Zachary Scott has published this newsletter since 1997 to bring you a thoughtful analysis of issues affecting middle-market businesses.

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PERSPECTIVES ON THE CAPITAL MARKETS FALL 2021

INSIGHT

The Butterfly Effect—Covid, China and Shipping Costs

Covid lays bare fragile supply chains.

by Ray Rezab

The current news is full of multiple examples of supply chain interruptions – from high lumber prices to computer chip and electronic goods shortages to shrinking new/used automobile inventories to high energy prices and crippling shipping costs. Some of these disruptions are likely to be relatively short term (lumber prices are already returning to prior levels), but other disruptions are proving to be much longer in duration.

What happened? The ready answer is Covid, but that explanation misses the mark. Covid wasn't the cause of the supply chain interruptions, it was merely the straw that broke the camel's back and exposed the structural and fundamental vulnerabilities of today's complex and often global supply chains. There is nothing "unexpected" about supply chain disruptions – they are inevitable, varying only in the degree or magnitude of the disruption. The vulnerability to disruptions is the real culprit and it is also where business owners and managers should focus their efforts to manage, or at the very least mitigate, the impact of disruptions to their supply chains.

SUPPLY CHAINS AND SHIPPING CONTAINERS

Covid laid bare the structural vulnerabilities of today's complex supply chains, impacting each of the four inputs that firms rely on in the supply chain – labor, raw materials, production and shipping. The Pacific Northwest has two major west coast ports (Seattle and Tacoma) and many companies in the Pacific Northwest rely on goods being transported from Asian sources to Seattle or Tacoma, where those goods are distributed nationally. To illustrate the devastating effect of supply chain disruption we will focus on what has happened to the supply chain for food and non-food consumer goods through shipping container disruptions, customs and port demurrage slowdowns, and ocean freight rates.

Global supply chain management was born out of Just-In-Time ("JIT") inventory management, part of the Toyota Production System implemented in post-World War II Japan. In the 1980s, after seeing the success of the Japanese Production System to the Japanese auto manufacturers, global companies copied or adapted their manufacturing processes to mirror that of their Japanese competitors, including JIT.

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Fast forward to today and the ruthless adherence to JIT combined with aggressive cost cutting and elimination of waste created a production system reliant on predictable and steady inputs, including foreign labor and cheap shipping, resulting in complex and often lengthy supply chains. And those lengthy supply chains relied on readily available and abundant shipping containers. As long as these supply chains operated "normally", it was a beautiful system that reduced costs and shrunk balance sheets. As the global economy grew, an increasing supply of shipping containers allowed the global supply chain to continue to operate "normally" while growing increasingly complex and lengthy in search of ever cheaper production and/or labor.

There were warning signs – the Fukushima earthquake of 2011 exposed Toyota's reliance on single-source semiconductors for many of its products. Other geopolitical disruptions caused minor temporary disruptions, but generally, these were negligible to the vast majority of global trade.

When Covid occurred, the perfect storm formed to materially disrupt both the overall supply and location of shipping containers throughout the world. First, shutdowns in China impacted both shipments into and out of China. In addition, China manufactures over 70% of the shipping containers in

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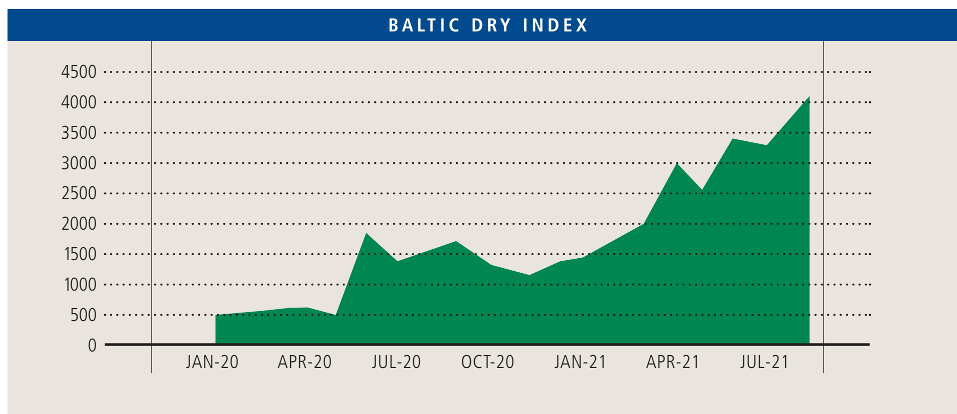
the world and, without workers, production ceased. Then, as China emerged from Covid earlier than did other countries, demand for Chinese products skyrocketed as online shopping increased, causing China to ship containers all over the world.

But, the ports receiving those containers suffered from more container volume handling needs exactly when fewer workers dealing with increased Covid measures were available to handle that volume – resulting in container ships often waiting weeks to offload. That slowdown in container throughput meant more containers were required to handle the volume – but China's manufacturing of containers has been slow to catch up as used containers sat in countries that were locked down or just recovering and not able to economically ship those containers back to China. The bottom line is that the normal manufacturing of new containers to serve growing world trade was interrupted, turnaround of containers slowed as ports tried to process them with fewer workers, and some containers sat idle in locations where they couldn't be used. As one can imagine, when demand greatly exceeds supply, costs increase – dramatically. Evidence of the effect of this increase is the Baltic Dry Index, a measure of the price of moving raw materials globally, which has increased eight times since early 2020.

Some companies that we know well have told us of the effect on their businesses. For example, an importer of consumer goods that are distributed nationally has experienced the cost of a dry goods container between China and Seattle going from $2500 to over $10,000.



Our Alaska seafood friends are finding that the cost of shipping a refrigerated container from China to the US East Coast has increased from $4,000 to over $20,000. What this means is that in cases of low margin products, freight costs are almost as much as the product itself and could mean that an 8-10% EBITDA margin could evaporate unless all the costs can be passed on to consumers.

The more complex the manufactured good, the longer and more severe the disruption.

MANAGING SUPPLY CHAIN DISRUPTIONS

Ocean freight rates are just one example of the disruption to supply chains. A shortage of memory chips has driven the price of used cars up, made it virtually impossible to get a rental car, and created vacant new automobile car lots. There are many other examples where the goods have global processes of inputs and production. As a general rule, the more complex the manufactured good (and implicitly, the more complex the supply chain), the longer and more severe the disruption.

These examples should server as a warning flag to business owners. After the Fukushima earthquake, Toyota realized it needed to secure a second source as well as maintain a larger level of semiconductor inventory (a highly vulnerable supply chain). We think many businesses are going to follow Toyota's example, which will increase product costs, balance sheets, and possibly consumer prices, but protect against the streamlined fragile supply chain. A thorough review of a company's supply chain and its vulnerabilities may not totally protect against the next inevitable supply chain disruption, but it may allow mitigation of the worst impacts and allow businesses to survive the next supply chain disruption. **ZS**

PE Reporting Requirements: Burden or Benefit?

Extra work for a CFO but increased knowledge can improve decision making.

by Brian Bergsagel

Many expected changes are top-of-mind when a founder or family-owned business is considering a partial sale to a sophisticated financial investor such as a private equity firm or family office. Sellers are typically concerned with major impacts such as losing their decision-making authority, disrupting employee or customer relationships, or saddling the business with too much debt.

One often-overlooked change is the increased breadth, depth, and frequency of financial and operating reporting. Owners of closely-held businesses often require limited financing reporting, partially because they don't make decisions based on reports and partially because they feel they are close to all the business decisions and don't need reports to tell them what they already know. Private equity-owned companies, on the other hand, typically produce a broad range of recurring financial and operational reports. This can be a difficult change for a company's owner and finance staff.

Implementation of stringent reporting requirements is a time-consuming effort and requires ongoing attention from the Chief Financial Officer (CFO) and his or her team on a monthly and even weekly basis. It can be easy to view these extra reports as useless, cumbersome, and even annoying at first. However, many of our clients who have remained invested in their businesses alongside private equity firms have eventually come around to see the value in this extra reporting.

Because they are removed from everyday management, private equity firms rely on institutionalized financial reports and key performance indicators (KPIs) to understand how the business is performing.

REPORTING IN A PRIVATE EQUITY ENVIRONMENT

Given how involved they are in the day-to-day management of the business, owners of closely-held businesses often view financial reporting as extraneous. Reports may consist only of monthly or quarterly income statements and balance sheets supplemented by year-end financial reports compiled or reviewed by a Certified Public Accountant. Several sizeable businesses we know have limited their financial reports to annual tax returns.

The characteristics of private equity ownership require a much different approach to financial reporting. As we discussed in our

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Summer 2016 article "Professionalizing the Family Business", private equity owners have a desire to institutionalize management systems so they are repeatable, data-driven, and not reliant upon a single person. Because they are removed from everyday management, private equity firms rely on institutionalized financial reports and key performance indicators (KPIs) to understand how the business is performing.

Private equity firms are also working against the clock to maximize financial returns. Detailed, timely reports allow them to make quick decisions and remain proactive with any necessary changes to business strategy or management in order to achieve key initiatives. To the extent that debt is involved in the new capital structure, lenders will have their own reporting requirements and will rely on the supplemental reporting that the private equity owners receive.

The exhibit on this page illustrates the dramatic difference in what a private equity owner of the business might expect relative to the Company's historical processes.

Exhibit: Sample Reporting Requirements Before and After a Transaction

Before (Closely-Held)	After (Private Equity Owned)
▪ Annual financial statement, compiled or reviewed by CPA ▪ Monthly or quarterly Income Statement and Balance Sheet ▪ Annual shareholder meeting to discuss how the business performed over the past year	▪ Annual financial statement, audited by a CPA ▪ Monthly financial statement with Income Statement, Balance Sheet, and Cash Flow Statement, with comparison of each statement to the budget for such month, year-to-date, and trailing twelve-month (TTM) period ▪ Monthly financial and operating metric reports measuring critical KPIs ▪ Monthly or quarterly covenant reporting to lenders and investors ▪ Weekly 13-week cash projection ▪ Monthly budget for the current and upcoming fiscal year, with different budgets for internal and lender purposes ▪ Updated budget on a monthly basis to reflect current expectations ▪ Rolling long-term (~5 years) forecast of financial performance and cash flows ▪ Quarterly Board Reports including financial, operational, and strategic updates ▪ Participation in annual meetings(s) of private equity firm ▪ Recurring weekly or monthly strategy/management meetings with investors ▪ Annual third-party valuations to update the estimated market value of the investment

BENEFITS OF ENHANCED REPORTING

Extra reporting requirements are not enacted simply to make the CFO's job more difficult. Rather, investors are looking for root causes and drivers of business performance with the philosophy that "you cannot make successful changes unless you understand what is actually happening."

Many businesses do not operate as efficiently as possible, and business models are often based on rules of thumb developed over a long period of time. As conditions change, the model does not necessarily adjust. Understanding the business at a more granular level allows ownership and management to make better-informed and more timely decisions which drive improved outcomes for the entire organization.

There are numerous examples of when performance improved after measurements were put in place, and the affected employees could see the impact of their daily actions. In one recent project, a business began tracking a new KPI which measured the rate of automation in its processes relative to the industry average. The company quickly concluded that it was automating at about half the rate of its typical competitor. By establishing an organization-wide focus on automation, the company was gradually able to reduce the manual labor associated with each client account, thereby allowing the company to take on new accounts without increasing headcount. This new operating leverage allowed each employee to serve a wider client base, with no negative impact on the level of service the existing clients received.

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Another former client was "forced" to implement a system to measure profitability by customer and product. Management found that there were marginal or even negative contributing products that were the creators of capacity constraints that were leading to a capital infusion to fund capacity expansion. Management was able to transition away from unprofitable products and fill the resulting capacity with more profitable business without adding additional physical capacity.

WHY WAIT?

There is no reason a closely-held business can't implement more insightful and impactful reporting and gain the associated benefits in advance of a transaction. By understanding how an institutional investor will look at their businesses, managers can implement changes and best practices that improve both the near-term and long-term prospects of their businesses regardless of whether a new partner is in the mix.

Developing a history of institutional-level reporting has the added benefit of making the business better prepared for new ownership during a sale process and giving prospective buyers added confidence in the management team and the business's underlying economics. **ZS**

Dissecting the Buyer's Pitch

Prospective acquirers are selling you on selling to them. Here's how to think about what they're telling you.

by David Working

Nearly every business owner has heard a pitch to acquire his business. Some pitches are invited, some are not; some are delivered in a boardroom backed by a 150-page slide deck, some are delivered over casual cocktails. Most are honest. All are artfully designed to act in the prospective buyer's best interests. Having been on both sides of hundreds of these pitches, we think it can be instructive for a business owner to understand the why behind what's being said.

Negotiating to try to acquire part or all of a business is fascinating and complex. There's tremendous value to a buyer in maintaining a healthy relationship with the seller after the transaction has closed, especially if the seller will retain a minority stake. It does not benefit the buyer to negotiate away the strength of the relationship to capture the last marginal dollar of price or terms in the transaction. At the very same time, the lower the buyer can push the purchase price, the more room exists to generate returns on the invested capital. Managing the competition between these two forces drives much of a buyer's approach to an owner – how to maximize goodwill in the ongoing relationship while minimizing purchase price.

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With that framework in mind, let's examine a few common pitch elements.

EARLY EXCLUSIVITY

An owner might hear a buyer propose that the owner work exclusively with that buyer. The buyer might argue for a "focused process with a single counterparty," the benefit to the seller being "a quiet, confidential process," or "increased speed to close," or "avoiding the headache of an auction." While there can be truth to each of these arguments, the key driver is that the buyer is trying to avoid a competitive auction process.

The dynamic of a competitive auction on a tight timeline is that it forces a group of buyers to come to the table with their very best offers. The difference between a buyer's "fair" offer, delivered without competition, and their "best" offer can be significant. There's a reason many private equity firms, in conversations with their limited partners, like to showcase their proportion of deals that that are "proprietary" (or "off-market" or "unbanked") instead of coming from "intermediaries" (usually investment bankers). The implication is that deals sourced outside of a competitive process offer

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the private equity firm an opportunity to invest at some discount, which is accretive to returns.

This is not to say that avoiding competitive processes is an underhanded tactic, or automatically results in lowball offers. There are investors who believe their value to the seller is best realized through a relationship developed over time, and there are sellers who won't get comfortable with bringing on a partner over a short timeframe. But an owner should recognize that absent other considerations, an exclusive process is primarily a way for buyers to avoid competition.

COMMON OWNERSHIP

An owner might hear a buyer invite a seller to maintain a minority stake in the business, or "rollover." This can sound like "wanting to have aligned incentives post-close," or "keeping some skin in the game," or realizing economic benefit at the next sale through "a second bite of the apple." This one is tricky – from some buyers, these are truthful points that should be taken at face value; from others, it indicates an attempt to manage the size of the equity check.

There are many reasons why an equity investor may want to shrink the check size. It

can be a way to make a few more investments out of a closed fund, or it can be a way to make an investment in a larger business without allocating an outsized proportion of available capital. If an equity investor doesn't have a captive fund, then it may be a way to keep the fundraising process manageable. Some investors will structure their investments as preferred to the owner's rolled equity – this is a way for the investor to improve the risk profile for its own invested capital.

As noted, wanting an owner—ostensibly the most knowledgeable person in the business—to be aligned with the new ownership is perfectly reasonable, and rollover can be an effective mechanism for creating alignment. But when rollover is expected without further discussion around the seller's ongoing role, then it's a fair bet that the rollover is being used as another source of equity in the transaction to accomplish another purpose for the buyer.

POST-TRANSACTION VALUE CREATION

Buyers often try to differentiate themselves by articulating their abilities, drawing focus away from the transaction itself. A seller might hear how a buyer is "hands-on" or can "draw on operating partners / industry experience / other portfolio companies," or simply hear that "our advice is valuable." These can absolutely be true statements, but it is also true that a buyer who can convince a seller of meaningful post-transaction value can win the deal with less total value at close.

For a seller retaining a minority interest in the post-transaction capital structure, the operational and strategic value brought to the table by a buyer can overwhelm the economics at transaction time, so this is hardly a minor consideration. But buyers can claim to create value much more easily than actually delivering it. A buyer with a demonstrated history of value creation in its investments will have reams

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of case studies, well-documented playbooks, a specific strategic plan for this opportunity, and an identified team with specific roles and responsibilities to share with a seller. The devil is in the details, and the details are a way for a seller to determine the depth to which a buyer is demonstrating expertise when it comes to value creation post-close.

CONCLUSION

As stated previously, our experience has been that most pitches are made in good faith, by honest businesspeople looking to make a fair deal. A seller can recognize specific elements of a pitch for what they are: true statements made about the parties or the transaction process that are framed in such a way as to benefit the buyer. In doing so, a seller can better understand a buyer's position and motives, and ultimately bring to light the pitch that brings the *seller* the most value. **ZS**

ABOUT ZACHARY SCOTT

Since 1991, Zachary Scott has assisted owners of privately-held businesses in the greater Pacific Northwest to plan and execute major business or ownership transitions by offering sell-side M&A and acquisition and investment advice. For more information on Zachary Scott, go to **ZacharyScott.com.**

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