

Investment Prospecting: Building Business Valuation through Strategic Planning

Donald R. Libey and Kevin Hillstrom

Every activity of a catalog, direct marketing or e-commerce business impacts the ultimate, tertiary valuation of the business enterprise, the resultant financial worth of the business at the execution of the exit strategy. For over a century, the direct marketing industry has prospected for new customers based on the short-term dynamics of response and immediate return on investment. Now, we suggest that a different view and a new strategic direction are essential for those forward-looking business shareholders desiring to influence and structure their end game business valuations for maximally abundant and satisfying “harvest events.”

The Historic View of Prospecting

Prospecting for new customers has traditionally been predicated on the amount of money available in the annual budget for prospecting, an intellectual *non sequitur* that has always been benignly enigmatic on the surface and, perhaps, fulminatingly insidious underneath.

Determining the number of new customers to be acquired on an annual or periodic basis has, most often historically, been determined by the total number of mailings necessary to create the total number of new customers necessary to create--within a prescribed level of expenditure--the approvals of the CEO and the board of directors. In other words, one backed into the prospecting plan through the door marked “Net Earnings.” Inevitably, catalog and direct marketing companies—and now e-commerce companies—created the new customer prospecting plan from the bottom line up; almost never was the prospecting plan derivative of the top line, or a defined strategy. This historical and largely unspoken dichotomy can be comparatively phrased as the philosophic difference between, “How many new customers can we afford?” and “What is the future value of a new customer acquisition to the future value of the enterprise?” Stated another way, the dichotomy can be interpreted as the difference between “short term, quarterly earnings-driven companies” and “tertiary, end game value-driven companies.”

To understand the broad history of prospecting attitudes and, therefore, activity, it is essential to view prospecting through the eyes of the catalog business owner of the 1950-1980’s Entrepreneurial Management Era. This period was characterized by strong, individualistic entrepreneurs who possessed proprietary knowledge about both niche markets and direct marketing techniques. In both the consumer and business-to-business arenas, dominating entrepreneur/owners pioneered and mastered the fundamentals of what is now nostalgically called “mail order marketing.” Often a seat-of-the-pants style of management, the balance between growth and profitability was maintained by the masters through close management of cash flow, inventories and prospecting. The hallmarks of this era of direct marketing were high response rates, high margins, high number of inventory turns, low overhead and low advertising costs resulting in above average levels of profitability. The predominant management structure was marketing-focused.

The Entrepreneurial Management Era evolved a cash-conscious, autocratic prospecting ethos. The owners, often first-generation, start-up operators, prospected up to the level of their operating cash comfort tolerance. This period was marked by its dominant prospecting strategy: “Put a lot of stuff in the mail, and people send you money!” As long as adequate cash was on hand to meet payroll and keep up the second mortgage on the house, the comfort level on prospecting could be moved up. Buying product was secondary since delivery times were three to six weeks; when the money came in, the products could then be purchased to fill the orders. Major corporations were built on the formulaic certainty of prospect response, the financial leverage of inventory-on-demand, and the simplistic prospecting strategy of, “mail more.”

With the entrepreneurial prospecting attitudes of the 1950s to the 1980s as the antecedent of today’s prospecting state-of-the-industry, it is clear that the industry has been, and continues to be, influenced by the short-term view. The past owners taught the present owners; the seasoned, present-day senior managers—who came into the industry in the 1970s and 1980s—learned from the entrepreneurs. And they learned well. The catalog and direct marketing industry has flourished and grown by magnitudes under their leadership. However, prospecting strategy and business valuation are still upside down.

Business Valuation

As advisors, we are asked every day to place a value on catalog companies. Of course, while there are rules of thumb, the only accurate valuation is the one assigned by the marketplace itself: the business is worth what someone will pay for it. The hallmark of value, however, is, has been and always will be earnings. A business with high earnings generally has a high valuation; a business with low or no earnings has, generally, a low valuation. If one summarizes broadly, one can speculate that an average catalog company with average earnings will be worth anywhere from 4 to 7 times earnings (earnings before income taxes, depreciation, and amortization, or EBITDA). Consequently, if \$1.00 from prospecting can be added to EBITDA, that \$1.00 is worth \$4.00 to \$7.00 at the “harvest event,” the sale of the business. Put another way, every \$1.00 resulting from a successful investment prospecting strategy puts an additional \$4.00 to \$7.00 in the shareholder’s pocket when the business is sold. That is usually better than compound interest, life insurance or the rate of return on CDs.

This quite startling revelation often causes owners to view *every* activity of the catalog company with fresh motivation. A seven-time return on *any* activity is positively stimulating to many; for the very first time, some owners begin to lead a “life examined.” And that examination inevitably leads to the realization of the truth of the Value Premise: *the only reason for any strategic and tactical decision is the outcome impact on end game business valuation*. Start with and focus intensely on that concept and you begin to understand the supreme importance and value significance of “end game strategy.”

There are several alphas and omegas of end game strategy. A catalog owner likely begins by being an early product master and then evolves into a marketing master; along the way, masteries of catalog creative, lists, circulation, and offers are accumulated; over time, one masters pagination subtleties, fulfillment, and e-commerce, as well as a litany of lesser skills. The resulting catalog master is, however, but an operating master. Several other masteries are necessary to produce the fully furnished and fire-burnished Master Cataloger: finance must be learned; people management must become innate; acquisitions must be experienced; international expansion must be tasted; and, in the end, *succession* and *mortality* must be faced and recognized. That is the essence of the mastery of the end game and the recognition of the Value Premise:

The only reason for any strategic and tactical decision is the outcome on end game business valuation.

Generally within the first ten minutes or so of a conversation with an owner or CEO, we obtain an indication of the level of mastery that has occurred. Focus on product, or market, or creative processes indicate “mastery in progress.” Focus on the end game harvest indicates an awareness of the Value Premise. To speak of strategic directions for business building is vastly different than speaking of strategic directions for wealth harvesting. The point: unless the multiple of earnings (EBITDA) is understood and the Value Premise has been integrated into the stable financial performance of the business, the business is not ready for harvest. For that reason, the critical issue for many, if not most, owners remains Investment Prospecting.

The Two Prime Metrics

With over a combined half-century of experience, we contend that there exist two Prime Metrics having influence on the Value Premise and, therefore, on the basis of Investment Prospecting. They are:

1. The cost to acquire a customer, to the penny, in every channel, by every promotion, and in the aggregate, known weekly for twenty rolling quarters of history at the minimum;
2. The EBITDA value of that customer, at a logical, fixed, harvest point in the future, to the enterprise value of the business.

If these two metrics are known, every prospecting decision becomes inextricably linked to the future invested value of the business; in effect, present prospecting is determined by future EBITDA outcome, by definition a more beneficial strategic premise than the customary, seat-of-the-pants, “back door” method cobbled together to obtain short term approbation for next quarter’s mailing plan.

With the two Prime Metrics in hand, much can be accomplished. The Financial Plan for the enterprise can be created with solidity and a specific goal: future wealth harvesting for the shareholder(s). What else is there? Having accomplished over one hundred Strategic Plans for client companies, never have we found a parallel Financial Plan extant for delivering the harvest of wealth upon the execution of the strategic and tactical goals and objectives. Not once.

The Financial Plan—developed in concert with the Strategic Plan—allows the owner or CEO of the multichannel company to view and plan prospecting expense within the Value Premise and to establish EBITDA outcome hurdles at a specific point in the future at which wealth is to be harvested. “If I spend \$1,000 in investment prospecting today, I obtain \$7,000 in EBITDA in three years.” With this clear goal in view, the owner or CEO then has the responsibility of determining the prospecting mail plan that accomplishes that clear and defined goal.

The Media Partner

For many organizations having senior catalog marketing managers schooled in the traditional method of media and mail planning, it will be difficult to create an understanding of the Value Premise; these veterans are simply classically conditioned to short-term profits. With a

full explanation and a strategic repositioning, however, it may be possible to influence the thought and planning processes. The media partner is an essential element in the equation.

The difference between a prospecting plan for orders and a prospecting plan for future EBITDA is enormous. Few traditional list brokerage houses will even understand the difference, much less be able to calculate the potential using your *pro forma* EBITDA financial projections. But, before you can harness expertise, you must share your Financial Plan.

The Financial Plan doesn't need to be terribly complicated. The Financial Plan can be a simple spreadsheet, one that illustrates what happens five years from now if you make certain decisions today. For example, take a look at this business, modeled via a spreadsheet model.

Multichannel Forensics: Single Channel Investment Simulation

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Power Function: 0.50

	Base Re-Purchase Rate	Spend Per Purchaser	Base Investment Per Customer	Actual Investment Per Customer	Estimated Re-Purchase Rate	Estimated Spend per Re-Purchaser	Beginning Inventory	After Year 1	After Year 2	After Year 3	After Year 4	After Year 5
0 to 12 Month, Existing Buyers	65.00%	\$300.00	\$15.00	\$15.00	65.00%	\$300.00	100,000	117,450	126,641	133,089	138,476	143,454
0 to 12 Month, New Buyers	45.00%	\$225.00	\$13.00	\$13.00	45.00%	\$225.00	50,000	50,000	50,000	50,000	50,000	50,000
13 to 24 Month Buyers	20.00%	\$200.00	\$7.00	\$7.00	20.00%	\$200.00	65,000	62,500	60,608	59,824	59,081	58,367
25 to 36 Month Buyers	12.00%	\$190.00	\$5.00	\$5.00	12.00%	\$190.00	65,000	60,000	54,886	49,459	43,920	38,285
37 to 48 Month Buyers	7.00%	\$180.00	\$4.00	\$4.00	7.00%	\$180.00	45,000	57,200	59,840	61,400	62,800	64,050
49 to 60 Month Buyers	4.00%	\$170.00	\$3.00	\$3.00	4.00%	\$170.00	25,000	41,850	53,196	63,851	73,500	82,150
61+ Month Buyers	2.00%	\$160.00	\$2.00	\$2.00	2.00%	\$160.00	50,000	73,000	111,716	160,550	210,764	263,832
New To File: Rest Of Year		\$100.00	\$6.50	\$6.50	100.00%	\$100.00						
New To File: First Purchase		\$100.00					50,000	50,000	50,000	50,000	50,000	50,000
New Customers: Base Investment							\$1,500,000	\$1,500,000	\$1,500,000	\$1,500,000	\$1,500,000	\$1,500,000
New Customers: Investment Change By Year								1,000	1,000	1,000	1,000	1,000
New Customers: Total Cost Per Customer							\$30.00	\$30.00	\$30.00	\$30.00	\$30.00	\$30.00
Customer Spending Inflation, By Year								1.000	1.000	1.000	1.000	1.000
Advertising Inflation, By Year								1.000	1.000	1.000	1.000	1.000
Profit And Loss Statement								After Year 1	After Year 2	After Year 3	After Year 4	After Year 5
Demand							\$40,341,500	\$43,254,550	\$45,114,906	\$46,585,769	\$47,899,895	\$48,989,895
Net Sales					75.0%		\$30,256,125	\$32,440,913	\$33,836,179	\$34,939,326	\$35,924,921	\$36,812,921
Gross Margin					55.0%		\$16,640,869	\$17,842,502	\$18,609,899	\$19,216,630	\$19,758,707	\$20,235,707
Less Marketing Cost							\$5,250,000	\$5,514,600	\$5,727,240	\$5,912,584	\$6,085,490	\$6,245,490
Less Pick/Pack/Ship Expense					12.0%		\$4,840,980	\$5,190,546	\$5,413,789	\$5,590,292	\$5,747,987	\$5,889,987
Variable Operating Profit							\$6,549,889	\$7,137,356	\$7,468,870	\$7,713,753	\$7,915,230	\$8,082,921
Less Fixed Costs							\$4,000,000	\$4,120,000	\$4,243,600	\$4,370,908	\$4,502,035	\$4,637,035
Earnings Before Taxes							\$2,549,889	\$3,017,356	\$3,225,270	\$3,342,845	\$3,413,195	\$3,445,886
EBT as a Percentage Of Net Sales							8.4%	9.3%	9.5%	9.6%	9.5%	9.5%
Variable Profit, 12 Month Buyers							\$6,437,389	\$7,024,856	\$7,356,370	\$7,601,253	\$7,802,730	\$7,973,730
Number of 12 Month Buyers							167,450	176,641	183,089	188,476	193,454	198,454
Profit per 12 Month Buyer							\$38.44	\$39.77	\$40.18	\$40.33	\$40.33	\$40.33
Variable Profit, New Customer Acquisition							\$112,500	\$112,500	\$112,500	\$112,500	\$112,500	\$112,500
Number of New Buyers							50,000	50,000	50,000	50,000	50,000	50,000
Profit per New Buyer							\$2.25	\$2.25	\$2.25	\$2.25	\$2.25	\$2.25

By all accounts, this is a very profitable business, generating Earnings Before Taxes of between 8.4% and 9.5% per year. This business is growing, both from a Net Sales and an Earnings perspective.

Now let's view the business from the context of maximizing long-term profit. Let's double the amount of money spent on New Customer Acquisition, for each of the next five years. Can we improve upon the profitability of a \$48 million dollar business that generates \$3.4 million dollars of pre-tax profit in five years? If we begin to lose money on customer acquisition, can we still cause the overall health of the business to improve?

Multichannel Forensics: Single Channel Investment Simulation

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Power Function: 0.50

	Base Re-Purchase Rate	Spend Per Purchaser	Base Investment Per Customer	Actual Investment Per Customer	Estimated Re-Purchase Rate	Estimated Spend per Re-Purchaser	Beginning Inventory	After Year 1	After Year 2	After Year 3	After Year 4	After Year 5
0 to 12 Month, Existing Buyers	65.00%	\$300.00	\$15.00	\$15.00	65.00%	\$300.00	100,000	117,450	135,960	150,745	163,296	174,389
0 to 12 Month, New Buyers	45.00%	\$225.00	\$13.00	\$13.00	45.00%	\$225.00	50,000	70,711	70,711	70,711	70,711	70,711
13 to 24 Month Buyers	20.00%	\$200.00	\$7.00	\$7.00	20.00%	\$200.00	85,000	62,500	79,998	86,477	91,651	96,045
25 to 36 Month Buyers	12.00%	\$190.00	\$5.00	\$5.00	12.00%	\$190.00	65,000	68,000	50,000	63,999	69,182	73,321
37 to 48 Month Buyers	7.00%	\$180.00	\$4.00	\$4.00	7.00%	\$180.00	45,000	57,200	59,840	44,000	56,319	60,880
49 to 60 Month Buyers	4.00%	\$170.00	\$3.00	\$3.00	4.00%	\$170.00	25,000	41,850	53,196	55,651	40,920	52,377
61+ Month Buyers	2.00%	\$160.00	\$2.00	\$2.00	2.00%	\$160.00	50,000	73,000	111,716	160,550	210,764	245,632
New To File: Rest Of Year		\$100.00	\$6.50	\$6.50	100.00%	\$100.00						
New To File: First Purchase		\$100.00					50,000	70,711	70,711	70,711	70,711	70,711
							\$1,500,000	\$3,000,000	\$3,000,000	\$3,000,000	\$3,000,000	\$3,000,000
New Customers: Base Investment								2,000	1,000	1,000	1,000	1,000
New Customers: Investment Change By Year							\$30.00	\$42.43	\$42.43	\$42.43	\$42.43	\$42.43
New Customers: Total Cost Per Customer								1,000	1,000	1,000	1,000	1,000
Customer Spending Inflation, By Year								1,000	1,000	1,000	1,000	1,000
Advertising Inflation, By Year								1,000	1,000	1,000	1,000	1,000
Profit And Loss Statement								After Year 1	After Year 2	After Year 3	After Year 4	After Year 5
Demand							\$44,483,636	\$49,493,642	\$53,626,994	\$57,061,633	\$60,050,050	
Net Sales	75.0%						\$33,362,727	\$37,120,231	\$40,220,246	\$42,796,225	\$45,037,538	
Gross Margin	55.0%						\$18,349,500	\$20,416,127	\$22,121,135	\$23,537,924	\$24,770,646	
Less Marketing Cost							\$6,884,619	\$7,418,458	\$7,850,631	\$8,229,413	\$8,585,332	
Less Pick/Pack/Ship Expense	12.0%						\$5,338,036	\$5,939,237	\$6,435,239	\$6,847,396	\$7,206,006	
Variable Operating Profit							\$6,126,844	\$7,058,432	\$7,835,264	\$8,461,114	\$8,979,308	
Less Fixed Costs							\$4,000,000	\$4,120,000	\$4,243,600	\$4,370,908	\$4,502,035	
Earnings Before Taxes							\$2,126,844	\$2,938,432	\$3,591,664	\$4,090,206	\$4,477,273	
EBT as a Percentage Of Net Sales							6.4%	7.9%	8.9%	9.6%	9.9%	
Variable Profit, 12 Month Buyers							\$6,846,425	\$7,778,013	\$8,554,845	\$9,180,695	\$9,698,889	
Number of 12 Month Buyers							188,161	206,671	221,455	234,007	245,099	
Profit per 12 Month Buyer							\$36.39	\$37.63	\$38.63	\$39.23	\$39.57	
Variable Profit, New Customer Acquisition							(\$719,581)	(\$719,581)	(\$719,581)	(\$719,581)	(\$719,581)	
Number of New Buyers							70,711	70,711	70,711	70,711	70,711	
Profit per New Buyer							(\$10.18)	(\$10.18)	(\$10.18)	(\$10.18)	(\$10.18)	

In this example, we trade short-term profit for long-term gain. We sacrifice a half-million dollars of profit over the next two years, yielding a business that generates \$60 million in Net Sales and \$4.5 million in Earnings. By making this subtle change, we significantly improve the value of this business ... by five million dollars if the business is sold in five years!

This investment decision is an easy one, one that benefits all. The investment decision didn't require anything more than a strategic review of the short-term and long-term tradeoffs associated with customer acquisition decisions.

Many years ago, many catalogs ago, we assembled all of the suppliers to the catalog business and outlined our Financial Plan for EBITDA at five years in the future. The creative suppliers were present; the print production suppliers were there, down to the actual press operators who would be printing the catalog; the paper merchant was present; the list broker was there; the merge-purge house was represented; in short, every key player was at the table and was included in the "success stake." The objective suddenly was no longer, "get a prospecting catalog out" but "create a cooperative prospecting effort that will deliver \$700,000 additional EBITDA in five years."

The list broker delivered a prospecting mailing plan that was markedly different. It was created not with response objectives, but with EBITDA objectives. A self-imposed hurdle had been set that focused on lists and carefully thought out segmentations that would produce future wealth, not just short-term orders or the simple expediences of a blind, "block-box" membership co-op solution. That was a significant process change and a significant strategic enhancement. The brokerage firm no longer "rented names" but rather, "created wealth" for our catalog. With this strategic partner approach, the catalog not only met its five-year objective, it exceeded it by nearly 1,000 percent. The point: the creation of a fully furnished Financial Plan, born out of the Value Premise, in concert with an effective Strategic Plan, shared with Trusted Advisor vendors who are committed to understanding and achieving a higher strategic intelligence, is the surest path to the desired maximally abundant and satisfying harvest event.

Owners, board members, CEOs and shareholders . . . Go forth and harvest!

About The Authors:

Kevin is President of MineThatData, a consultancy that helps CEOs understand the complex relationship between Customers, Advertising, Products, Brands, and Channels. Kevin supports a diverse set of clients, including internet startups, thirty million dollar catalog merchants, international brands, and billion dollar multichannel retailers.

Prior to founding [MineThatData](#), Kevin held various roles at leading multichannel brands, including Vice President of Database Marketing at Nordstrom, Director of Circulation at Eddie Bauer, and Manager of Analytical Services at Lands' End. Kevin is President of MineThatData, a consultancy that helps CEOs understand the complex relationship between Customers, Advertising, Products, Brands, and Channels. Kevin supports a diverse set of clients, including internet startups, thirty million dollar catalog merchants, international brands, and billion dollar multichannel retailers.

Donald R. Libey is president of Libey Incorporated. He is a well-known international advisor, M&A intermediary and forensic performance analyst to CEOs and boards of multichannel marketing companies here, in the U.K and in Europe.

He is a specialist in multichannel growth strategies, performance metrics and optimization strategies to maximize corporate valuation. He is the author of ten books on direct marketing, including *Libey and Pickering on RFM and Beyond*, (first and second editions) co-written with Christopher Pickering and published by MeritDirect Press and is the author of the *Libey Multichannel Advisor*, a monthly newsletter now in its 20th year. In mid-2009, he will launch the new online direct marketing hub, *Libey's Daily DM* www.DailyDM.com, a news, information, resource and education center for direct marketers worldwide.

He has been the CEO, owner or senior executive of numerous catalog companies over the past thirty years and sits on the boards of a number of large multichannel companies in the U.S. and in the U.K. Don lives in Des Moines, Iowa and Wiltshire, England. He can be reached at www.libey.com, email libey@libey.com.

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