DIFFERENCE MAKERS: KEY PERSON(S) VALUATION

The business value of a person or people

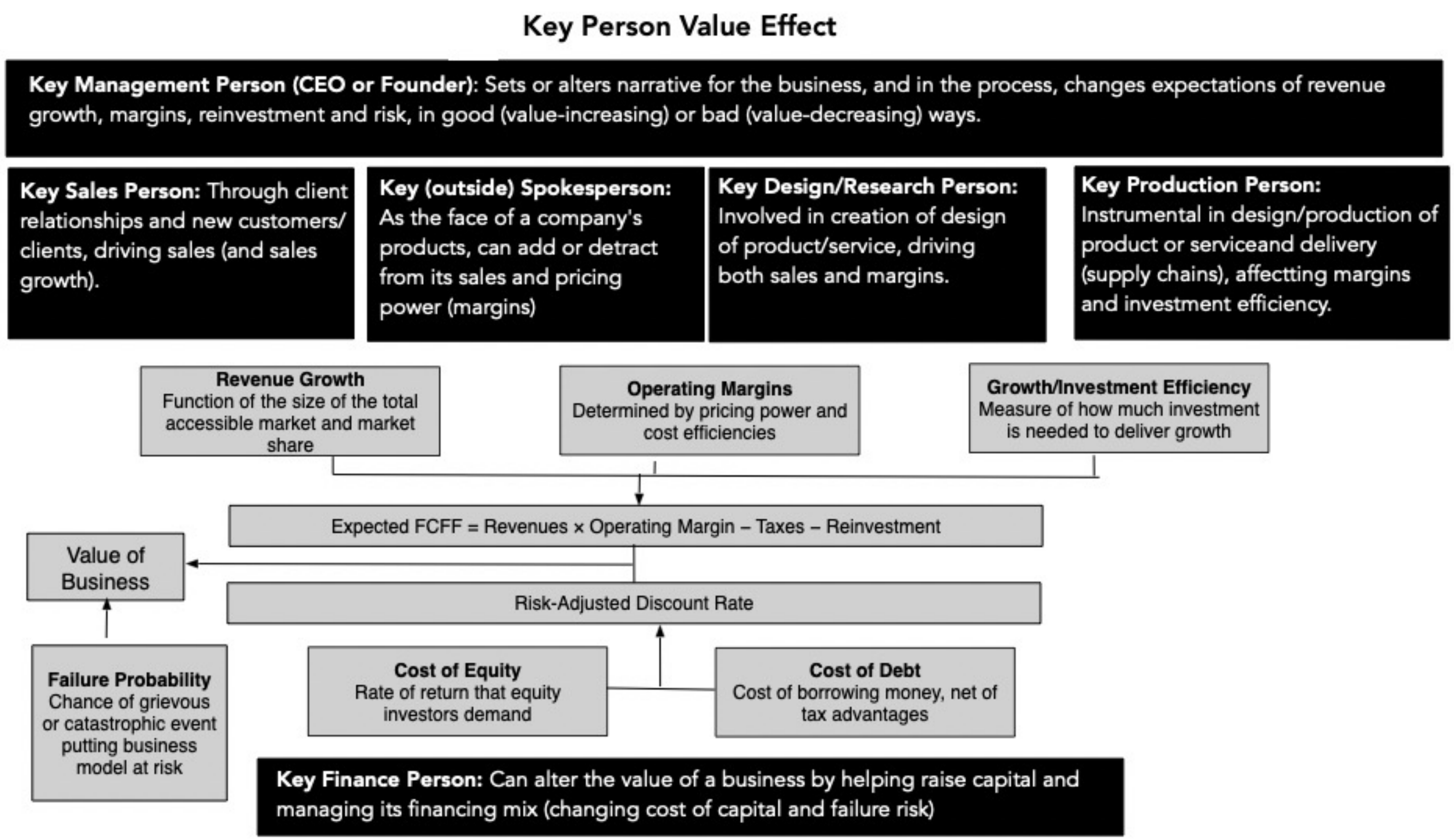
The Lead In

- Can one person make a difference to the value of a business? Of course, and with small businesses, especially those built around personal services (a doctor or plumber’s practice), it is part of the valuation process, where the key person is valued or at least priced and incorporated into valuation.
  - While that effect tends to fade as businesses get larger, the tumult at Open AI, where the board dismissed Sam Altman as CEO, and then faced with a meltdown in the enterprise.
  - In fact, at Tesla, a company that I have valued at regular intervals over the last decade, the question of what Elon Musk adds or detracts from value has become more significant over time, rather than fading.
  - Charlie Munger's passing at the age of ninety-nine brought to a close one of the most storied key person teams of all time at Berkshire Hathaway, and generations of investors who had attached a premium to the company because of his presence mourned.

Key Person: The Who?

- It starts of course with **founders who create organizations** and lead them through their early years and extends into top managers, partly because they represent their companies to the rest of the world, but because they mold these companies, at least in their formative years.
- Staying at the top, **CEOs for companies** often become entwined with their companies, especially as their tenure lengthens. From Alfred Sloan at General Motors to Jack Welch at General Electric to Steve Jobs at Apple, there is a history of CEOs being tagged as superstars (and indispensable to the organizations that they head), in successful companies
- As you move down the organization, there can be **key players in almost every area**, with a scientist or scientists at pharmaceutical companies who come up with pathbreaking discoveries that become the basis for blockbuster drugs or a design specialist.
- In businesses driven by selling, a **master-salesperson or dealmaker** can become a central driver of its value, bringing in a clientele that is more attached to the sales personnel than they are to the organization providing the product or service.
- In people-oriented businesses, especially in service, a **manager or employee that cultivates strong relationships with customers, suppliers and other employees**, can be a key person, with the loss of that person leading to not just lost sales, as clients flee, but create ripple effects across the organization.
- In some businesses, the **key person may not work for the organization** but contribute a significant amount to its value as a spokesperson or advertising person. In sports and entertainment, for instance, business can gain value from having a celebrity representing them in a paid or unpaid capacity.

Key Person: Pathways to Value



Key Person Valuation: Three Approaches

1. Key person valuation: You value the company twice, once with the key persons included, with all that they bring to it's cash flows and value, and then again, without those key persons, reflecting the changes that will occur to value inputs:

Value of key person(s) = Value of business with key person - Value of business without key person

2. Replacement Cost: In some cases, the value of a key person can be computed by estimating the cost of replacing that person. Thus, key people with specific and replicable skills, such as skilled scientists or engineers, may be easier to value than key people, with fuzzier skill sets, such as strong connections and people skills.

3. Insurance cost: Finally, there are some key people in an organization who can be insured, where insurance companies, in return for a premium payment, will pay out an amount to compensate for the loss of these key people. For companies that buy insurance, the key person value then become monetized as a cost, reducing the value of these companies when the key person is present, while increasing its value, when it loses that person.

Value Implications

- Differences across firms: The key person valuation approach, while general, can not only yield different values for key people in different firms. There is no “one-size-fits-all”.
- Positive or Negative: The approach can also generate a value effect that is negative for a key person whose influence on value that is malignant.
- Changes over time: Finally, the framework can also help explain how the value of a key person can evolve over time, from a huge positive at one stage of an organization to neutral later or even a huge negative, explaining why some key people get pushed out of organizations, including those that they may have founded.

Key Person: Pricing in Private Business Appraisals

- In appraisal practice, the effect of the potential loss of an owner, founder or other key person in a business that you are acquiring is usually captured with a key person discount, where you price the business first, based upon its existing financials (earnings, growth and cash flows), and then reduce that pricing by 15%, 20% or more to reflect the absence of the key person.
  - Shannon Pratt, in his widely used work on valuing private companies, suggested a key person discount of between 10%-25%, though he left the number almost entirely to appraiser discretion.
  - In addition, the nature of private company appraisal, where valuations are done for tax or legal purposes, has also meant that the acceptable levels of discount for key people have been determined more by courts, in their ruling on these valuations, than by first principles.

Key Person: Market Reactions to CEO Deaths

- In the HBO hit series, Succession, the death of Logan Roy, the autocratic CEO of the company causes the stock price of Waystar Royco, his family-controlled company, to drop precipitously.
- While that was fiction and perhaps exaggerated for dramatic effect, there is research that looks at the market reaction to the deaths of CEOs of publicly traded companies, albeit with mixed results.
  - A study of CEO deaths at 240 publicly traded companies between 1950 and 2009 finds that in almost half of all of these cases, the stock price increases on the death of a CEO, and unsurprisingly, the reactions tended to be negative with under-performing CEOs and positive with highly regarded ones.
  - Interestingly, this study also finds that the impact of CEOs, both positive and negative, was greater in the later time periods, than in earlier ones.
  - A different study documented that the stock price reaction to CEO deaths was greater for longer-tenured CEOs in badly performing firms, strengthening the negative value effect argument.

Key Person: Market Reactions to CEO Replacements/Retirements

1. CEO (forced) replacements: CEOs are most likely to be replaced in companies, where their policies are at odds with those that their shareholders desire, but given the powers of incumbency, change may require the presence of a large and vocal shareholder (activist), pushing for change.
   - To the extent that shareholders have good reasons to be disgruntled, the companies can be viewed as case studies for key-person negative value, where the top manager is reducing value with his or her actions.
   - Research on what happens to stock prices and company performance after forced replacements largely confirm this hypothesis, with stock prices rising on the firing, and improved performance following, under a new CEO.
2. CEO retirements: If CEO deaths represent unexpected losses of key people, and CEO dismissals represent the subset of firms where CEOs are more likely to be value-reducing key people, it stands to reason that CEO retirements should be more of a mixed bag.
   - Research backs up this hypothesis, with the average stock price reaction to voluntary CEO departures being close to zero, with a mildly negative reaction to age-related departures.
   - It is worth noting that market reactions tend to be much more positive, when CEOs are replaced by outsiders than by someone from within the firm, suggesting that shareholders see value in changing the way businesses are run.

Key Person: Market Reactions to Celebrity/ Spokespersons

- When **Tiger Woods**, who operated as a spokesperson or product endorser for five companies (Accenture, Nike, Gillette, Electronic Arts and Gatorade), had personal troubles that were made public, these five companies collectively lost 2-3% of their market value (about $5-12 billion).
- In an earlier episode, Nike also lost billions in market capitalizations, when **Michael Jordan**, an NBA superstar whose name-branded footwear (Air Jordan) had become a staple for Nike, unexpectedly announced in 1993, that he would be retiring from basketball, to play baseball.
- Finally, and this is perhaps a reach at this point, the biggest story coming out of the National Football League (NFL) this year has been the **Taylor Swift**-Travis Kielce romance, which in addition to creating tabloid headlines, has also increased NFL ratings, especially among women.

Managing Key Person Risks

1. Insurance: Smaller businesses that are dependent on a person or persons for a significant portion of their revenues and profits can buy insurance against losing them, with the insurance premia reflecting the expected value loss. You are trading lower earnings (because of the premiums paid) in periods when the key person is still present for higher earnings, when they are absent.
2. No-compete clauses: One of the concerns that businesses have with key people is not just the loss of value from their departure, but that they can take client lists, trade secrets or product ideas to a competitor. It is for this reason that companies put in no-compete clauses into employment contracts, but the degree of protection will depend on what the key person takes with them, when they leave.
3. Overlapping tenure: Since the key person reduces the sales proceeds to the old owner, there is an incentive to reduce the key person discount, and one practice that may help is for the old owner to stay on in an official or unofficial capacity, even after the business has been sold, to smooth the transition.
4. Team building: To the extent that key people can build teams that reflect and magnify their skills, they are reducing their key person value to the business. That team building includes hiring the “right’ people and not just offering them on-the-job training and guidance, but also the autonomy to act on their own.
5. Succession planning: A good succession plan starts of course by finding the person with the qualities that you believe are necessary to replicate what you do, as a successful manager, but being willing to share knowledge and power, ahead of the transfer of power.

The Key Person Conundrum

- Some of the actions that reduce key people value must come from those key people, and that may seem odd. After all, why would anyone want to make themselves less valuable to an organization?
- The truth is that from the organization's perspective, the most valuable key people find ways to make themselves more dispensable and less valuable over time by finding successors and building teams who can replicate what they can do. In doing so, they reduce their key person value.
- That may be at odds with the key person's interests, leading to a trade off a lower value added from being key people for a much higher value for the organization, and if they own a large enough stake in the latter, can end with being better off financially at the end.

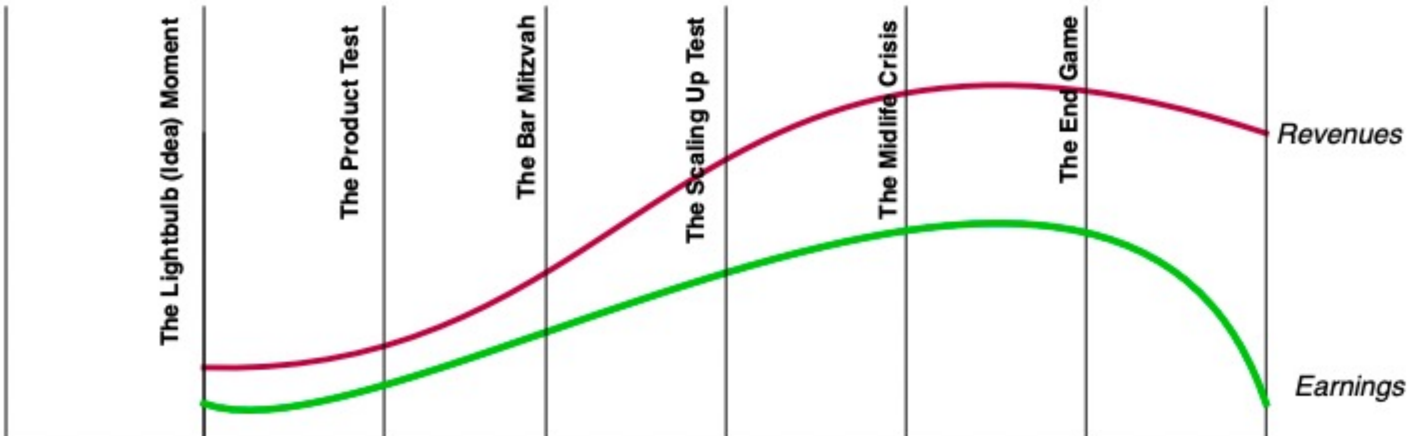
Determinants of Key Person Value

- The value of a key person or persons will vary across companies for many reasons.
  - Company size: A key person or persons will make a greater value difference at a small rather than a large firm.
  - Life cycle: All else held constant, a key person or persons will matter more at young than mature firms.
  - Micro versus Macro: A key person or persons will affect value more at firms that derive their value from micro (company-specific) choices than at firms that are macro-driven.
  - Business moats: A key person or persons will drive value more at companies that have more transitory moats (competitive advantages) than at firms with long-standing and sustainable moats.

1. Company Size

- In general, the value of a key person or persons should decrease as an organization increases in size.
  - The value added by a superstar trader will be greater if he or she works at a ten-person trading group than if they work at a large investment bank.
  - There are clearly exceptions to this rule, with Tesla being the most visible example, but at the largest companies, with hundreds or even thousands of employees, and multiple products and clients, it becomes more and more difficult for a single person or group to make a significant difference.

2. Stage in Life Cycle



Life Cycle Stage	**Start-Up**	**Young Growth**	**High Growth**	**Mature Growth**	**Mature Stable**	**Decline**
Management's Importance	Critical, in selling vision and creating business model		Decreases as firm matures, and more so in macro businesses			Significant, since denial or desperation can be costly
Management role in narrative/ numbers	Visionary/ storyteller	Stay consistent with words and actions	Deliver numbers to back up story	Keep narrative in sync with numbers	Adjust your narrative to reflect where you are in the life cycle.	Act your age (in terms of narrative and choices)
Key CEO Characteristics	Sell a vision (story) to investors and employees	Build a business model to deliver on vision	Scale up the business model	Extend the business model into new markets	Defend the business model against competitors	Scale down the business model
Key Person Value Effect	**Very High**	**---> High**	**---> Moderate**		**---> Lower**	**----> High**

Life Cycle Implications: Open AI and Tesla

- At OpenAI, for better or worse, it is Sam Altman who has been the face of the company, laying out the narrative for the future of AI, and Open AI remains a young company, notwithstanding its large estimated value. While the board of directors felt that he was on a dangerous path, the capital providers, which included not only venture capitalists, but Microsoft as a joint-venture investor, were clearly swayed by Altman's story, and Open AI's employees were loyal to him.
- With Tesla, the story is more complicated, but it has always revolved around Elon Musk.
  - As a young company, where investors and legacy auto companies viewed it as foolhardy in its pursuit of electric cars, Musk was indispensable to its growth and survival.
  - As Tesla has brought the rest of the auto business to its narrative, and become not just a successful company, but one worth a trillion or more at its peak, Musk has remained the center of the story, in good and bad ways. His vision continues to animate the company's thinking on everything from the Cryptotruck to robotaxis, but his capacity for distraction has also sometimes hijacked the narrative.
  - Thus, the debate of whether Musk, as a key person, is adding or detracting from Tesla's value has been joined, and while I remain convinced that heremains a net positive, since I cannot imagine Tesla without him, there are many who disagree with me.
  - At the same time, Musk is mortal, and it remains an open question whether he is willing to make himself dispensable, by not only building a management teams that outlasts him, but also a successor that he is willing to share power and the limelight.

3. Micro versus Macro Businesses

- There are some companies where value comes more from company-specific decisions on products/services to offer, markets to enter and pricing decisions, and others, where the value comes more from macro variables moving.
  - A media company, like Disney, where offerings constantly have to adjust to reflect changing demand and in response to competition, would be an example of the former, whereas an oil company, where it is the oil price that is the key determinant of revenues and earnings, would be an example of the latter.
  - In general, you are far more likely to find key people, who can add or take away from value at the former (micro companies) than at the latter (macro companies).

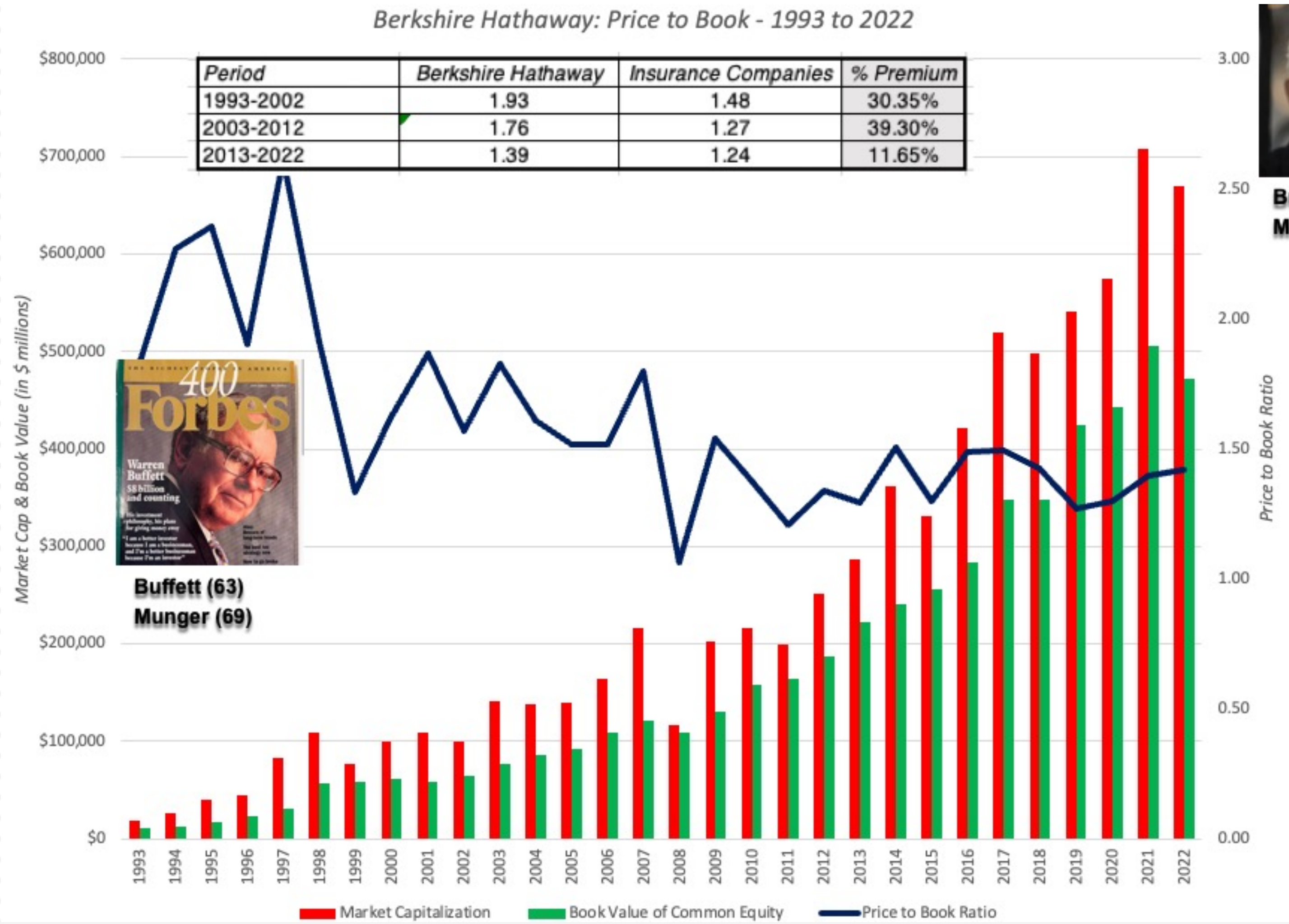
4. Business Moats

- Business moats refer to competitive advantages that companies have over their competitors that allow them to not just grow and be profitable, but to create value by earning well above their cost of capital.
- That said, moats can range the spectrum, both in terms of sources (cheap raw material, brand names, patents) as well as sustainability (some last for decades and others are transient). Some moats are inherited by management, and others are earned, and some are high maintenance and others require little care.
- In general, there will be less key person value at companies with inherited moats that are sustainable and need little care and more key person value at companies where moats need to be recreated and maintained. To illustrate, consider two companies at opposite ends of the spectrum.
  - At one end, Aramco, one of the most valuable companies in the world, derives almost all of its value from its control of the Saudi oil sands, allowing it to extract oil at a traction of the cost faced by other oil companies, and it is unlikely that there is any person or group of people in the organizational that could affect it value very much.
  - At the other end, an entertainment software company like Take-Two Software is only as good as its latest game or product, and success can be fleeting. It should come as no surprise that there are far more key people, both value-adders and value-destroyers,

Key Person Value Implications: The Aging of Key People

- As key people, especially at the top of an organization age, investors should start factoring in not just their eventual departures, but a decline in effectiveness, as they get older.
- Speaking of key people in large companies, Berkshire Hathaway has a had a special status, an insurance company with the best portfolio managers in the world in Warren Buffett and Charlie Munger.
- As you undoubtedly have heard, Munger passed away at the age of 99, and while Buffett remains mentally and physically active, the baton for investment picking has been passed on to Ted Weschler and Todd Combs.
- While Buffett undoubtedly has a say in investment choices, it is also clear that he has a far lesser role than he used, which may explain Berkshire's bet on a company like Snowflake, a company that has a snowball's chance in hell of getting through a Buffett-Munger investment screening.

The Buffett-Munger Premium over time



Period	Berkshire Hathaway	Insurance Companies	% Premium
1993-2002	1.93	1.48	30.35%
2003-2012	1.76	1.27	39.30%
2013-2022	1.39	1.24	11.65%

Buffett (93)
Munger (RIP)

Key Person Implication: Industry Structure

- As we shift away from a twentieth century economy, where manufacturing and financial service companies dominated, to one where technology and service companies are atop the largest company list, we are also moving into a period where value will come as much from key people in the organization as it does from physical assets.
- It follows that companies will invest more in human capital to preserve their value, and here, as in much of the new economy, accounting is missing the boat. While there have been attempts to increase corporate disclosure about employee, the impetus seems to be coming more from diversity advocates than from value appraisers.
- If human capital is to be treated as a source of value, what companies spend in recruitment, training and nurturing employee loyalty is more capital expenditure than operating expense, and as with any other investment, these expenses must be judged by the consequences for employee turnover and key person losses.

Key Person Implication: Compensation

- In organizations where they are valuable key people, you should expect to see much greater differences in compensation across employees, with the most valued key people being paid huge multiples of what the typical employee earns.
  - In addition, to encourage these key people to make themselves less key, by building teams and grooming successors, you would expect the pay to be more in the form on equity (restricted stock or options) than in cash.
  - While that may strike you as inequitable or unfair, it reflects the economics of businesses, and legislating limits will either cause key people to move on or to find loopholes in the laws.
- Lest I be viewed as an apologist for monstrously large top management compensation packages, I would suggest that the key person framework can be a useful in checking boards of directors that grant absurdly high compensation packages to top managers in companies, where their presence adds little value.
  - Thus, I don't see why you would pay tens of millions of dollars to the CEOs of Target (a mature to declining retail company, no matter who runs it), Royal Dutch (an almost pure oil play) or Coca Cola (where the management is endowed with a brand name that they had little role in creating). This may be a bit unfair, but I would wager that an AI-generated CEO could replace the CEOs of half or more of the S&P 500 companies, and no one would notice the difference.

In conclusion…

- There are many canards about intrinsic valuation that are in wide circulation, and one is that intrinsic valuations do not reflect the value of people in a company.
- That is not true, since intrinsic valuations done right should incorporate the value of a key person or people in a business, reflecting that value in cash flows, growth or risk inputs.
- That said, intrinsic value is built, not on nostalgia or emotion, but on the cold realities that key people can sometimes destroy value, that a key person can go from being a value creator to a value destroyer, in a company, over time and that key people, in particular, and human capital, in general, will matter less in some companies (more mature, manufacturing and with long-standing competitive advantages) than in other companies (younger, service-oriented and with transitory and changing moats.