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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).

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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:

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.

- 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. 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.

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.

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

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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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