

CHAPTER 1

Market Overview

The owners of today's middle market businesses face a world completely different than the one their parents faced. There are more businesses now, more capital, more buyers, and more sellers, each fighting to win in a market that is both expanding and contracting at the same time. There are also more opportunities. Market niches are getting smaller and better suited to midsize businesses, allowing some to create more value. Midsize businesses are big enough to get the job done, and small enough to seize opportunities quickly. The mid-market takes on a whole new look and importance as it evolves and globalizes. Its role in the economy is highlighted as a procession of large, familiar companies, once thought too big to fail, close their doors permanently.

At about 300,000 businesses, each with revenue between \$5 million and \$500 million, the middle market comprises less than 1 percent of all U.S. businesses. Yet, despite these small numbers, it employs 39 million people, over a third of the nation's workforce, and produces about 40 percent of the gross domestic product. That is why winning in the middle market is so critical to the owners of those businesses and so vital to the U.S. economy. But why do some businesses win and others lose? By looking at the market, the obstacles owners face, and the strategies they use to overcome them, we will try to answer that question.

Others have studied individual mid-market companies by analyzing how they operate as well as how to value, capitalize, and transfer them. They have studied the fish, if you'll excuse the analogy; they have not studied the fishbowl. This is a first attempt to view the mid-market as a whole from as many different vantage points as possible. Aside from looking at the trends that drive the market, we will examine the rise of the market, what separates it from other markets, its structure, and what binds it together, as well as how mid-market companies operate successfully in various industries. These are all attempts to understand the fishbowl, or market, in order to provide a context for developing effective middle market strategies. Better decisions

are only possible when owners consider the overall market in which their company swims.

The Time Warp

“It’s like we’re in a time warp,” Jim said. “I’m stuck in this business while the rest of the world is in hyperspace. When I bought the company from Dad 20 years ago, it wasn’t this complicated. But I’m 54 now, and it’s time to change.

“In Dad’s time the business had only \$5 million in sales. Now we have \$30 million. Mom did the books by herself; now we have a CFO with a staff. She had handwritten ledgers. We have 30 computers strung together.

“When Dad wanted to sell he had only two alternatives. We have a dozen, and each one says the business is worth something different. It seemed so simple then. Our lawyer drew up the papers. The bank added my name to the loan and credit line and Dad financed the balance. He loved saying, ‘My security is great. If you don’t pay, I’ll take it out of the estate.’

“It’s the same business—but everything seems different. Our CFO claims he can arrange financing to buy the company. Two competitors are interested and say they have backing. There’s also a company consolidating in the industry and a European buyer sniffing around.

“Changes come too fast. Dad had too few buyers, and we have too many. This deal involves family decisions, business decisions, and estate decisions. We need help figuring it out.”

Baby boomers who experience the contrast between business practices now and the way they used to be may feel they’ve moved through a time warp (see accompanying box). Trends in this time warp easily escape notice while they’re developing. Nevertheless, they have far-reaching implications for business owners, investors, the larger economy, and society as a whole. Each trend is a bundle of contradictions presenting both opportunities and threats. Success or failure depends on the ability to recognize these trends, understand the market, and implement effective strategies. The most significant trend impacting the time-warped baby boomer is the emergence of a middle capital market.

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Of course, there have always been midsize businesses. What is new is the emerging private capital market dedicated to serving these businesses. The market now offers an arsenal of weapons to help owners overcome obstacles, leap over restrictive walls, and reap rewards. However, the capital market equips all sides, but not necessarily equally. It is much like the arms merchant who is happy to sell his wares to all parties.

Introducing new arms, or new capital, intensifies a conflict. Capital elevates risk and raises the stakes. It bestows benefits on some and exacts penalties from others. It defines the rules of engagement for those who need money. Further, the market is capricious, flooded with capital at one moment while it may freeze solid at another.

Rule changes redefine markets.

The idea of building business equity value is not new, but access to the resources to build and harvest maximum value is new. Decades ago, when Dad sold the business to his son, it was difficult to get capital in and out of a business. What reason did he have to build maximum enterprise value when he was faced with a restricted market or a simple transfer to his son? Like most owners, Dad pulled as much cash as possible out of the business all along. Only when capital is available, and a range of transfer possibilities exists, is there real incentive to create market value. With apologies to Hillary Clinton, "It takes a market to raise a company's value."

From the son's perspective it may be the same business, but from the market perspective it is not. Like Grandpa's old ax, yes, it is 40 years old, but it has had two new blades and three new handles. It is just not the same old ax, and neither is it the same old business. Both the business and the market have changed. Dad's equity was locked up in the business. The son has opportunities his father could only dream of. Trends that impact this baby boomer's situation, and the rule changes that could either help him or keep him from overcoming his own walls, warrant further exploration.

Confluent Trends

Overwhelming trends crash across the market from several directions at the same time. Each is pregnant with possibility and loaded with peril. In broad terms they are:

- Capital deluges and droughts.
- Information insurgency.
- The value-creation imperative.

- Redefinition of risk.
- An expanding/contracting market.
- Transfer turbulence.

These trends are reshaping the middle market. They can simultaneously wreak havoc while stimulating value creation. They have spawned one of the best economic environments in history—and one of the riskiest. The dilemma for those caught in the storm-tossed market is how to triangulate a winning strategy. The goal of this book is to help owners develop that strategy.

An Avalanche of Capital

A huge mass of capital has cascaded onto the middle market with the potential to inundate it. This influx certainly will not leave the market unchanged. Total middle market capitalization will rise from an estimated \$1.8 trillion in 1980 to \$4.2 trillion by 2010. Providing that capital was once the exclusive province of community banks. Now multiple funding sources compete to make massive amounts of capital available.

The market morphed from a lack of capital to an excess of capital. It can change back.

With the variety of capital now available, it is possible to separate various levels of risk and return in the middle market. At one time, players had only limited ability to seek risk-adjusted returns because capital was lumped in a peasant stew. New capital is served as a gourmet smorgasbord complete with a selection of fine wines. Diners can balance a desire for delicacies with their concern about calories. Similarly, investors and company owners can choose from an assortment of capital types, each with different risks and different expected returns, making it possible to effectively sort through options, separate out factors, and add transparency to financial decisions.

Several rule changes grip the market as the availability of capital fluctuates. Some reflect a change in the nature of capital itself. Financial capital once ruled the market, but now intellectual capital dominates it. Security is no longer vested solely in physical assets: It is now located in intellectual assets, at least as far as overcoming obstacles is concerned. Lack of capital was the defining characteristic while Dad owned the business; when he sold it to his son, there was an excess of capital. The ever-changing capital flow stimulates competition, innovation, rule changes, and improved operations—and it demands more information.

Information Insurgency

The mid-market is fully engaged in the rapidly developing information economy. Most of its businesses have a growing intellectual capital component. In fact, the fastest growing sector of the mid-market is the services sector, where data and information businesses are thriving. In the past, knowledge of the mid-market and its businesses was minimal. Now it is abundant. The middle market worked differently when very few people had access to, or control of, information. Now successful mid-market businesses generate high-quality data that collectively forms the building blocks of a growing middle market economy. But make no mistake about it: These businesses generate information primarily because capital sources and competition demand it.

In response to this information insurgency, winning mid-market businesses are changing from traditional business models to conceptual models. The latter are built on intellectual capital rather than on the bricks, mortar, and machinery. The switch to conceptual business models is a strategy that enables winners to create more value.

The Value-Creation Imperative

There is a paradox in the big picture. Business owners seldom talk about creating value. However, the record of growth and value creation belies their silence on the matter. In 1980, the middle market had an estimated \$635 billion in shareholder equity. It will reach \$1.5 trillion by 2010. Not bad for a group of largely unknown companies. Wealth creation is gaining momentum. Unfortunately, not all firms participate.

Simply defined, creating value means earning a return greater than the risk involved. That is easily said, but market demographics show how difficult it is to achieve. Prior to the deluge of capital and the turbulent transfer market, many owners could hide out in the obscurity of a comfortable market niche. Unfortunately, very few noncompetitive niches remain. Adopting winning strategies, and developing business models to implement them, requires an understanding of the features and functions of the market which are the subjects of the first two parts of this book.

Operational rule changes reflect paradoxical trends in creating value. Owners were once required to build and defend a business model; now they are required to change business models. Once they were pressured to achieve economies of scale and scope; now they feel pressure to innovate. Once best practices were hoarded; now they are shared. Formerly, low cost and low price won; now value wins. Once companies had to own every step in their process chain; now they only need to own those steps that add value. Once it was good enough for the company to create value; now

each employee and every operation must create value. These rule changes demand new risk assessments.

Redefinition of Risk

With the introduction of more capital and greater competition, the market has become more risky. In fact, the very definition of risk is changing. As recently as 1980 it was difficult, if not impossible, for owners and investors to achieve risk-adjusted returns. Now it is not only possible, it is a critical factor in their success. In the past most business owners did everything possible to avoid risk. Now successful owners work to manage risk, rather than avoid it completely. Survival used to be the goal; now the goal is to win. One of the ways business owners win is by offering limited products and services over an expanded geographic base.

An Expanding/Contracting Market

The market for goods and services produced by mid-market companies is simultaneously expanding and contracting. Communication and technology allow companies to compete in larger markets by seeking smaller niches. The paradox is that as markets grow larger, niches become smaller.

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There is a revolution in the rules governing the market for goods and services in which mid-market companies compete. The rules are largely unwritten except as they appear in the financial covenants of various players, but they are no less real and no less imposing. Formerly, it was enough for managers to focus on improving operations and tactics. Now those are only a minimal threshold. Improving strategy is the imperative. In the past, managers operated with severely limited market information; now information overload is the issue.

These rule changes compel owners to abandon the pursuit of large markets and focus instead on identifying and attacking niches. Owners are compelled to abandon comfortable, provincial market views and adopt a global view. However, it is a global view of a narrow set of niches where they compete most effectively.

Transfer Turbulence

The transfer market now has more of everything. There are more buyers, sellers, deals, technology, money, and transfer methods available, and more of each continuing to be developed. The range of business transfers includes

those made to employees and co-owners or conveyed to family, those sold to outsiders in whole or in part, and initial public offerings. The size of these individual transactions seldom garners headlines. Collectively, however, the numbers are large and are reshaping the business landscape.

The annual number of mid-market business transfers doubled between 1980 and 2002. It will double again by 2010. The percentage of businesses being sold is also rising. Selling a business in 2010, when the market is four times larger, is an entirely different project than it was in 1980.

New Rules of the Game

All these changes give rise to a whole new set of rules governing the mid-market. At one time, the market was limited and unsophisticated; now it is expansive and complicated. These largely unwritten rules pervade all areas of the market, from owner's motivation to capital, information, operations, and the transfer market. Many of the rules are the direct opposite of the old rules. For example, goals that were once unobtainable are now obtainable, and capital that was once scarce has become abundant. It takes an understanding of the market and its rule changes for owners to tackle the obstacles they confront.

Overcoming Walls

A series of obstacles keep business owners from meeting their goals. These can be conceptualized from many perspectives, but many owners think of them as walls. Market demographics clearly show that walls exist. But demographics are silent on the questions of how they are formed and, more important, how they can be overcome. These barriers can take many forms—for instance, market rule changes can become walls.

Overcoming *personal motivational walls* takes on greater importance when the market is flush with capital and full of successful transfers. Overcoming *capital walls* involves conquering revenue and earnings restrictions, quality of earnings requirements, access boundaries, and cost of capital limitations. This can be done by developing business models to manage financial assets. *Operational walls* demand high performance as a minimum threshold for obtaining equity and mezzanine financing, and for selling at higher market multiples. *Market walls* restrict companies not in alignment with economic trends, or not in sync with the way the market works. *Transfer walls* are the difficulties that small businesses face in trying to fetch the same multiple of earning as their larger brethren, partially because some transfer methods are not available to them.

Amazingly, some companies successfully overcome this maze of walls.

Winning the Middle Market

Winners in business use market rules, patterns, and mechanisms to overcome walls and create value. They turn long-term trends into real-time competitive advantages. At the very least, winning means increasing equity value, not merely surviving. The next box depicts a winner named Steve whose business development reflects visceral integration of trends as most of us experience them: day-to-day and gritty.

The Control Freak

When I asked how his cabinet manufacturing business grew so fast, Steve jumped into his story.

“We grow by solving problems, not by a formal plan. A supplier ran into financial problems and became unreliable, so we bought his assets. We run it with its own P&L and customer base. We did this with three other suppliers mostly to solve problems and control work flow.

“We run a tight ship here. I know what everything costs, the margin on every job, exactly what every project manager contributes to the margin. So do they, and so does the bank. My margins are at the top of the industry—and I keep ’em that way.”

When I pointed out that he doesn’t have much bank debt, Steve replied, “I don’t like banks. But there’s no sense being stupid about it. It’s simple: The better information I give them, the better rate they give me.

“I’m a control freak,” he admitted. “I get a daily report from all profit centers by 10:00 A.M. If it’s not on time, the orders are that everyone stops what they’re doing until I get my report. If you don’t know what you’re doing, there’s no sense doing anything.”

Leaning forward, Steve whispered, “I only need to pull this shtick about once a year.

“Our controls led us to a couple of niches,” he continued. “One is a product line we developed when competitors couldn’t manage production costs and inventory. We don’t have those problems. The other comes from our ability to put our product on the customer’s job site—on time, anywhere.”

He mused, “I guess it will work the same way for a buyer. If I give them enough information to take control, they’ll give me a better price. But I don’t know enough about selling my business to control the process—and I’m not going to start until I do.”

Although it isn't possible to control a market the way you can control a company, winners like Steve are great at growing the market value of their companies. They overcome obstacles by controlling as much as possible, utilizing market rules, patterns, players, and mechanisms. Owners have the first opportunity to create value. It is not an opportunity to be squandered.

Why Is Winning Important?

A growing middle market distinguishes the United States from other market economies. Without a vibrant middle market there is no place for small businesses to grow into, and no place for large businesses to grow out of. But markets are delicate, and we could be only one policy change away from losing this important market. It is clear that business owners already face huge obstacles.

Without the middle market, the U.S. economy, its businesses, and its workers would suffer a declining standard of living, something few of us would want. To put the current size in perspective, if the U.S. middle market economy were freestanding, it would rank as the fifth largest in the world after the U.S. economy as a whole, the United Kingdom, Japan, and Germany. We see and hear a great deal of media coverage on China, but when was the last time you heard anything about the U.S. middle market?

The U.S. mid-market is the fifth largest economy in the world.

This is all well and good—but there is a big problem. Ninety-five percent of all firms will never outgrow their segment. Most companies fail to create equity value. However, there are owners, some of whose stories are told here, who overcome huge walls using effective middle market strategies. Understanding the middle market and learning how winners overcome obstacles are the central purposes of this book.

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