much less insight into the quality of a firm’s knowledge base than its physical capital in KIFs, primarily because physical assets are adequately measured in financial statements, whereas knowledge is systematically excluded. Coff (1999) gives three reasons for the uncertainty related to the value of knowledge-based assets which are difficult to assess compared to tangible assets: 1) quality is more difficult to observe or measure, 2) the buyer cannot be certain what can be transferred, and 3) the prospects for synergy are difficult to assess.

To cope with these uncertainties in the estimate of target’s value, Coff (1999) recommends that buyers (1) offer lower premia, (2) seek better information from the target (avoid tender offers and rely on lengthy negotiations) Formulas given below are based on the taxonomy provided by Johnson (1999) which is similar to that used in Joia (2000) except for location of relational capital:

$$\textit{Book Value} = \textit{Physical Capital} + \textit{Financial Capital}$$

$$\textit{Intellectual Capital} = \textit{Human Capital} + \textit{Relational Capital} + \textit{Structural Capital}$$

$$\textit{Market Value} = \textit{Book Value} + \textit{Intellectual Capital}$$

Chapter 4

Framework for Owner-Dependence

4.1 Design

Designing a useful framework for owner-dependence was a real challenge. Various scholarly articles and resources were exploited to come up with relevant points for owner-dependence in terms of classical KIFs. Final form of the designed framework could be further elaborated by use of diverse resources from consulting firms and independent authors. However, only points supported by reliable academic sources were included in the framework, except two authors renowned in this field whose ideas and statements are taken as valuable input to the framework.

After having relevant elements and their respective characteristics challenging phase was to design a suitable framework. This part is of high importance because the message and the objective of the framework have to be very clear and at the same time all the relationships have to be logically depicted. Figure 15 given in the appendix B. is the general description of the framework designed. The framework has two sides where the left side reflects extreme owner-dependent business and the right side on the contrary reflects extreme owner-independent business:

Central position of the framework has five elements in total, where all the elements belong to the right side, however only three of them belong to the left side. Mutual three elements of both sides which are clientele base, manager and human resource are the inevitable elements of any classical small knowledge intensive firm. The firm cannot be imagined in the absence of any of these three elements. Although the elements are mutual, left and right sides do not share the same characteristics, which are in fact contrast to each other.

All of the above mentioned characteristics of a clientele base imply two types of clientele base one of which provides assurance of adequate revenue stream after ownership change, while the other one does not. In the worst scenario, difficult transition of client relationships doubled with personal network and little diversification exaggerates the problem even more.

Bold aspects in each aspect box on both sides refer to the generalization of three aspects under it. For instance, a broad and diversified customer base plus the positive effect of trusted brand name, and easy transition of built relationships are playing extremely important role in promising sustainable profits for a buyer. Because condition of bold aspects depends on the aspects below them, in the final chapter these bold aspects will be commented and generalization made using study of other aspects.

Elements with the aspects on the left side of the framework lead to an extremely owner-dependent business, whereas elements with the aspects on the right side lead to an extremely owner-independent firm. The additional two elements part of the right side, business processes and sales and marketing, which are uncommon to many of the classical small knowledge firms are playing substantial role in taking firms step further ahead in making them owner-independent.

Message of the framework should be understood for both sides. Left side of the framework depicts main elements that are inherent to all small knowledge businesses covered and their relevant characteristics that lead to an extremely owner-dependent business and makes it almost unsalable for a reasonable price. Such a business is exposed to huge risk of losing most or almost all value when the owner decides to leave the business thereby taking most of the value with him. Thus, left side of the framework will be used to determine the potential value loss of a firm which is caused by the negative characteristics of the elements putting heavy reliance on the owner. It is obvious that the owner with such a business has never planned for exit in the future.

Figure 4 Left side of the framework

Considering the right side, if a firm possesses the five elements with the given characteristics, then the firm is almost independent of its owner which results in almost no value loss if the owner leaves. From owner-dependence perspective, right side of the framework is the ideal situation for a firm. By determining the difference between the firm’s current situation and the ideal situation, it is possible to have insight into potential gain firm could reasonably obtain if it were to take measures towards maximum owner-independence by adopting given aspects on the right side over a period of certain years.

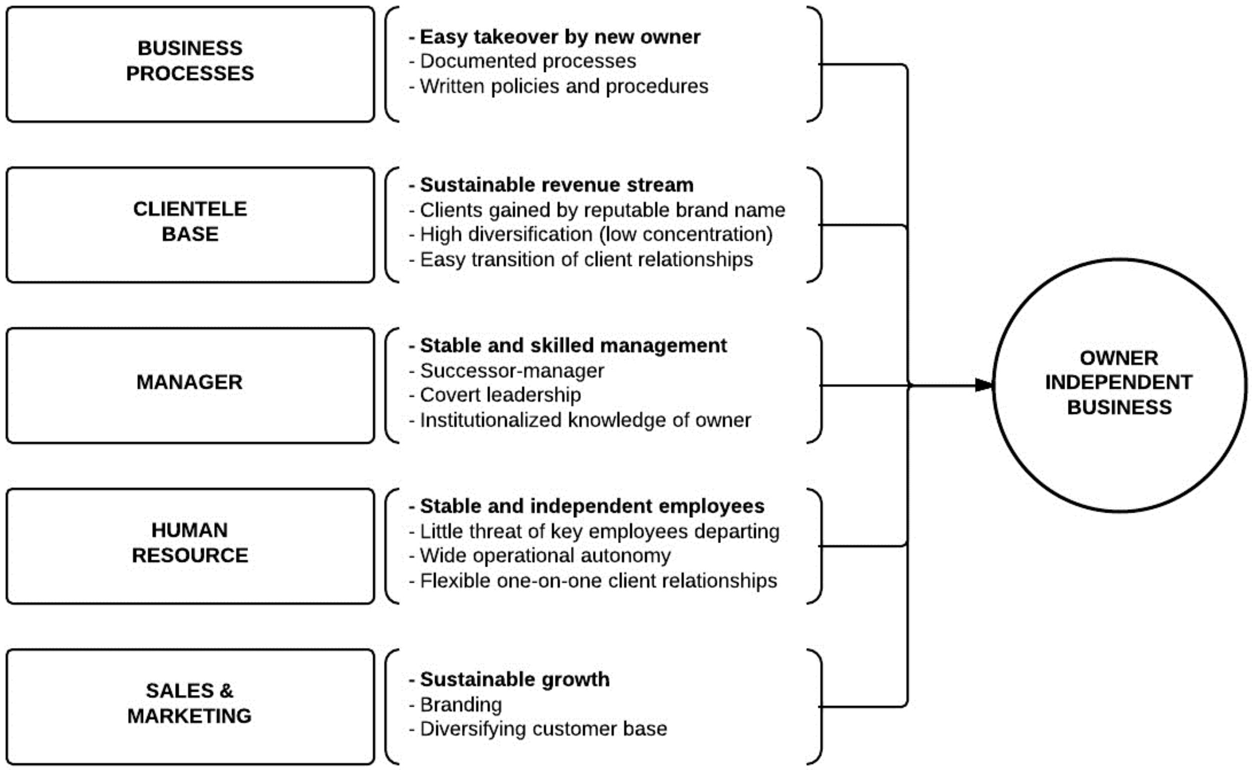


Figure 5 Right side of the framework

4.2 Main elements and related aspects

4.2.1 Manager

Owner-manager vs. successor-manager

When an owner leaves the company, a few natural questions can be posed. How is this business run? Is there any strong, stable management in place? Or has it been only the owner who has been making all the key decisions until now? Having someone with necessary skills and capabilities to lead the firm is very important in the valuation of a small knowledge intensive business which is also an important factor for making business independent of its owner. Having a successor management is one of the important aspects to potential buyers influencing value of the firm (Heslop 2008).

In an owner-dependent business, owner is at the same time manager who is doing most of the managerial works himself. Such an owner has not groomed someone to take on responsibility that may set owner free of these tasks. One of the crucial actions that an owner may take to reduce firm’s dependence on him is to prepare a skilled manager as a successor so that his leaving does not affect the value immensely.

Structural vs. covert leadership

Managing knowledge within the firm is one of the most crucial issues because having knowledge and the capability to create and utilize such knowledge are the most important sources of competitive advantage for the firm (Ditillo 2004). Leadership that is conducted in a way that appears to be manipulating or controlling others is referred to as structural leadership. The term covert leadership is referred to as ‘being there without being there’ highlights the paradoxical nature of leadership in knowledge intensive firms (e Cunha 2002).

Robertson and Swan (2003) states that there have always existed dilemmas in terms of managing KIFs around practicing efficient balance of autonomy and control. Classical KIFs are characterized by highly autonomous employees where leadership requires a delicate balance between a degree of formalization necessary for coordinated action (i.e. organizational routines) and low levels of formalization to facilitate (i.e. flexibility, knowledge creation). However, tough part in terms of leadership is to know how to achieve this balance. A cautious and individual method to the management of the skillful workforce is recommended by many scholars as on that relies deeply the growth of a culture of responsible autonomy.

Institutionalization of owner’s knowledge and experience

Another big problem that makes a business unsalable in the absence of an owner is the situation that owner plays central role in the human capital and at the same time he has not institutionalized his specialist knowledge (Blayney 2009). This implies that business is built around specialist knowledge of the owner. Institutional knowledge is a combined set of information, theories, experience and know-how possessed by a cluster of people (the owner in this case). Institutionalization of this knowledge refers to the transmission of this accumulation of the owner to the members of the group as it transcends the owner and reinforces continuity of the business. Non-institutionalization makes transfer of knowledge very difficult in a short-term which is a negative factor during sale process that may cause huge value loss to the firm. Owner-manager of a small consultant firm can be given as an example to depict the situation. If we consider that the owner-manager is the chief consultant and adds most of the value to client projects, plus if his specialist knowledge is also not institutionalized, this essentially makes the business unimaginable in the absence of this owner.

4.2.2 Clientele base

Owner's network vs. reputable brand name

Successful and profitable firm may extinguish in a moment when the owner decides to leave the business. From the perspective of owner-dependence, another significant element influencing value of a business is the nature of a clientele base. Clientele base of a business dependent on the owner is characterized by the personal and professional network of the owner (Blayney 2009). Such businesses are built around this personal network and the biggest problem is that they have no or little brand value. In such an undesirable situation, when the owner decides to leave the business, this personal network resolves quickly causing great trouble. Before any positive aspect of a clientele base is mentioned, it should be noted that without a clientele base gained by trusted brand name has also negative effect on other aspects and disables or reduces eventual benefits of them significantly.

Diversification and concentration of clients

Highly diversified client portfolio is characterized by broad spread of different customer segments of distinct sizes which is a special attention point for potential buyers. A huge concentration of billings in one client cluster may need a more pool based approach because there is superior risk of a substantial loss of revenue. A firm relying on revenue stream from many different customers is always better off than a company relying on few major customers which is a significant risk in the view of a potential buyer (Heslop 2008). Despite reputable brand name of the company when the owner leaves, there still remains risk of some clients ending contract with the firm. In this case, company having a diversified customer portfolio reduces the risk of high concentration.

Your business may be successful and profitable, but if it depends on a small number of customers for most of its revenue, a potential buyer is going to consider this a significant risk. The value of a particular business can be several times greater if the spread of customers is broader (Heslop 2008). But in the case that customer base is not well diversified which is characterized by overreliance on certain customers for the survival of the business, there remains considerable risk that if owner leaves some of these important customers may decide to suspend business with the firm. Therefore, to protect firm value from such a risky aspect of owner-dependence, clientele portfolio has to be well diversified.

Some professional service companies, such as accounting, financial administration, etc. as a natural part of their businesses have customer bases with many small firms. Because in these businesses, service is provided throughout a year with active ordering frequency relatively homogenous among all clients, in this case each client contributes a bit to the overall profitability. As a result, risk of losing some customers caused by ownership change is reduced automatically (Tuller 2008).

Transition of client relationships

During acquisition of a firm, one of the priority issues for the new owner is the transition of current client relationships. Simple question of a potential buyer emphasizes the concern: Will clients work with me? If customers are constituted from personal network and close contacts, in the absence of a current owner, most probably they will be not willing to continue with a new owner.

Main constituents of the value of a knowledge intensive firm are intangible assets part of which is based primarily on an assessment of the relationships the firm has with its clients. It is a challenging task to assure that the transition will be successful. Therefore, it is of critical importance to the buying party to be able to achieve a transition of the client relationships.

Contrary to an owner-dependent firm, it is relatively easy to transfer client relationships in the event of ownership change because most of the customers have been gained through brand name rather than personal network. From the same perspective, contracted revenue streams from clients can also have quite important effect in influencing the value of a business because it allows some transition period (Heslop 2008). If a potential buyer cannot clearly see how profits will be sustained in the longer term they are unlikely to be very interested. Clientele base of an owner-independent firm promises sustainable revenue stream in the absence of the owner.

4.2.3 Human capital

Threat of key employees departing

Human capital is another element besides clientele base that a business cannot be imagined without. In knowledge intensive businesses human capital plays central role and adds the greatest value in all the work done. It may take several years to build a solid human capital, but it may take a few months for it to get dissolved. Value loss in human capital affects firm value directly.

Will key employees stay when the company changes proprietorship? It is not unusual for key employees to depart from the company for a more well-paid position with a larger opponent. Many periods, the key employees stay with the company as they are handy with the owner and are in a position to donate to the company's growth and triumph and feel they will be salaried heavily sometime. Will your crew be glad to work under a new owner or will there be a danger of key personnel passing? So, assessing the link between employee gratification (performance) and owner and deciding effect of owner (manager) on employees when leaving and subsequently on the company performance are decisive points to care on.

Employee loyalty is almost as important as customer loyalty (e Cunha 2002). Workforce of knowledge intensive firms are characterized by high competence and education level which are valuable and at the same time scarce resource which put pressure on these firms to be very careful in managing their employees. If some of the key employees leave, the business will be worth less. For example, the profitability of a law firm may collapse if the key person leaves who will take important customers with him. Having relatives of business owner among key employees is another important reason triggering departure.

In an owner-independent firm threat of key employees leaving the firm is relatively low. But this risk always remains because there is never certain guarantee for it will not happen. However, as an exception, there is one way to retain employees which is by making contracts that stick employees to the firm for a specific range of time. This is seen as a valuable input in the sale process which relieves the new owner to certain degree from fear of key employees leaving. This contract period enables the new owner to start to bring in his own staff gradually or build close relationships with current employees.

Operational autonomy

Human capital that has restricted operational autonomy which has been used to be given instructions on most of the work faces loss during valuation because of their dependence on the owner. With less operational autonomy human capital cannot show sufficient performance in the absence of the owner and therefore has a destructive role during valuation of the business.

Wide operational autonomy is one of the most desired characteristics of a human capital which reduces reliance of the firm over the owner significantly. Operational autonomy implies that employees making up human capital are adequately empowered to take initiatives, make necessary decisions etc. This allows employees improve themselves better and working without being used to following and looking for direct instructions from the owner. Thus, management plays an important role in giving necessary operational autonomy to employees which also helps to prepare them to the challenges of the future and on the other hand improves strength and capabilities of them which are important in how others value the business (Heslop 2008).

e Cunha (2002) considers the most suitable structure for knowledge intensive firm labeled as ‘minimal structure’ which is defined as: “coordination devices that attempt to focus the activities of people around a common set of goals and deadlines without limiting their discretion in deciding how best to reach these goals”. In the context of structural type, minimal structure plays middle role between too much and too little structure, control and organization. In this case individuals in the firm enjoy considerable operational autonomy which at the same time minimizes the ability of managers to exercise control over them.

Close vs. flexible one-on-one client relationships

This factor plays indirect role in terms of owner-dependence which is related to departure of key employees. Flexible one-on-one customer relationships imply that in case any of the employees leaves the firm, customers will not be affected because of flexible and interchangeable relationships among all employees. Within the firm, service is provided by differentiating among employees so that clients are not used to specific employees making it difficult for transfer of intimate relationships.

It might be likely to grow a system in order to collate and spread knowledge of persons within the firm, but implicit knowledge of them is the most appreciated knowledge (Morris and Empson 1998). This precise knowledge is extended through years of practice and it is consequently not a cool task to sanctify and codify it. In the same way, long-standing interactions of a firm between its client companies are based on particularly on close personal relationships, definitely between individual experts and individual clients.

4.2.4 Business processes

Rigby (2012) notes that the business owner needs to begin to build infrastructure. Barrow (2011) suggests that one documents processes, and writes policies and procedures so someone can take over when and as needed. The simplest place is to start with defining and documenting operational processes. The key operational processes in an adviser business may include:

- Acquiring clients including prospecting, networking, and referral systems;
- Conducting exploratory meetings;
- Conducting data gathering meetings;
- Preparing analysis and SOA;
- Presenting SOA;
- Implementing business;
- Investment approach;
- Managing customer relationships;
- Fee structures; and
- Conducting reviews.

4.2.5 Sales and marketing

One of the main functions of marketing is branding which seeks to build a reputable brand name that customers trust (Buckingham 2010). Branding helps the firm to start to set itself apart from owner’s personal network and increase ties with the outer world. To get rid of firm’s dependence on its owner, it is very crucial to engage marketing staff to improve customer base of the firm and generate more income independent of owner’s personal network from clients who are not directly known to owner and who get involved with your business through third parties or through reputation (Blayney 2009).

Potential buyers, besides firm’s stable revenue stream, are also interested in sustainable growth of the firm. Usually, sustainable growth target of the firm is realized by having sales and marketing at a firm with a reputable brand value. This is an important factor for a buyer because it is gives certain clue about the future of this business.

Chapter 5

Case Study: Determining potential valuation gap due to owner-dependence

5.1 Firm description

The firm is operating already over five years as a financial administration firm which offers a complete range of financial/fiscal services to its clients in the financial services industry. The firm focuses mainly on companies, both large and small, and startups, but also provides services for associations, foundations, and individuals. In general, the firm offers the following services to its clients:

- Financial administration
- Salary and personnel administration
- Annual reports and forecasting
- Tax advice and tax returns
- Advice and guidance for starters

Given the nature of its services and activities, the firm can be classified as a small knowledge intensive firm in the professional services industry according to the statistical classification of economic activities in the European Community (NACE 7412).

In terms of five elements of the owner-dependence framework introduced in the previous chapter, the firm has clientele base of hundred clients, human resource of four key employees including a manager. However, business processes and sales & marketing elements do not exist in the firm. In general, human resource and manager elements are in a positive state which could further be improved however clientele base is in a negative state which requires progress in order to prevent potential valuation loss. These points will be further elaborated in the following sections.

5.2 Identification of the problem

5.2.1 General problem

This study is aimed to capture the potential valuation loss as a result of instant sale of the firm and potential valuation gain as a result of careful exit planning in a several years period (e.g. five years) in terms of owner-dependence. The primary objective of the case study is exploratory (finding out what the current situation is and explaining it) and the primary data used in the case study is qualitative.

5.2.2 Why is the problem important?

As explained earlier, owner-dependence makes a firm unsalable for the desired or reasonable price which causes value loss due to offered discounted price in case of instant acquisition attempt. Therefore, it is of high importance for the owner of this firm to know if he can sell his firm today without any potential loss. Besides, the owner can increase the perceived value of the business even further to outsiders by making use of a smooth exit plan over several years term which includes detection and improvement of positive and negative aspects of the framework elements and at the same time adoption of non-existent aspects for total owner-independence.

5.2.3 Method for problem identification

The framework developed in the previous chapter is used to identify if the firm may face valuation loss in case of instant sale and if there is also potential for valuation gain by smooth exit plan. Because this framework helps to map relevant aspects which lead both to owner-dependence and -independence, it is possible to point out negative and positive aspects of the elements on the framework for the firm being studied in the case study. Immediately afterwards, one should be able to visualize if the valuation concern exists due to owner-dependence and approximately to what degree before diving into elaboration and study of the aspects for valuation purpose.

Described approach for problem identification has been done through discussions with the owner, manager and employees using the framework of owner-dependence and relevant points and their characteristics have been identified which are depicted in figure 6 on the next page. General strong points determined by use of the framework are summarized below:

- Many clients are from the personal network of the owner.
- Manager in the firm is not the owner himself.
- Owner has fully institutionalized his knowledge and expertise.
- There is little threat of key employees departing.
- Transition of most of the clients does not seem troubling.
- Business processes and sales & marketing elements do not exist in the firm.

These general comments made are useful to form an initial opinion over the owner-dependence level of the firm and the framework here serves in a manner to determine the existence of the problem by visualizing positive and negative aspects which requires further analysis for the problem enormity. Additionally, interviews conducted with the employees, manager and owner reinforces the initial opinion. At the first glance, the following figure 6 basically suggests that in the case of instant sale firm will experience value loss due to certain degree of owner-dependence, however there also remains potential to fill in the gaps towards maximum owner-independence, thereby increase the perceived value of the firm.

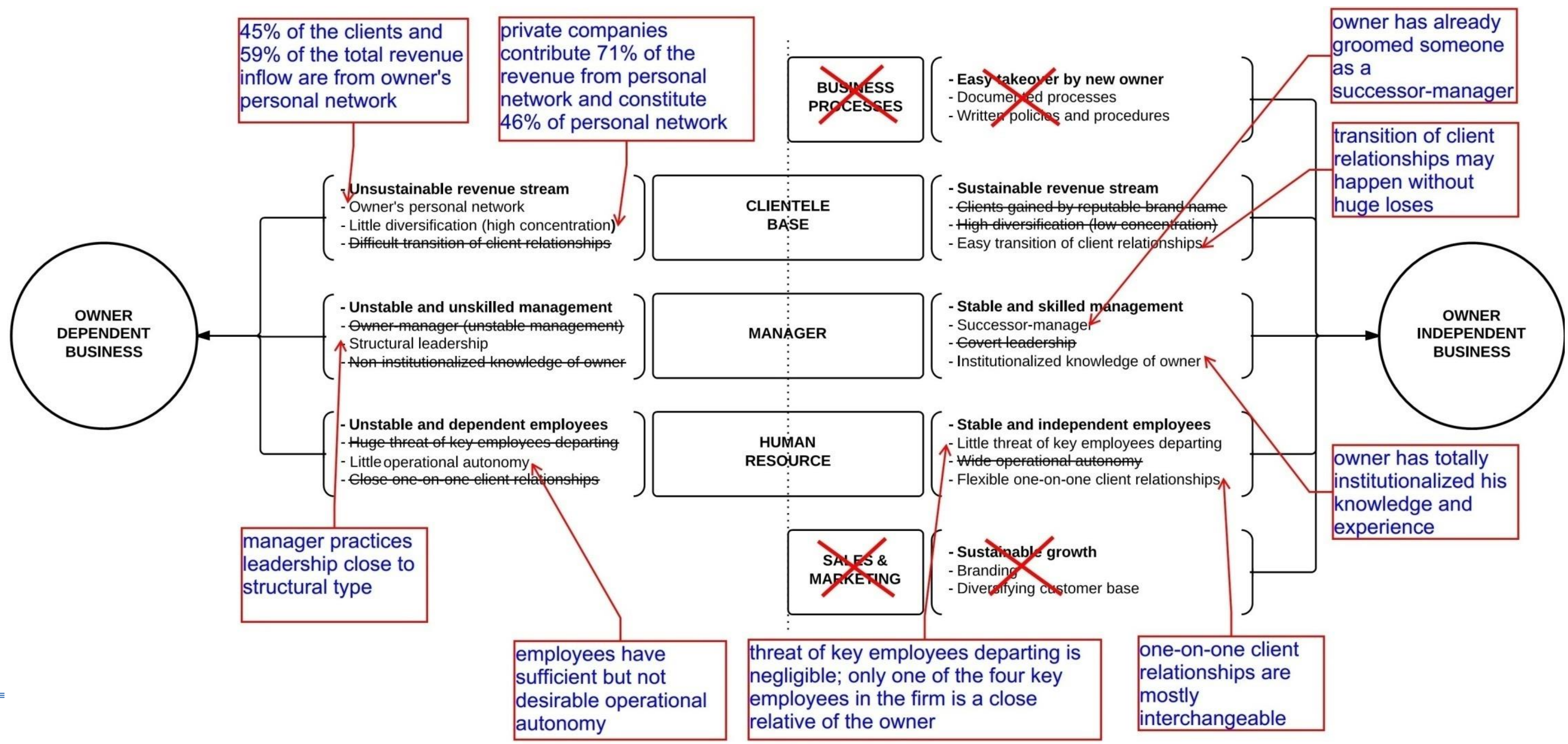


Figure 6 Firm relevant comments on the framework.

5.3 Steps taken to address the problem

As it is determined in the previous part that the firm is likely to experience potential valuation problems during sale, now it is time to address the problem of determining this potential valuation issue. Therefore, in the following paragraphs each element in the owner-dependence framework for this firm will be studied and then their combined effects on the value of the firm will be approximated. Table given below lists the aspects of elements according to positive or negative criteria. The table is a summary of the study (conducted in the following parts) of each aspect for each element where red circle is negative, green is positive, blue is attainable:

Aspect	**Current state**		
	Negative	**Non-existent**	**Positive**
Owner's personal network	●		
Little diversification (high concentration)	●		
Easy transition of client relationships			●
Successor-manager			●
Structural leadership	●		
Institutionalized knowledge of owner			●
Little threat of key employees departing			●
Operational autonomy	●		
Flexible one-on-one client relationships			●
Documented processes		●	
Written policies and procedures		●	
Branding		●	
Diversifying customers base		●	

Table 3 Framework aspects and their current states for the firm

Then, element analysis will be brought together and generalized in terms of: sustainability of the revenue stream, stable and skilled management and stable and independent employees. And from this, two scenarios will be derived for quantification purposes which will later be used to capture potential valuation loss in case of instant acquisition. Besides, expectations will be specified over potential valuation gain in the future as a result of shift towards owner-independence.

5.4 Study of framework elements in terms of owner-dependence

5.4.1 Study of the first element: clientele base

- Owner's personal network has large stake in the clientele base.

Among all the aspects of an owner-dependent firm, determining whether majority of customers are from the personal and professional network of the owner is the most important matter to the potential buyer. It basically gives an idea on the scale of shake-up that may occur in the revenue stream of the firm due to dependence on the owner considering that no other major change happens with the new owner.

Clientele base of the firm includes hundred clients. From the study of the base and formal interviews with the manager and the owner of the firm, it was found that large portion of the clientele base (see figures below) comes from the owner's personal network. No distinction has been made among relatives, friends, etc. by the owner of the firm which means that all the clients included in the personal network are treated equally in terms of owner-dependence. For the purpose of separating owner-dependent clients from the rest, clientele base has been divided into two broad sections: clients gained by personal network of the owner and all other clients.

Others section includes clients out of the personal network of the owner which represents the independent (of the owner) part of the clientele base. These clients have chosen the firm mainly due to positive opinions they heard from other clients about the service and reputation of the firm and they are willing to stay with the firm as long as they are satisfied with the level of service they receive. In terms of reputation and level of service, name of the firm by itself doesn't mean much to those who are not clients of the firm which suggests that the brand value of the firm is very low. Others section of the clientele base is regarded as unaffected by the ownership change in the firm and therefore is not treated in this case study. In the following paragraphs, main focus of the analysis will be given to the personal network part of the clientele base.

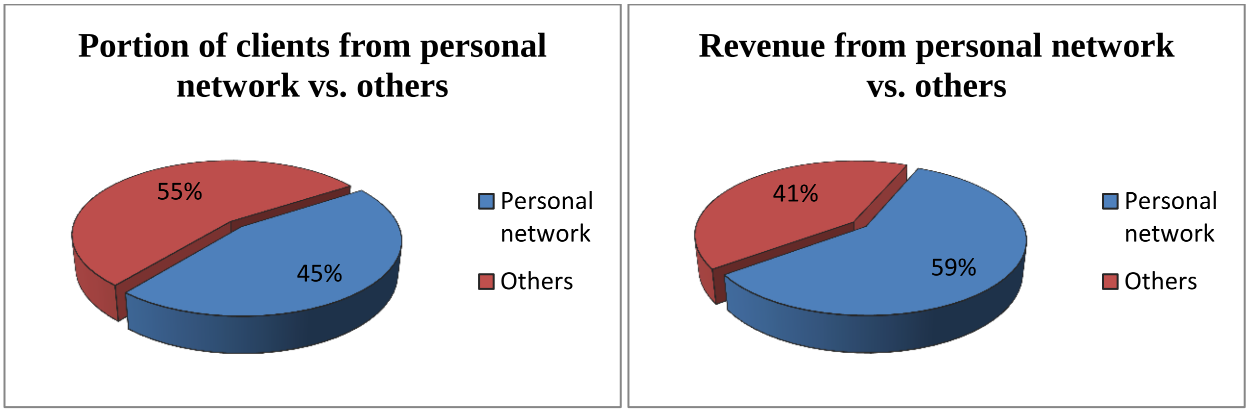


Figure 7 Diversification among clients (personal network vs. others)

The figure above indicates that around 45% of the clients constitute personal network of the owner. However, despite the fact that others segment has slight dominance over personal network by number, the revenue from personal network is about 20% more than the revenue from other clients. In this case, the situation is even worsened because departure of some clients from the personal network will have greater effect on the revenue stream of the firm which is a major ingredient in the valuation process. Therefore, this aspect of the clientele base is considered to be highly negative which has big adverse impact on the relational capital of the firm.

As we try to understand the effect of personal network dominance on the perceived value of the firm, it is important to be cautious in one point. If we relied and based our valuation on the bare information that many clients come from personal network without gaining deeper insight into the current state of the client relationships, we would have different valuation figure than if we conducted a thorough analysis (case study) to discover the true nature of the clientele base and respective relationships.

- Diversification and concentration of clients is troublesome.

Though it is already known that personal network has dominance in overall revenue inflow of the firm, it is not sufficient to have clear judgment on the risk of revenue loss due to concentration of the clients within the category (personal network). Therefore, study of the personal network is an important step to evaluate this risk adequately. The figure below provides information over the portion of clients and revenue concentration among business types in the personal network of the owner:

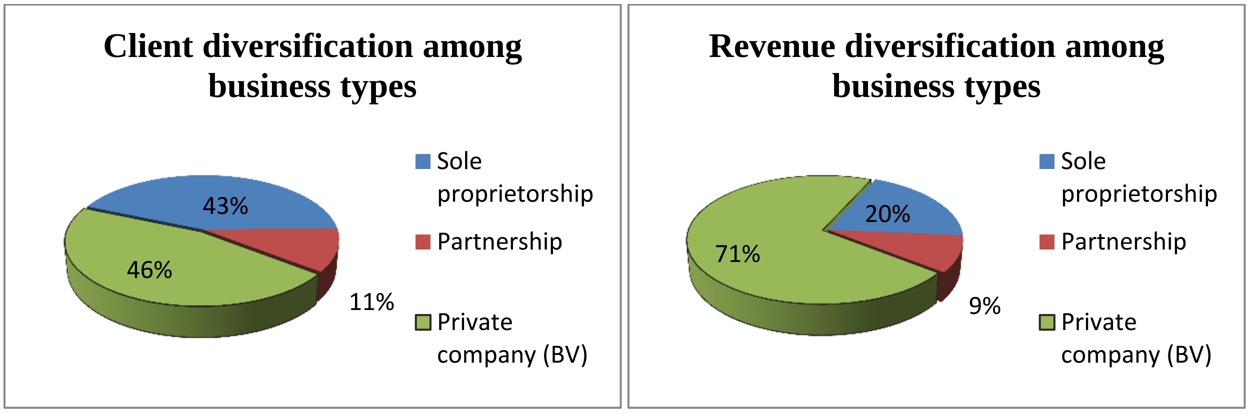
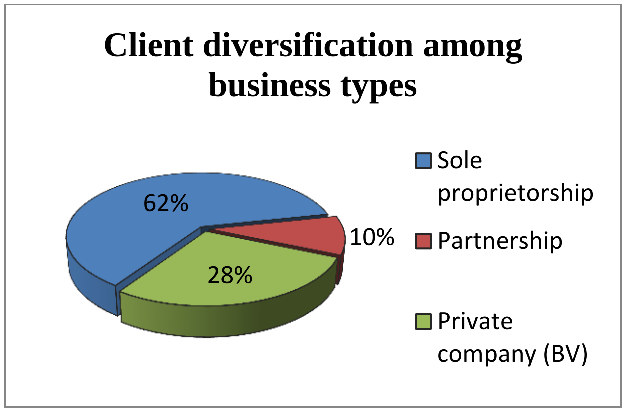


Figure 8 Diversification among business types (personal network)

Private companies have slight majority over sole proprietorships by number; however they have clear dominance (71%) over the revenue stream from the personal network. Despite being almost same in the number of clients with private companies, effect of sole proprietorships on the revenue inflow drops sharply to 20% of the total revenue. Partnerships maintain their minor fraction in both figures. This picture is troubling in terms of owner-dependence primarily due to the risk of departure among private company clients.

If some of the clients among sole proprietorships or partnerships suspend their business with the firm it will influence the revenue inflow to a certain degree but not immensely. However, departure of some private companies will be felt immediately in the revenue stream in a large scale. Above all, before ownership change it is not possible to determine departure rates among business types in precise terms, because it is largely dependent upon the subjective approach of the potential buyer over the state of these client relationships. As additional information remaining figures below provide snapshots of the clientele base in general:



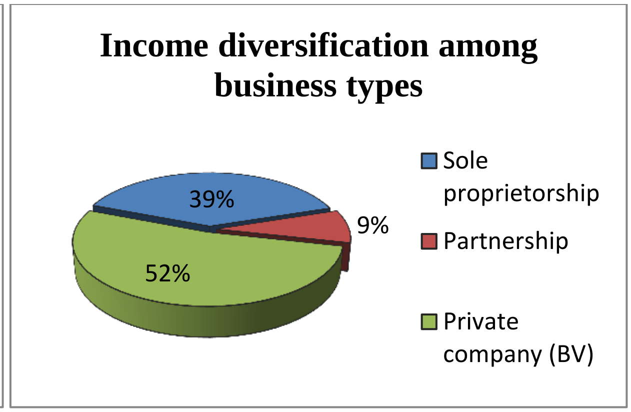
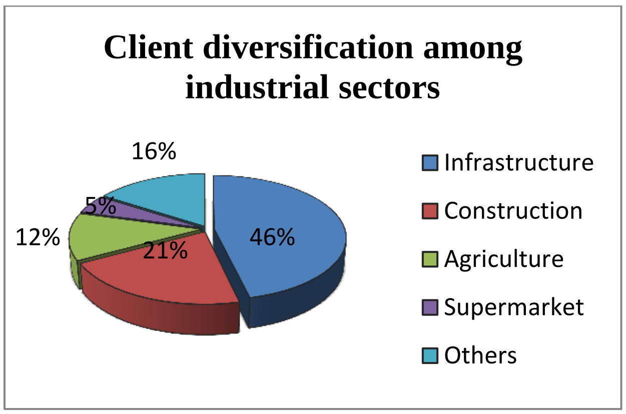


Figure 9 Diversification among business types (clientele base)



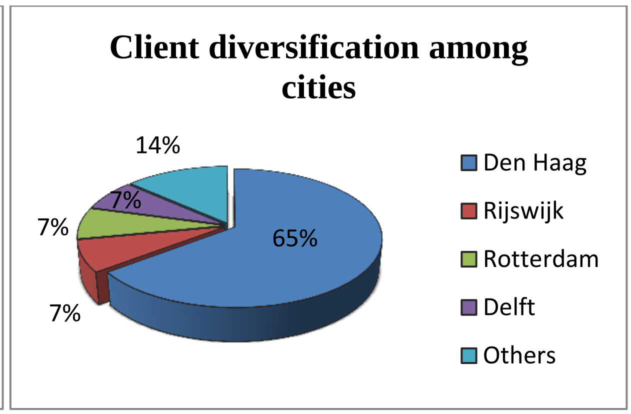


Figure 10 Diversification among industrial sectors and cities (clientele base)

- Transition of client relationships may take place with moderate losses.

As it is already determined that around half of the clientele base is gained by the personal network of the owner which includes friends, relatives, friends of relatives etc. and it contributes about 60% of the total revenue, natural question arises about the transition of these client relationships to a new owner. The real uncertainty here which has also substantial importance to a potential buyer is to determine approximately how many clients will continue business with the firm and how many will leave after ownership change.

To tackle the problem the easiest way may seem to be conducting a survey among the clients around the question "would you stay with the firm if the owner sold the business to somebody else" and depending on the provided answers to decide on the approximate proportion of the clientele base remaining. However, in this case study this approach has not been regarded reliable enough to answer the question adequately mainly due to three reasons:

i. Clients having strong and somewhat close ties with the owner will be more inclined to give negative answers (that there are not going to stay with the firm) to show their emotional closeness.
ii. Considering low educational level and cultural aspects of many clients, they may think of different objective behind the survey and answer accordingly which suggests that the answers they will provide may be highly exposed to certain bias.
iii. Conducting the survey among all clients is not practical. There is also statistical error in sampling that chosen number of random clients to be surveyed may not reflect the true standing of the personal network as a whole.

However, conducting interviews with the owner, manager and employees has been regarded as the most efficient way of finding answers to the question posed, because they are familiar with the clients from many sides in and out of daily business through years of experience. From the conducted discussions and interviews and the study of the client relationships in the firm, it is possible to say that the nature of the clientele base has shifted to a more independent state over years while owner’s departure will not cause most of the clients to leave the firm.

After initiation of the business, owner has gradually made himself redundant from daily business activities. During past several years clients have not been working with the owner directly, and they have been meeting him rarely in the firm. Over this period, clients have got used to the absence of the owner, and at the same time they have built close relationships with the employees. These factors are important in the smooth transition of client relationships to the new owner. Though it is highly subjective to provide a value over the departure rate, from the study of the clientele base the owner and manager project the number of clients that may be lost during transition to be maximum 30% of the personal network.

5.4.2 Study of the second element: manager

- Owner has already groomed someone as a manager.

At the moment, the firm cannot be considered as owner-independent, but it can be considered as completely owner-redundant. Owner of the firm has appointed one of the employees as the manager (chief administrator) in the firm several years ago who conducts all the necessary managerial tasks besides being a critical part of the human resource. Over five years his managerial skills and capabilities have increased steadily and the owner has succeeded to absolutely remove himself from daily business activities and has someone in the firm who takes responsibility instead. This is an important achievement of the owner in terms of having someone to replace him which has an important positive effect during valuation of the firm.

Most of the acquirers are interested in such a successor management who is experienced and skilled enough to run the business after the ownership change. As far as this firm is concerned, having a skilled management capable of working independent of the owner is not a concern for a potential buyer because the firm already has such a management. However, another concern may exist for the buyer which is the stability of this management ensuring that successor-manager will remain in the firm after ownership change.

Another achievement of the owner regarding this issue is that he has appointed a manager primarily because of his affinity to the business, loyalty to the firm and willingness to stay in the firm in owner's absence. To increase the attachment of the manager to the firm, owner has also made the manager a shareholder of a little portion in the firm long ago. The current manager doesn't have any close ties (i.e. relative) with the owner. As the owner mentioned in the interview, from the beginning he has been concerned over continuity of the firm after his departure if he had been the manager and therefore with an intention to save the firm from such a management loss he appointed a manager with such qualities who is willing and capable of running the business independently.

- Manager practices leadership close to structural type.

One of the important issues for gaining competitive advantage over others is how you manage knowledge within the firm. From the study of manager-employee interactions in the firm it was clear that the manager is not for the covert leadership. Most of the time, he appears to be influencing or controlling others though it is less strict over the last years. This type of leadership that he prefers is close to structural leadership.

- Owner has institutionalized his knowledge and experience.

Besides having someone to lead the firm after his departure, owner has already taken another important step which is to fully institutionalize all his knowledge and experience to the manager and employees of the firm. It basically means that at the moment business in not built around the specialist knowledge of the owner. Normally this is not observed in most of the knowledge intensive businesses while it is much more common to see owner as an inseparable part of the human resource of the firm. Institutionalization of owner's knowledge is among the crucial aspects affecting the value of the firm. If the owner, integral part of the human resource, decided to sell his business, it would cause huge value loss if he hasn't institutionalized his years of knowledge and experience accumulation.

When the owner founded the firm he was part of the human resource. Later, he employed two key employees who brought strong theoretical knowledge into the firm which combined with the experience of the owner boosted the firm performance and helped the owner to settle the business properly. And subsequently, owner made a smooth exit from the human resource and during this time he transferred all his expertise to the manager and employees. Process of institutionalizing his knowledge has also shifted central focus of customers from the owner to others in the firm. As such, customers are also aware of this fact that owner doesn't not contribute anything from his expertise at the moment which is highly appreciated in terms of owner-independence.

5.4.3 Study of the third element: human resource

- Threat of key employees departing is negligible.

This threat is also one of the few substantial aspects of owner-dependent business that potential buyers give special attention during acquisition because the new owner has to be sure that the present team will continue to work under his ownership with the same satisfaction and performance level. In this firm, key employees, responsible for most of the client operations, are main ingredients of the human capital.

By assigning a manager in the firm and being away from the daily business activities several years ago, the owner has been successful in keeping the staff independent of himself. Informal discussions and the study of formal interviews with the employees reveal that under similar conditions they would be willing to stay in the firm even if the owner leaves. Some important findings that bring to this conclusion are listed below:

- ✓ *Only one of the four key employees in the firm is the close relative of the owner. Other employees have been hired as a result of employee networking (not through direct application for the vacancy).*
- ✓ *When questioned about their contentment both with their position and function at the moment, all employees expressed reasonable level of satisfaction, except two employees who think their knowledge and capabilities could be better utilized due to their superior education backgrounds.*
- ✓ *Except for the only relative (employee) of the owner in the firm, all other employee relationships are based on the owner-employee and close friendly ties.*
- ✓ *All employees are willing to stay in the firm in case of ownership change considering that the new owner will not make any radical changes which may otherwise make them think twice over the decision to stay.*
- ✓ *Main reason that they are currently working in the firm is mainly due to the job itself, not because of any closeness to the owner. However, they are also open to evaluate anytime better job offers from other firms.*

- Employees have sufficient but not desirable operational autonomy.

Having lack of operational autonomy makes an employee dependent on the manager, where employee becomes reliant on regular instructions and is incapable of making necessary and timely decisions regarding client business. Because the owner has no managerial role in the firm, there is no direct relationship between owner departure and operational autonomy of employees in terms of owner-dependence. However, if owner departure triggers chief administrator (successor-manager) departure there is an indirect relationship that business may stagger due to insufficient operational autonomy of employees which essentially may cause dissatisfaction of the clients and trigger their ultimate departure:

Departure of the owner

Departure of the manager

Departure of the client

During discussions and interviews employees have acknowledged that in the past they had very restricted operational autonomy. There were many complaints from employees due to the reason that they were reporting almost every single issue to the manager that could easily be resolved by the initiative of the employee. However, despite the fact that the manager was hesitating to distribute some tasks, as time passed he has increased operational autonomy of employees as he witnessed benefits of doing so. Employees also confess there has been positive improvement concerning their operational autonomy in the past several years. However, employees do not think that they have desirable autonomy, though they agree that it is sufficient at the moment. Manager besides getting involved in his part of daily business routines, he is mainly responsible for making planning of client works to be delivered by schedule throughout a year.

One-on-one client relationships are mostly interchangeable.

After around five month of observation in the firm, it is possible to infer that there exist close, but mostly flexible (transferable, interchangeable) one-on-one customer-employee relationships. Main point here which is intriguing in terms of the case study is to know whether the client will resist working with another or a new employee if the present employee he has been doing business for so long will leave due to the owner departure. As the figure below illustrates, there is an indirect relationship in the context of owner-dependence where departure of the owner causes departure of the client through departure of the employee:

Departure of the owner

Departure of the employee

Departure of the client

Discussions with employees and observation over the state of client relationships exposed two important points which are crucial to determine the level of interchangeability:

- ✓ *Existing inflexible client relationships apply only to one of the key employees who is the close relative of the owner. Therefore, taking into account that around half of the clientele base is from the personal network of the owner, some of these clients are more willing to work with this employee most of the time.*
- ✓ *Other employees have been trying to keep client relationships interchangeable with each other. Except for one employee (relative of the owner), this has become a company culture among the employees to make the client work with all of them equally within the firm.*

From many similar instances, a conversation that I personally witnessed in the past month was exactly on the same issue. For some reason there happened undesired things between the client and the owner of the firm. The client phoned the closest employee (relative of the owner) to him in the firm and during a long conversation discussed the issue, expressed his resentment for the things happened. In the end, the client told the employee that he was still willing to work with the firm and the reason he was not suspending the contract was mainly because of him (the employee).

Because the employee has done his business with care over years and the client was always satisfied with the level of service, he didn’t want to leave the firm. In case this employee decided to leave the firm, the client probably would not be willing to stay with the firm anymore. This and several similar occurred instances depict the situation which stresses the importance of flexible client relationships within the firm. However, the explained instance only applies to some client relationships which are only linked to the employee who is the relative of the owner.

5.5 Putting the studies together

Analysis of the clientele base element shows that if the realistic state of the base is studied adequately, it will cause valuation loss. However, belief on the general picture of the clientele base (that around half of the clientele base is from the personal network of the owner) may lead potential buyers to bid much lower prices. Assumptions of the potential buyer over the sustainability of the revenue stream are highly subjective. Taking into account main points listed below and owner/manager anticipation over retention of clients (min. 70%) it is possible to state that the clientele base around half of which is from the personal network of the owner makes the overall revenue stream unsustainable.

_______________***Unsustainable Revenue Stream***

- ✓ 41% percent of the revenue stream is assumed to be sustainable, because clients out of the personal network of the owner are treated as unaffected by the ownership change.
- ✓ 59% percent of the revenue stream comes from the personal network of the owner and all these clients are treated equally in terms of owner-dependence.
- ✓ 71% of 59% percent revenue stream is concentrated on private companies which increases the risk of revenue shake-up, though private companies make up 46% of the personal network.
- ✓ Owner/manager expectation over minimum retention of the clients from personal network is around 70%.

Owner has already managed to set the employees independent of him. Therefore, considering close to flexible relationships almost apply to most of the clients this situation does not cause, from owner-dependence perspective, much an indirect potential value loss to the firm, such that owner departure may trigger employee departure, and but ultimately doesn't trigger client departure. Because employees are not willing to leave the firm after ownership change, plus they have been keeping client relationships interchangeable with each other.

_______________***Stable and skilled management***

- ✓ Owner has made himself totally redundant from the daily business activities already more than five years.
- ✓ He has already groomed a successor-manager with necessary skills and capabilities who has been a manager independent of the owner several years and is willing to stay even after the ownership change.
- ✓ Owner has also made the manager a shareholder of a small portion in the firm to increase his loyalty and motivation for the business.
- ✓ Successor-manager has no close relationship with the owner out of the business.

- ✓ Manager practices neither completely structural nor cover leadership, somewhere between.
- ✓ Owner has fully institutionalized and transferred all his knowledge and experience to the manager and employees of the firm.
- ✓ It is already several years that customers are also aware of this fact that owner doesn't not contribute anything from his expertise and has no role in the human resource at the moment.

Risk of departure among the employees is more probable for the relative of the owner. However, his departure may only trigger some client departures only from the personal network because inflexible relationships do not apply to the client out of the network. In general, employees can be considered stable and independent from the owner. But due to lack of desirable operational autonomy of employees and relative of the owner human resource can be further improved in terms of owner-dependence.

_______________***Stable and independent employees***

- ✓ Except for the only relative (employee) of the owner in the firm, all other employee relationships are based on the owner-employee and close friendly ties.
- ✓ All employees are willing to stay in the firm in case of ownership change considering that the new owner will not make any radical changes which may otherwise make them think twice over the decision to stay.
- ✓ Through years employees have gradually gained sufficient operational autonomy which could be further improved according to them.
- ✓ Existing inflexible client relationships apply only to one of the key employees who is the close relative of the owner.
- ✓ Other employees have been trying to keep client relationships interchangeable with each other. Except for one employee (relative of the owner), this has become a company culture among the employees to make the client work with all of them equally within the firm.

It is very subjective to provide a scheme according to which valuation loss will happen due to owner-dependence. However, in the following paragraphs two scenarios will be used. First scenario assumes that the human resource and manager elements are positive, and clientele base is the main element that affects valuation negatively. Therefore, owner and manager expectation over retention rate (70%) is taken and applied to the revenue stream. Second scenario considers the lacking sides of the human resource and manager elements and adding that the expectation of 70% may not be reliable enough, and thus retention rate is dropped by10%.

5.6 Results of the case study

Using the model of Johnson (1999) given in figure 1 aspects (e.g. institutionalized knowledge of owner) of owner-dependence framework specific to the firm have been categorized under intellectual capital. Figure 12 on the next page serves to illustrate the overall state of the intellectual capital in terms of owner-dependence which is the primary constituent affecting the market value of this knowledge intensive firm. Intellectual capital of the firm consists of human, structural and relational capitals which are affected by the positive, negative and potential attainable aspects of the owner-dependence framework.

In the figure each aspect (e.g. successor-manager) has been assigned a circle. For simplicity, only three sizes – small, medium and big – have been selected for the circles which refer to the impact of each aspect on the overall state of the respective capital (e.g. human capital). Each aspect has also been assigned a color: green, red and blue. Green color suggests that the aspect for this firm is positive, red color suggests that the aspect is negative and blue color suggests that the firm doesn't have this particular aspect. Dark and light colors represent more and less positive (negative) aspects respectfully. Again for simplicity, only three darkness (lightness) levels have been assigned to colors: dark (very positive or negative), medium (somewhat positive or negative) and light (less positive or negative). Darkness (lightness) feature doesn't apply to blue color because it represents only non-existent aspects.

The figure should be understood in the following way. Let's consider the successor-manager aspect which is represented by a big circle with dark green color. Dark green color means that the aspect is very positive which requires almost no further improvement and the big circle means that it has huge impact on the value of the human capital which has significant effect on the intellectual capital and at the same time on the market value of the firm.

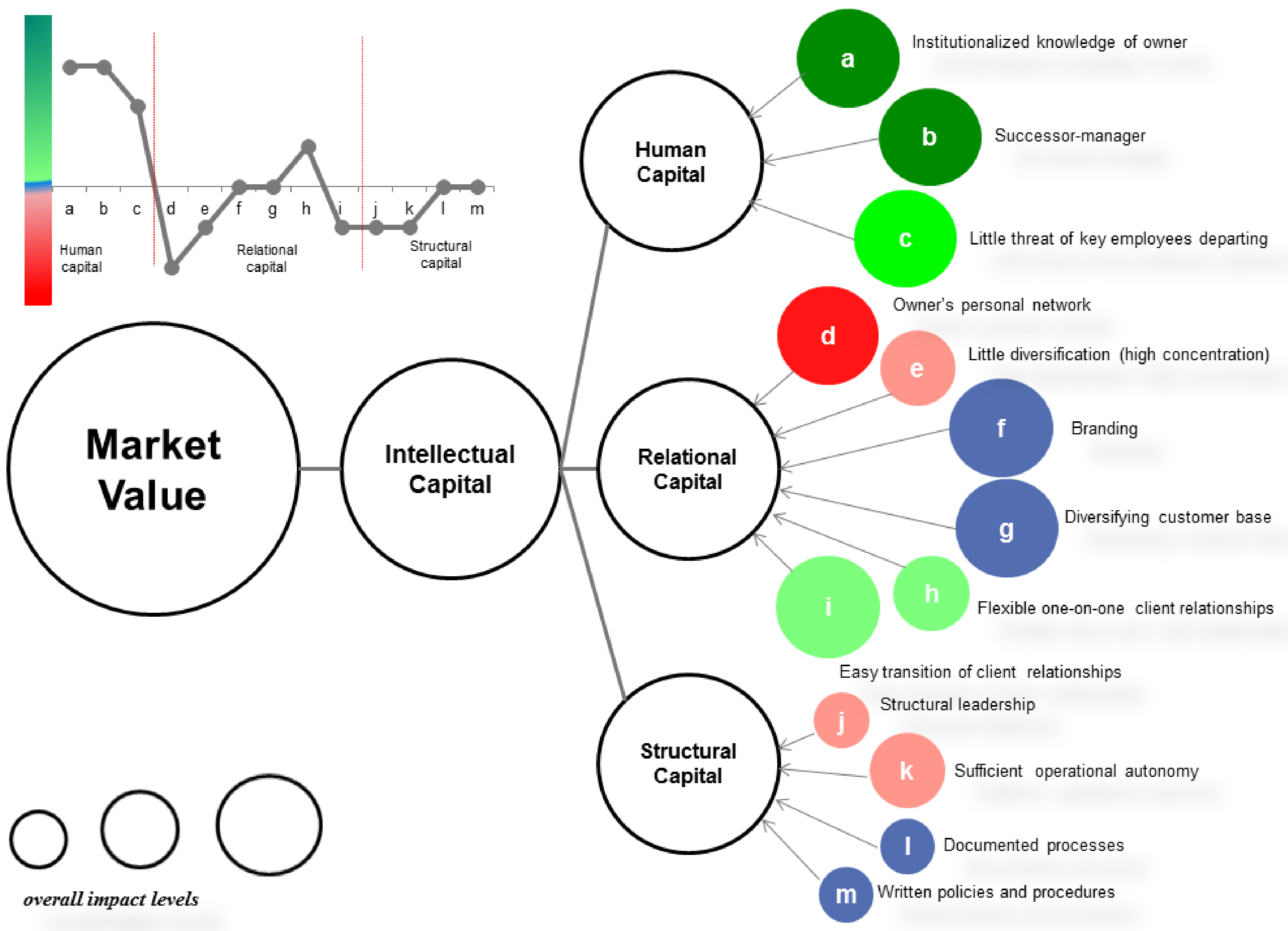


Figure 11 Effect of aspects on intellectual capital

As it was determined after the generalization of the qualitative analysis, for the quantification of the effect of owner-dependence on the firm's market value, two scenarios will be evaluated in terms of the revenue stream of the firm. Revenue division between personal network and other clients are 59% and 41% respectively:

Scenario 1: 40% reduction in the revenue inflow from the personal network
Under this scenario overall effect of owner-dependence on the firm will be 24% (59% x 0.4%) reduction in the total revenue inflow.

Scenario 2: 30% reduction in the revenue inflow from the personal network
Under this scenario overall effect of owner-dependence on the firm will be 17% (59% x 0.3%) reduction in the total revenue inflow.

Operating result (EBIT) of the firm for the year 2012 is provided below:

INCOME STATEMENT *for the year ended 31 December 2012*	
REVENUE	264,131.57
COGS	(5,992.00)
Costs	
Personnel	(140,235.64)
Housing	(19,293.52)
Office	(18,150.29)
Transport	(6,969.67)
General	(2,240.58)
Total costs	(186,889.7)
Operating Profit (EBIT)	71,249.87

Figure 12 Income Statement for the year 2012

In the adjusted income statement for both scenarios in the figure 14, original values of COGS, office, transport and general costs are reduced by the change rate in the revenue figure (17% and 24%) because they are considered as variable costs. Personnel and housing costs are regarded as fixed which are not affected by the revenue inflow. Around 75% of all the costs of the firm are attributable to personnel costs which emphasizes the importance of human resource. In some cases reduction in the revenue stream may lead to salary cuts which may generate other problems such as satisfaction of the employees, risk of employee departure and so on. Therefore, personnel costs as the main cost figure is treated as fixed.

INCOME STATEMENT (with adjustment) *for the year ended 31 December 2012*		
	17% adjust.	**24% adjust.**
REVENUE	219,229.20	200,739.99
COGS	(4,973.36)	(4,553.92)
Costs		
Personnel	(140,235.64)	(140,235.64)
Housing	(19,293.52)	(19,293.52)
Office	(15,064.74)	(13,794.22)
Transport	(5,784.82)	(5,296.94)
General	(1,859.68)	(1,702.84)
Total costs	(182,238.41)	(180,323.17)
Operating Profit (EBIT)	36,990.79	20,416.82

Figure 13 Adjusted Income Statement for the year 2012

Generally, to find a market value of a firm multiple and discounted cash flow (DCF) methods are used. The most popular multiple methods include P/E multiple, market to book multiple, price to revenue multiple, enterprise value to EBIT (or EBITDA) multiple. The most popular DCF methods include NPV, IRR, or EVA based methods, WACC method, APV method, CF to Equity method. The firm analyzed in the case study is a young firm with volatile income figures which makes it difficult to forecast future values. Therefore, DCF methods are not preferred for this firm. Among multiple methods, enterprise value to EBIT method is used which is also very suitable to our scenarios to find the market value of the firm.

Because the firm is a knowledge intensive firm (a non-capital intensive firm) depreciation and amortization costs are very small. Therefore, for the enterprise value multiples method operating result (EBIT) will be used. From the review of enterprise value multiples by industry, relevant multiple for a knowledge-intensive firm (e.g. a financial administration firm) was considered to be around thirteen. Below enterprise value of the firm was calculated according to the original and adjusted income statements using the EBIT figure (amounts in euro):

- Current: $enterprise\_value_0$ = 71,249.87 x 13 = 926,248.31
- First scenario: $enterprise\_value_1$ = 20,416.82 x 13 = 265,418.66
- Second scenario: $enterprise\_value_2$ = 36,990.79 x 13 = 480,880.27

Simply, it is possible to say that today the enterprise value of the firm is around 1 million euro. However, if the firm is sold, due to the discounted price because of owner-dependence around 0.7 million euro and 0.45 million euro of the firm value may be lost according to scenario one and two respectively. From the valuation figures it is seen that moderate reduction in the revenue leads to a huge loss in the value of the firm which is primarily due to fixed huge personnel costs.

The graph below illustrates the final outcome of the case study. Vertical arrow represents the market value of the firm, and horizontal arrow indicates the time since the firm was founded by the owner. Horizontal difference between C and F or L and G refers to the period of exit planning. For this firm the average period for such an exit plan is assumed to be around five years. Vertical difference between C and L in year eight (today) refers to the potential loss which may occur in an instant acquisition attempt due to owner-dependence. This potential losses have been found to be 0.7 million (or 0.45 million euro). In year thirteen, vertical difference between G and F indicates valuation gain as the owner.

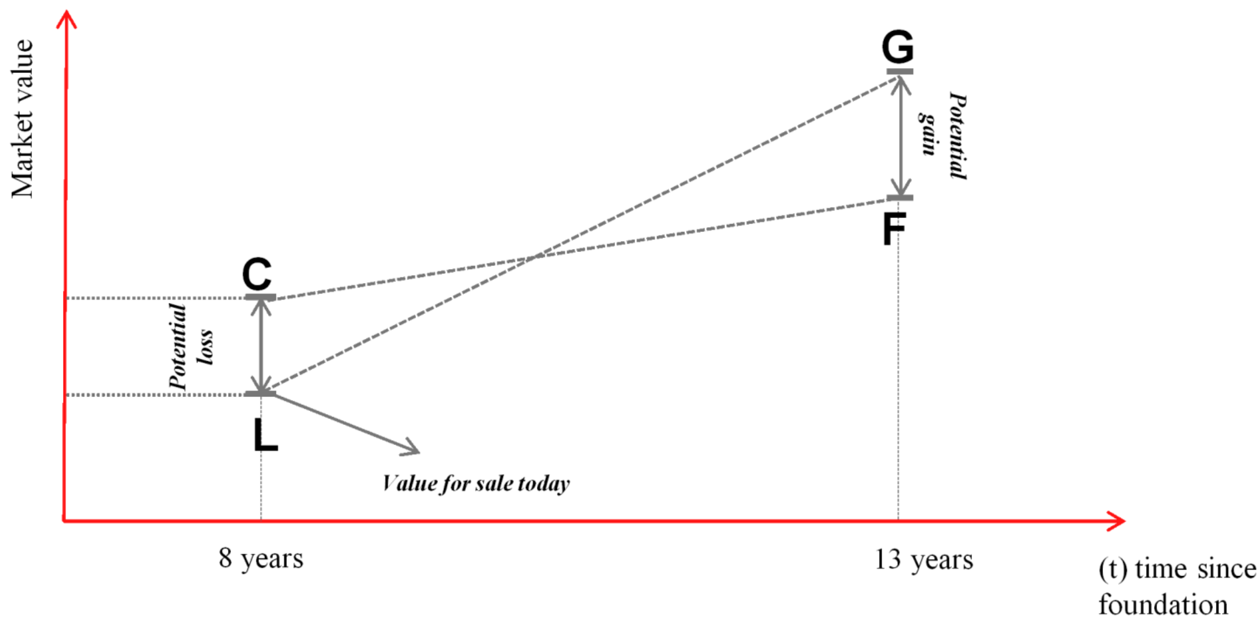


Figure 14 Potential valuation loss (gain)

C – current market value of the firm today (with the owner)

L – potential sale price of the firm today

F – market value of the firm in the future (with the owner)

G – potential sale price of the firm in the future

Vertical difference between C and F refers to the increase in the value of the firm with the owner as the firm continues to operate under the same conditions. However, vertical difference between L and G refers to the increase in the sale value of the firm without the owner as the negative and positive aspects of owner-dependence are improved and non-existent aspects are adopted on an average five year period. Dashed lines between C and G or C and F are symbolic. Because it is not practical to find out the changes in market value of the firm over the next five years, dashed lines have been used to show the overall change.

If the owner plans to exit the business after several years, he can improve negative and positive aspects and adopt non-existent aspects for total owner-independence and thereby achieve potential valuation gain in the future.

Conclusion

The first objective we set was to provide opening information about knowledge intensive firms (KIFs) and a big challenge they face during sale process. We have done so by providing information over KIFs collected from scholarly articles, their taxonomy in which classical KIFs are pointed out. Later, we emphasize and explain one major problem that these firms experience which is owner-dependence. After getting familiar with KIFs and the term owner-dependence, we provided general theories over valuation of KIFs. Importance of knowledge and value creation mechanism in KIFs was explained and value constituents were identified.

The second goal was to design a framework for owner-dependence and incorporate it in a qualitative valuation of a classical KIF. Here elements and their respective aspects associated with owner-dependence in terms of classical KIFs were brought together in a simple framework to be able to distinguish between owner-dependent and -independent business. Aspects of every element were explored and explained in terms of owner-dependence. Lastly, this framework was used to determine potential valuation loss/gain in an acquisition attempt of the firm.

Results of the case study in the last chapter indicate the relevance of owner-dependence being conceived as a threat to the value of a firm. As the qualitative study of the framework elements pointed out weak, strong and lacking points, depending on the subjective opinion of a potential buyer, the firm will have to face discounted price during sale process. However, there also remains big opportunities toward complete owner-independence if achieved will not only preserve but increase the perceived value of the firm.

Briefly summing up, we have designed a framework for owner-dependence in classical KIFs using various academic resources and incorporated it in a qualitative valuation of small classical KIF to determine the valuation loss/gain the firm will face during sale process in terms of owner-dependence.

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Appendix

A. Interview questionnaire

➔ Key employee interview questionnaire

-- ***Departure of key employees*** --

1. How many years have you been working in the firm and what is your function currently?
2. How have you started working in the firm?
3. Are you well satisfied with your current position and the work you do?
4. Do you have other relationship with the owner besides being an employee?
5. Do you see him as the owner, employer, friend or even closer familiar?
6. Would you stay in the firm if the owner sold it to somebody else?
7. If yes, what are the reasons you would leave the firm?
8. If no, what are the reasons you would stay in the firm?
9. Would you like to stay if certain conditions were provided for you by the new owner?

--- ***Operational Autonomy*** ---

10. Do you have reasonable amount of operational autonomy to conduct all your responsible tasks by yourself?
11. How much are you independent from the manager (chief administrator) to take initiatives for solving emerging problems besides your daily routine tasks?
12. If any problems occur, who is the one blamed and how are these problems resolved?

-------------------------------------- ***Close on-one client relationships*** -----------------------------------

13. Approximately how many clients of the firm do you know personally?
14. How close do you keep relationships with your clients? What is the degree of formality and informality?
15. Do you help your clients in most of the matters related to the work?

16. Do your clients also receive the same service from other employees or are you the only one your clients come to for the same type of work?
17. How willing are they to have the same service from other employees?
18. Are the clients satisfied the same degree with the other employees in the firm for the same service?
19. In case you decide to leave the firm, can it affect the clients' decisions to work with the firm?
20. If yes (no), what do you see as main reasons for it to happen?

➔ Manager interview questionnaire

1. How many years have you been working in the firm and what is your function currently?
2. How much are you independent from the owner?
3. In what cases do you consult the owner of the firm?
4. What kind of leadership do you practice in the firm?
5. How much operational autonomy do you give to the employees?
6. Approximately how many clients in the clientele base do you recognize to come from your personal network or to be gained by reputable brand name?
7. Do you see yourself as a successor-manager? Would you stay in the firm if the owner sold it to somebody else?
8. What would be possible reasons behind your stay or departure?
9. In case of ownership change, do you expect transition of client relationships to the new owner to be troublesome?
10. What would be possible reasons behind this trouble?

➔ Owner interview questionnaire

1. What was the main reason that you founded the firm?
2. Have you ever considered selling the business at some point in the future?
3. Do you have any function in the firm besides being a major shareholder?
4. Do you see yourself as a completely redundant owner?

5. Have you fully institutionalized all your knowledge and expertise related to all the aspects of the business?
6. Have you appointed the chief administrator as a manager in the firm? What was the main reason behind this action? Can you show him as a stable manager in case of selling your firm?
7. Approximately how many clients in the clientele base do you recognize to come from your personal network or to be gained by reputable brand name?
8. Buyers pay special attention to the future of current client relationships. Do you think your clients will stay with the firm if you decide to sell it to somebody else?
9. Are there any ways you can guarantee to the buyer that majority of the clients are going to stay and what would the possible ways to ensure this transition?
10. Buyers also pay special attention to the threat of key employees departing. Do you think your employees will stay in the firm if you decide to sell it to somebody else?
11. Are there any ways you can guarantee to the buyer that key employees are going to stay and what would the possible ways to ensure this?

B. Framework for owner dependence

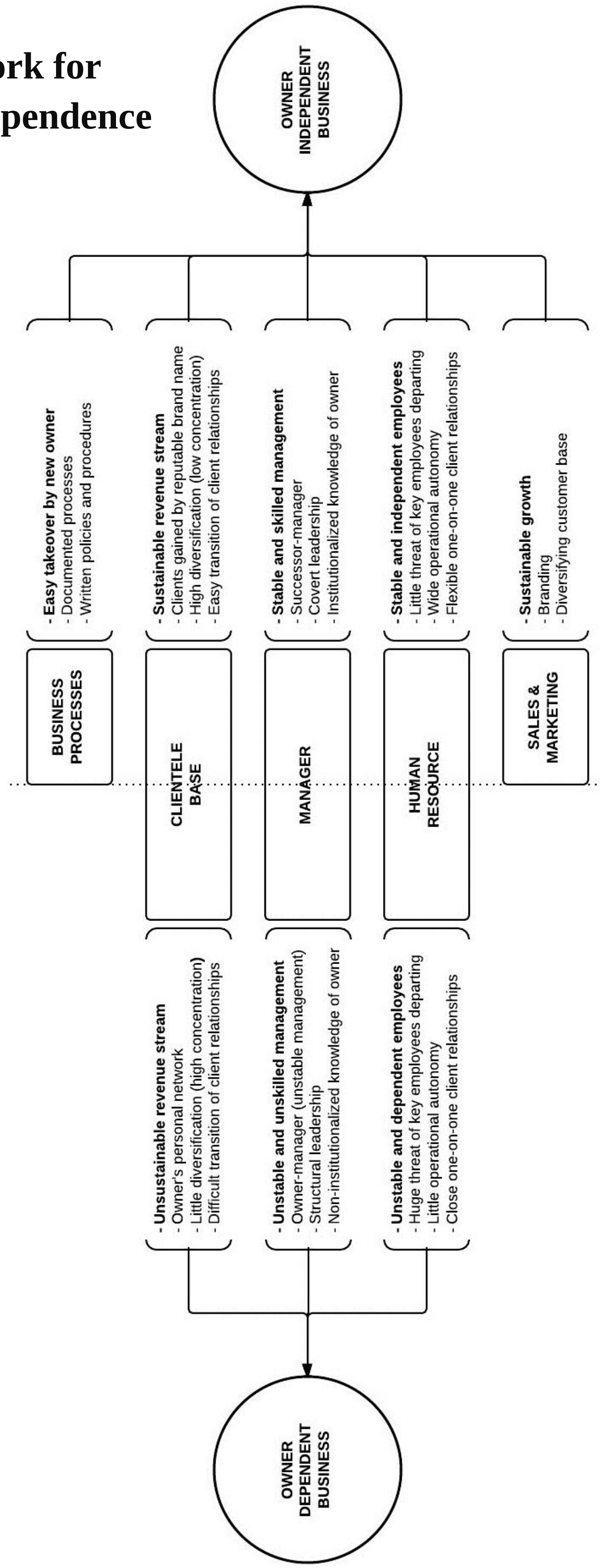

Figure 15 Framework for owner-dependent vs. –independent firm