



# The Nature of Change

*Successful companies that do not identify and respond to changes in their environment, ultimately fail.*

by Mark D. Working

In a natural setting, the ecology of an ecosystem represents a delicate balance of interactions between different organisms and their environment. Small changes in habitat, food sources, or the introduction of new predators can alter the dynamics of the ecosystem and impact all of its participants. Some organisms adapt and thrive in the new environment, while others perish. It is the same in business, yet it seems to be an utterly

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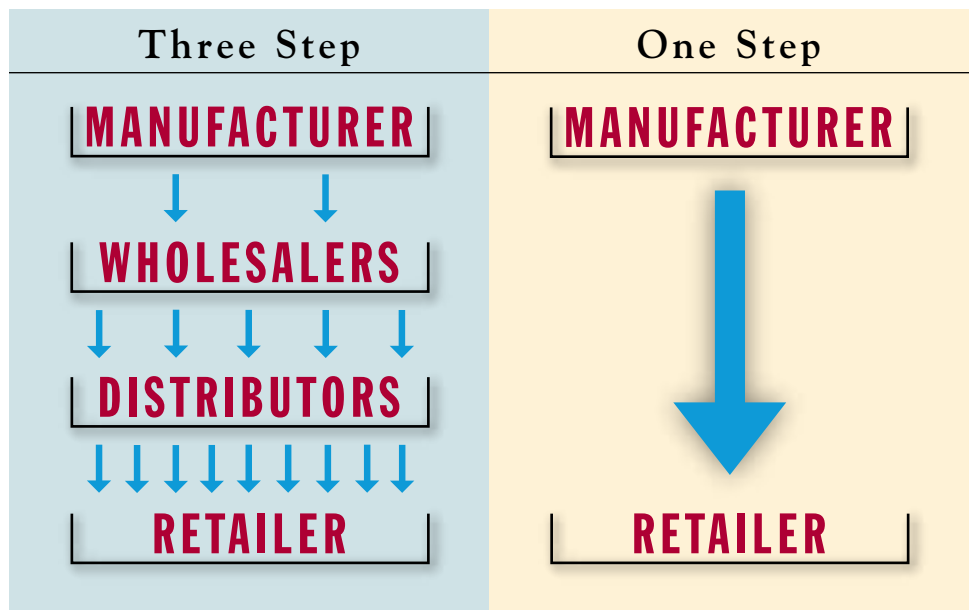
perplexing phenomenon and source of surprise when historically successful companies fail to respond effectively to changes in the environment and fall by the wayside. In the midst of a complex and often baffling economy, business leadership needs to determine if the business cycle is at work or the environment is changing.

The business cycle moves like the tide—it goes out and, in time, comes back in. Business prospects rise and fall on the tide. Business leaders cut costs during the slow down and invest during the upside. Successful companies are often defined by a competitive proposition that rests on a unique and compelling blend of strategy, process, relationships and values. Over time, some change in the environment undercuts this winning formula, causing a shift in the competitive dynamic, which allows winners and losers to be determined anew.

Although it may seem counterintuitive, the root of the decline for many firms actually lies in their past success. The strategies, processes, relationships, and values that underlie past achievement tend to be institutionalized. Once the code has been broken to reveal the formula for success, the culture

### Competitive Shift: Product Distribution

*Lowe's and Home Depot reshaped the economics of product distribution. These retailers effectively bypassed most distributors by going directly to manufacturers. This caught their competition by surprise and propelled them to positions of industry leaders.*



and status quo invariably become deeply ingrained. As a result, the ability to adapt to a changing competitive landscape ends up being stifled.

One of the more visible examples of a competitive shift that has caught a number

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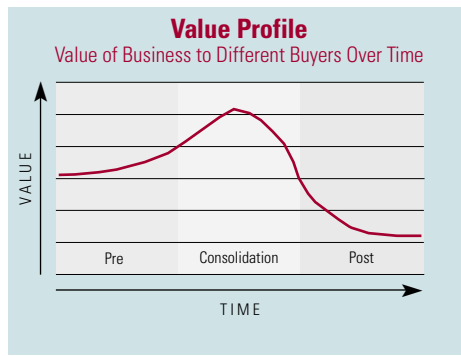
of previously successful firms flatfooted during the past decade, has been the move from two or three-step distribution (manufacturers – wholesalers – distributors – retailers) to one-step distribution (manufacturers – retailers). There is an impressive buzzword for the process of eliminating the middlemen in the

supply chain – disintermediation – and the building products industry is a prime example. Lowe's and Home Depot reshaped the economics of product distribution in a number of ways. Having amassed enormous volume-based buying power, these retailers effectively bypassed most distributors by buying directly from manufacturers. In turn, this set off a wave of consolidation among wholesalers and distributors that resulted in many of these firms shutting their doors. Regional building-material manufacturers found their distribution channels disrupted and previously profitable business taken away by competitors that demonstrated an ability to directly service a national retail footprint. This led to consolidation of manufacturers in an effort to achieve economies of scale in production and distribution. In essence, the whole competitive landscape realigned.

Owners frequently find it difficult to appreciate the fact that the value of a business may rise and fall, independent of its own financial

performance. The restructuring of the building-products supply chain emphasizes the fact that as industries evolve and businesses adapt, significant strategic value is gained and lost by individual businesses. Our experience is that the greatest value is at stake once the new reality is widely understood and the race is on to reconfigure into a position of competitive strength. It is in these times that the optimum value of a business may be its ability to allow another business to achieve its strategic objective. The chart in the next column illustrates how the value of a business to different potential buyers can change over time as a result of these external forces. Business owners should recognize that their personal timeline and investment horizon might not coincide with maximization of the business' value in a dynamic market.

We have observed far too often that when



the economy is retrenching, some business leaders pull in their horns and live on the hope that conditions will "return to normal." They count on the strategies, processes, relationships and values that brought past success to help them return to glory when the market "straightens itself out." The fact is that "nor-

mal" is in a constant state of flux and what was thought to be normal may never be experienced again.

It's hard enough to run the internal aspects of a business. It is harder yet to analyze and adapt to the external forces that impact business success. It is incumbent upon management to pay particular attention to the major external forces and competitive developments that are influencing their industry, suppliers and customers. Only after management comes to grips with the changes and obstacles that it faces, can it develop a program of change. To the individual company, this evolutionary process can result in periods of tumultuous change in order to avoid joining the industry's endangered species list. We believe that this evolutionary change, much like in a natural ecosystem, is the only way to sustained prosperity. ♦



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Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, please go to [ZacharyScott.com](http://ZacharyScott.com).

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