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Staying Smart About Growth

Does more growth bring more value?

by David Working

It would be reasonable for today's middle-market business owner to believe that the sole avenue for creating value is through growth. He is bombarded with the message that "Growth is King" from every angle: consultants publish reams of reports describing the accessibility of new market opportunities, while investment bankers dedicate entire sections of confidential memoranda to growth opportunities. The stated or implied correlation is that more growth brings more value. The misapplied quote by self-help guru Anthony Robbins states the general feeling of the investment world:

"If you're not growing, you're dying."

GROWTH OR IMPROVEMENT?

While the underlying tenet of fighting complacency is worthwhile, this explicit focus on growth loses the forest for the trees. We would change Mr. Robbins' quote to read, "If you're not *improving*, you're dying," where *improvement* captures all of an organization's efforts to most efficiently earn the greatest return on its invested capital. Growth can be expensive, both in absolute dollars and in opportunity cost of employing an organization's limited physical and human capital resources. The best strategy for a certain business may actually be to solidify its competitive niche and forego growth efforts. Depending on the risks and opportunities facing a business, the most prudent course of action for an owner may not be to invest in growing the top line—but rather to cut costs and invest in technology to increase the barrier to competitors, and drop low-margin customers. Profits can be used to pay down debt and distribute cash to shareholders. Jay Schembs' IN$IGHT article, "What's In a Multiple?" (Summer 2014), presents a thorough mathematical analysis for why pursuit of greater sales may not lead to the greatest value to an owner.

The marketplace is littered with companies that pursued growth in an adjacent market or industry segment and failed, sometimes with grave consequences to the entire business.

GROWTH AND FAILURE

Growth can be expensive, and sometimes, too expensive. The following true story illustrates when self-confidence and vision developed out of success do not always drive further successes. In fact, the marketplace is littered with companies that pursued growth in an adjacent market or industry segment and failed, sometimes with grave consequences to the entire business.

ABC Company (actual name redacted) was a designer and manufacturer of a specialty technical product. After completing all design work in-house, it contracted basic manufacturing to lower-level suppliers and then assembled final products on-site. Products were sold both directly and through a distribution layer to end users. ABC's reputation stood out clearly as the "best of class" based on its unique technical designs and high precision quality end product. Because the products provided important product attributes unmatched by competitors to its customers, it enjoyed extremely high margins and market share dominance in a specific small niche of the industry.

After several years of very modest growth in the niche, ABC set its sights on the larger segment of the market, believing that its brand name and reputation would allow it to move downmarket and push aside existing "less capable" competitors. Customers in the larger market segment depended less on the technical design and high precision attributes of ABC's products, selling more commoditized products on the basis of price. This larger market, while several orders of magnitude larger than ABC's niche, was also experiencing flat to low single digit yearly growth at the time, and was populated by three much larger competitors.

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ABC spent millions of dollars hiring additional engineering staff to design new lower-cost products, and expanded the sales team to introduce the product line to distributors. Scaling up operations took months, and resulted in the unveiling of a new line of products into the mass market. The response was met with stiff competition by existing competitors and resulted in significantly lower sales figures than planned, as well as significantly lower gross margins than to which ABC was accustomed. Three surprises resulted from the effort: it was very difficult to take away customers from existing suppliers; the brand reputation didn't translate to the lower price point market; and ABC's introduction of lower-cost options cannibalized sales away from some of its existing high value product customers, who were attracted to the brand name but didn't always have a need for the most robust performance level. Even more problematic was that the brand's hard-won clarity began to fog over. ABC found it increasingly difficult to defend its unique reputation, as it became one of several manufacturers that compete across all segments.

THE NET RESULT

The growth initiative undertaken by ABC did in fact achieve higher sales; but the net result, after accounting for the unrecoverable

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investments of time and capital in creating the new product line, and the decreased profitability due to a larger share of sales to low-margin products and increased structural cost burden, has been one of significant value loss to the owner. The company was eventually acquired by one of its competitors, which immediately closed out all of ABC's larger market products and tried to return it to a niche segment brand. As it turns out, the value of the business was only related to the strength it had in its core niche, only now less valuable as a result of the degradation to the brand reputation and self-created cannibalization.

Instead of preparing a costly assault on a stagnant market populated with experienced competitors, the invested capital would have been better spent either on maintaining the quality advantage that propelled ABC to a dominant position within its niche in the first place, or simply kept cozy in the owner's pocket until a truly attractive opportunity came about. When the time came to sell the business, a stronger defensible niche would have likely attracted a stronger purchase offer.

Although stories like ABC's are plentiful across the middle-market, far be it from us to suggest that searching out growth is a recipe for disaster. Nor is it our intent to portray risk as undesirable, or even avoidable in the course of running a business. It is only by taking measured risks that new products and services can reach previously untapped markets. But the key word here is *measured*, and it is with the help of an experienced, capable financial and strategic advisor that the palette of business opportunities can be fairly evaluated. **ZS**

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ABOUT ZACHARY SCOTT

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, go to **ZacharyScott.com.**

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