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 SUMMER 2019

INSIGHT

Managing Growth, Part II: How to Support Good Growth

How to build the appropriate infrastructure to support growth initiatives.

by Jay Schembs

In the first part of this two-part series, we asked "what is good growth?" In the context of successful growth relative to business value, we sought to build a framework for identifying strategies for value-creating growth—as developing accretive growth is more complex than simply finding how to increase the top line.

But once the future direction of the business and its growth initiatives have been identified, what then can the business do to ensure the success of those initiatives? What does successful support look like, and what are some common pitfalls that can be avoided? In the second part of the Managing Growth series, we will outline our views on growth infrastructure and share from our experience with clients the challenge of putting ideas and plans into practice.

PART II: SUPPORTING VALUE-CREATING GROWTH

Identifying the opportunity and determining the appropriate strategy are only the beginning. Growth plans generally assume

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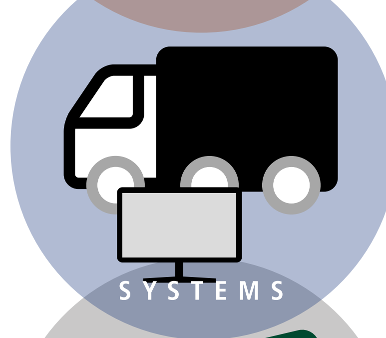
smooth curves and incremental improvements, but a company's infrastructure—its collective personnel, equipment, processes, and capital structure—rarely adapts or scales smoothly in accordance with plan.

Imagine this scenario: for years, a lower middle market business has tracked customer orders with a spreadsheet. As the business grew from one to ten to twenty orders per day, the spreadsheet was cost-effective and passable infrastructure for supporting order tracking. But at some point in the future—maybe fifty orders per day, maybe one hundred—the spreadsheet and the person managing it will be overwhelmed, and the legacy system will no longer be effective. This tipping point marks the end of the scalability of the previous infrastructure and the beginning of a need for an updated system appropriately sized for the next phase of growth.



3 ELEMENTS OF A COMPANY'S INFRASTRUCTURE

These tipping points and their resulting step changes in cost and functionality happen all across a growing organization, and rarely come in aligned batches. Successfully supporting growth means identifying and managing each of these tipping points across the organization, before they develop into issues that can slow or halt the growth plan.

We can break up the company's infrastructure into three elements: people, or the personnel that guide and carry out the plan; systems, or the processes and equipment involved in the company's sales and operational growth; and capital, the financing that supports people and systems.

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PEOPLE

Growth can put a significant strain on a company's employees. For a sleepy business that has not experienced significant growth, employees may enjoy the status quo and find themselves unable or unwilling to adjust to new demands from customers, suppliers, and internal teams. As responsibilities shift, people will feel out of place—an account manager with double the relationships to cover or a sales manager with five direct reports instead of two can feel stretched or uncomfortable with a new role. Growth forecasts shouldn't simply involve spreadsheets, but honest assessments of current personnel in terms of their ability to handle new demands and thrive in what will likely be a

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different business.

This applies to all business personnel, from top to bottom. A strong board of directors can provide useful guidance and oversight to ensure rapid growth is proceeding as expected while not unduly burdening the company's existing resources. Board members are more valuable to the business when they are encouraged to speak their minds, and do not feel stifled by a strong-willed founder who reacts negatively when confronted with data that conflicts with and suggests changes to engrained past practices.

SYSTEMS

Operational tactics to support a new growth plan are very situational. First, a new growth initiative often requires a different sales and marketing approach. For example, if entering a new geographic market, third-party sales representatives can offer flexibility to dip a toe in the water without incurring fixed labor costs. Second, the existing supply chain needs to support the new strategy. Ensuring vendors, which may be new to the firm, are able to keep up is critical. Last, customer bases may change as a result of a successfully-executed growth initiative. Rapid growth driven by a major customer is not uncommon for aerospace manufacturers asked by Boeing or Tier I suppliers to rapidly ramp production for a new program. Assuming acceptable margins and capital investment, the resulting growth likely creates value, but with the offset risk of an even greater reliance on a primary customer. In instances such as this, seeking to lock customers into long-term agreements is one way to help mitigate the increased risk. In all of these scenarios, some foresight into the degree of change expected helps to drive the overall system design.

CAPITAL

Few great growth strategies can be executed without capital. Too often we see businesses design a capital structure by investigating what is available rather than what is required to support the business strategy. The first step should instead be to determine how much new capital is required, and the degree of flexibility required from the capital, to provide a stable foundation for the intended plan. Only then should the source, timing, and pricing of the capital be considered.

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Will the capital be used to expand headcount, further R&D efforts, or build a new facility? Adequately sizing the new capital budget to ensure sufficient capacity to execute the strategy without burdening the existing business with substantial underutilization and fixed costs is a critical exercise. Should the plan be funded with internal cash, an equity infusion from an owner's outside resources, or a third-party capital provider? How an owner chooses to finance a growth initiative is a decision that impacts returns, balance sheet flexibility, and ultimately the business itself.

The private capital markets are such that there is usually a source of capital to match every amount and risk parameter imagined. The crucial job to optimize a capital structure to fund growth is to understand the risks surrounding the future plan, and therefore what characteristics—amortization or return flexibility and schedules—best match the business. What business owners often don't appreciate is the wealth of knowledge that capital providers have that they can share, all the way from senior lenders benchmarking performance of different industry participants to equity investors with previous direct experience following the current company's path.

CONCLUSION

Growth is good. Usually. When contemplating a plan to achieve above-average growth, owners need to understand the margin profile and capital investment necessary to achieve that growth, and whether the longer-term outcome of such a plan will in fact grow the value of the enterprise. Even when convinced to move forward, building a well-vetted strategy and tactics that ensure the right people, processes, and capital to execute are all imperative. **ZS**

Every Company Needs a Margin Story

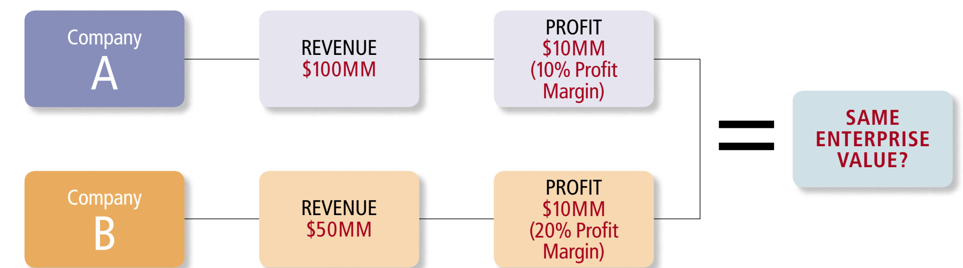
You cannot become fixated on revenues and cashflow alone.

by Kapil Sharma

In the Fall 2017 issue of IN$IGHT, we discussed why "Every Company Needs a Growth Story". We explained how growth orientation influences company culture, perceived opportunity, and ultimately value.

In their quest to grow, it is not unusual for middle market companies to become fixated on revenues and cashflow as a measure of progress. However, success measured on these milestones alone is likely to be short-lived. In the long run, these milestones don't matter if the business will not be profitable and the growth itself doesn't contribute appropriately to profitability. To understand the overall health of the business and whether its growth will be sustainable, one needs to grasp its margin story.

Consider two companies in the same industry that each generated $10MM of profit. The larger company, Company A, accomplished it on revenue of $100MM at a 10% profit margin. The smaller company, Company B, did it on $50MM of revenue at a 20% margin. Application of a "multiple" would yield the same enterprise value for the two businesses, but is that an appropriate methodology? As we will examine, it depends on each company's margin story.



GROSS OR NET PROFIT MARGIN?

Let's first distinguish the two commonly used measures for calculating margin. Gross profit margin is a metric used to measure how well any particular product or group of products is performing. The net profit margin, which is based on a company's total revenue and operating expenses, provides the big picture view of a company's performance.

Margin profiles vary by industry and aren't really comparable. A successful large airline might have gross margin of just 7% and net margin just above 5%. Most of the costs in this business are at the operations level and relatively little at the overhead level. By way of contrast, a software business is almost the opposite because once the software is built, the costs of production are low. However, marketing and

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administration costs in this industry are very high. Therefore, an absolute margin level is less important than the relative level against peers and competitors in the industry.

MARGINS ARE AFFECTED BY CHANGES IN OPERATIONS

Product mix shifts, price increases, economies of scale, and commodity cost declines, among others, are valid reasons for gross margins to change over time. Some of these costs are fixed in nature and can affect gross margins depending on what point in the demand curve the measurement is taken. Most often improvements in margins below the gross margin level are achieved by cutting overhead costs. This is easier to implement but harder to overcome if the support requirements for the business are harmed. Cutting overhead in high growth companies can be counterproductive.

HOWEVER, ALL COMPANIES NEED A MARGIN STORY

Companies can improve margins in the medium- to long-term if they have a clear strategy. Notwithstanding that generalizations can be dangerous, below are four successful strategies that we have seen work.

1. Reduce number of SKUs and rationalize prices. Companies should look at the profitability of each product they offer and consider eliminating the worst performing ones. The resultant capacity can be refocused to increase volume or quality of its remaining product lines. For example, many beer distributors are realizing that only a small number of SKUs contribute to their profits. Underperforming SKUs not only drag down a company's performance with added labor, occupancy costs, capital costs, and damaged goods losses coming from the added inventory, but also from added sales and merchandising costs to support the effort to move the SKUs. The hidden cost is the fact that in addition to underperforming, these SKUs can cannibalize volume from profitable SKUs.

2. Eliminate unprofitable customers. CFOs should periodically analyze the profitability of their top 20 customers by order volume. Even if certain customers deliver large volumes, the cost to serve might outweigh profitability. In such instances, price increases for these customers might be justified, even if there is a risk of losing them. A related problem is dealing with customers that are consistently tardy with payment. CFOs should ask whether the cost of additional working capital needed to deal with these customers should also be factored into pricing decisions.

3. Incentivize employees on margins not just sales. Companies should expect its salespeople to deliver not just sales, but profitable sales. When companies start paying commissions on gross margin rather than on sales, the impact can be clear and quick. Salespeople are likely to curtail discounts and refocus efforts on more profitable product lines. During a recent assignment for a contractor involved in commercial construction, we saw dramatic improvements in average job profitability when salespeople were moved to a gross margin-based commission structure.

How a company chooses to service its customers, which customers it sells to, and how it positions itself relative to its competitors is a function of strategy and management. Thinking deeply about a company's margin story can lead the way to unlocking additional value.

4. Reduce spoilage and waste. Many companies suffer from hidden production issues. They might have manufacturing quality issues and poor forecasting that have the potential to significantly drag down margins. We recently had an opportunity to look closely at numbers of two competing contract food manufacturers—one profitable and one losing money. Since ingredients are the largest cost item in this industry and gross margins are relatively thin, it wasn't surprising that the unprofitable company had significantly higher wastage during production.

COMPARING OUR TWO IMAGINARY COMPANIES

All things else equal, the smaller business with the higher gross margin, Company B, would be viewed more favorably by investors. Higher gross margins represent a buffer to economic downturns because of the ability to absorb volume declines and pricing pressure. And, in an expanding market, the implication is that it will take less growth capital to support an additional dollar of profits. Also, in a consolidation with another company where overhead would represent redundancies, there could be a significant opportunity to reduce costs without sacrificing product quality or service to the customer.

However a deeper dive into each company's margin story could be instructive. Company B was operating at maximum capacity and additional capacity was very expensive, thereby restricting its ability to grow with its customers. Company B had maximized its margin profile and further growth would come at the expense of profitability. The margins of the larger company, Company A, were masked by recent costs incurred in adding additional capacity. Additional growth for this business would be accretive to margin as utilization of its cost structure increased, representing a bright future of growth opportunity.

The added wrinkle tells us that margins are not entirely dictated by the market. In a competitive environment, prices can be—but how a company chooses to service its customers, which customers it sells to, and how it positions itself relative to its competitors is a function of strategy and management. Thinking deeply about a company's margin story can lead the way to unlocking additional value. **zs**

The Illusion of a Competitive Advantage

You may be ignoring risks by assuming you are superior in your marketplace.

by Mike Dannenberg

One of the interesting components of the middle market, and especially the lower middle market, is the preponderance of unique businesses that operate in niche markets. For a variety of reasons, these businesses can generate exceptional profits, often despite competing with or being adjacent to larger competitors who have significantly more resources to invest in new technologies, systems, processes, and management teams.

Traditional economic theory and basic business sense tells us that generating abnormal rates of return over a period of time equates to having a sustained competitive advantage over the competition. While in the long run, markets are relatively efficient, they can be much less efficient in shorter timeframes and in smaller market niches. As a result of these localized inefficiencies, we see many circumstances where these very profitable companies earn a higher return on capital than one would expect given their competitive positioning and risk characteristics (which can include customer concentration, unique product profile, cost advantage, supplier risk, absence of data collection and reporting systems, or key-personnel risk, to name a few).

It's easy and comfortable to conclude that outsized returns are proof of a platform built to sustain those returns—when in reality, there can be other factors at play that can bring those outsized returns to an end.

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COMPETITIVE ADVANTAGE OR CLOSING WINDOW?

The lower middle market is littered with businesses that overestimated their competitive advantages, precipitously declining seemingly overnight. Often management teams point to specific events that drove the decline, but generally it's the result of not taking steps to improve multiple parts of the business until it is too late. Although every situation is different, we've seen a few of the same movies several times, and they tend to follow familiar story lines. The following disguised examples are illustrative of these themes:

- A small but highly profitable business lost a key customer. The key customer accounted for only 25% of revenue but a much larger percentage of gross profit. When managers tried to replace that volume, they learned that rates in the industry were well below what they had received from the key contract. There was no opportunity to replace the gross margin dollars and there was no member of the management team capable of executing an alternative plan. A rapid decline in profitability ensued, forcing the owners into a distressed situation. In reality, the core business was never profitable—it only appeared so in aggregate with its key customer.

It's easy and comfortable to conclude that outsized returns are proof of a platform built to sustain those returns—when in reality, there can be other factors at play that can bring those outsized returns to an end.

When it was finally required to respond, no infrastructure existed to do so.

- A business manufactured and marketed a product that was critical to the supply chain in its industry. Patents had long since expired but the business was still able to generate high margins based on service and customer relationships, which management believed kept competitors out of the market. After decades of sustained profitability and relative isolation in the market, a competitor decided to enter the market. Immediately, price wars ensued, market share was lost, margins were compressed, and the business was never able to recover. For years, the business earned above average returns operating in a small market, relying on its core product without significant innovation and believing that its service and customer relationships formed a substantial barrier to entry. When it was time to react, it was simply too late.
- A profitable business in an asset intensive industry was facing competitive pressures that caused it to lose volume for a variety of reasons. Without diagnosing the root cause or developing a long-term strategy, management cut prices, deciding that what was most important was to keep the assets operating. Cutting prices reduced margins, so to negate the overall impact to free cashflow (and the owners' distributions), there was no investment in needed equipment. In turn, maintenance expenses increased and product quality suffered, causing the business to lose more pricing power and forcing further price reductions. Before long, weak contracts and aging capital equipment were all that was left of the business. Eventually the business will not be able to sustain itself and its value will fall to the value of its equipment.

It can be easy to point to a run of success and conclude that a sustainable barrier to entry is the basis for outsized returns, when it's possbile that the window on an inefficient market is closing and the business is in the process of being marginalized.

These situations are not unique. Most closely-held businesses in the middle market are risky, and most entrepreneurs tend to underweight the riskiness of their operations. It can be easy to point to a run of success and conclude that a sustainable barrier to entry is the basis for outsized returns, when it's possible that the window on an inefficient market is closing, and the business is in the process of being marginalized.

In each of these situations, a profitable business successfully operated within a defined market for an extended period of time. Each ownership and management group believed it had a competitive advantage, but then suffered a sudden decline at the hands of a singular event. In reality, each of these businesses had been slowly marginalized over a long period of time. The failure in these cases was not in the final act, but instead, in ignoring the inherent risks.

CONCLUSION:

A sales process can bring to light the conflict of visions between the seller, who has observed the history of the business, and a buyer, who has a view of the future. Buyers will devote significant effort to understanding the competitive environment and the key risk factors that could impact long-term profitability. A thoughtful investment thesis will incorporate all of these factors in conclusions about the desirability of a transaction and its value.

It's not enough to assume that the past will continue to repeat simply because it has. Even though business performance may be strong, owners should try to evaluate their own investments as a fresh set of eyes would and develop a plan to address identified risks. Businesses are organic entities operating in ever-changing environments, and pressures can come from many directions. It pays to look towards the horizon to see coming storms in advance and to prepare for them before their arrival. **ZS**

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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 through three service lines: sell-side M&A, acquisition and investment advice, and direct investing. For more information on Zachary Scott, go to **ZacharyScott.com.**

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