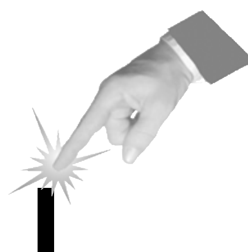

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Midas Managers

Some businesspeople intuitively know how to create wealth. They are constantly increasing the value of their business holdings, regardless of industry conditions or economic cycles. It's more than good luck, since the same people strike gold again and again. These wealth-creators just seem to have the Midas touch. I call them Midas Managers.

Midas Managers are a rare breed: they account for less than 1% of all businesspeople. This, in part, explains the lack of value currently being created by private owners. Less than a quarter of private companies in the U.S. will be worth more in five years than they are today.

Midas Managers are also unusual people. They build substantial wealth based on market knowledge, and the ability, as legendary entrepreneur Ted Turner describes it, to see "just over the horizon." They are motivated by money, but seek to create both personal and business wealth. They focus on a few critical success factors and use straightforward metrics to measure their progress toward them. They understand the behavior and motives of players around them. They are reflective, but with enough salesmanship to get what they want. They think strategically, but act practically. They usually master only one or two wealth-creating strategies; then they look for situations where they can apply these same strategies over and over. More often than not, they

are contrarians. J. Paul Getty, a Midas Manager of the first degree, famously summed up their mindset when he said that "no one can possibly achieve any real and lasting success … by being a conformist."

Of course, Midas Managers have existed as long as there's been commercial activity. Their names are very familiar to any student of business: Medici, Rothschild, Morgan, Rockefeller, Buffett, and Gates. Most Midas Managers, however, do not have familiar names. Only their families and community know that they "fell into something." It is this lesser-known group that interests me, especially their ability to create wealth from relatively small companies even during changing times. This book contains their stories.

New Rules of Wealth Creation

Every so often the rules of business change. In the past 200 years this has occurred several times. First came the Industrial Revolution, which in the early 19th century ushered in the Industrial Age. John Henry may have beaten the mechanical spike-driver in lore, but machines have dominated in every other way for more than 150 years. Next came the Information Age, which began in the 1950's with the arrival of computers and reached a climax in the 1990's with the explosion of the Internet. Computers changed the way we work, making complex jobs easy and enabling routine tasks to be performed at ever-lower costs. During this Age, knowledge workers and MBAs reigned supreme.

Now we have entered the Conceptual Age. On September 11, 2001, the United States was thrust into a global war with terrorists. At about the same time, China entered the World Trade Organization. The combination of these events birthed the Conceptual Age and thrust U.S. businesses into a global war of their own. The Conceptual Age marks the intersection of globalization, logistics, and advanced technology. This Age is defined by multi-dimensional thinking. This Age requires business owners to concep-

tualize their way to success. Operational excellence is no longer enough. In the Conceptual Age, it is merely the starting point. Machines, capital and employees are no longer the main factors in creating business wealth. In the Conceptual Age, the biggest is the manager's ability to conceptualize solutions. Walt Disney would be proud: our imaginations are now the major constraint on wealth creation.

There are various ways to describe behavior required for creating wealth in the Conceptual Age. But the most important skills center on the human mind, or, more precisely, on the two hemispheres of the brain. The Information Age worked the left side of our brains, where we do heavy analytical lifting; success in the current Age relies on the right side, the source of our creativity. In his book, *A Whole New Mind: Moving from the Information Age to the Conceptual Age*, author Daniel H. Pink argues that the left brain capabilities that ruled the Information Age, while still necessary, aren't sufficient in the Conceptual Age. The skill sets required now reflect the imperative placed on design, innovation and market knowledge in the 21st century. As children, many of us were told to avoid artistic careers in favor of a more reliable future in business. In the Conceptual Age, our ability to be "artsy" will in large part determine our success in business. In a world where the major resources are available to everyone, it is the ability to do more with less that separates winners from losers.

Companies today compete in a technology-enabled, logistics-powered, globalized economy. Competition is no longer local, it's global, and the rules of wealth creation have changed. Let's consider some of the New Rules:

1. Every person working in or for a business must create value to remain employed.
2. Job security is a function of the number of value-creating skill sets a person possesses.

3. A company can expand its returns through arbitrage if its managers understand how to exploit market opportunities.
4. Companies should adopt conceptual business models to create wealth. As such, a company should control – not own – its process chain.
5. In order to make good investment and financing decisions, and thereby create wealth, managers must raise their Private Finance I.Q.

Although playing by these New Rules will help business owners and managers create wealth, we can't escape the paradoxical nature of the Conceptual Age. This is best illustrated by the first entry in the "rules to consider" section of Wikipedia, the volunteer- written Internet encyclopedia: Ignore all rules.

Skill Sets and Value

The notion that everyone is responsible for his or her own value creation is a new one. Until recently, most people have assumed that doing a good job was enough. Training, development, and even education were shared responsibilities: employers and the government were charged with ensuring everyone's personal competitiveness. This changed in the 1980s when corporations began downsizing, thus breaking the Employer-Employee contract. Since then, whether they know it or not, everybody has been responsible for developing and maintaining value-creating skill sets.

A skill set consists of the capabilities needed to complete a major task. The Three R's - reading, 'riting and 'rithmetic - are not skill sets. The ability to use chemistry to create new formulas is a skill set. The ability to write legal contracts is a skill set. Yet with the exception of technical and engineering programs, most schools do not teach skill sets; rather, students are taught how to learn skill sets.

In a globalized world, job security is directly related to the number and quality of value-creating skill sets a person possesses. Of course, possessing a skill set does not guarantee value creation, because demand patterns change. For instance, unless she updated her skills, the best DOS-era programmer probably no longer creates value. Everyone needs to constantly update and add to his or her skills to continue to create value. And one skill set is not enough. Several inter-connected, value-creating skill sets are needed to ensure personal competitiveness. An ancillary benefit of acquiring skill sets is that it inevitably leads to the development of a more sophisticated view of the market place and what's required to win.

Arbitrage

It's human nature to want something for nothing. This feeling is enhanced when what's offered for free is worth millions of dollars. Arbitrage business strategies convert this feeling into reality. The word smells of money and it's frequently used in the same breath with words like "fortune," "boatload" or "killing." The dictionary defines arbitrage as the simultaneous purchase and sale of the same securities in different markets to profit from unequal prices. I define arbitrage as the ability to create wealth by taking advantage of inter-market opportunities. Managers create an arbitraged return when they understand capital markets well enough to discover and exploit a risk/return imbalance in the market. Properly implemented, arbitrage strategies enable a manager to receive a return that is greater than the underlying risk of the investment.

Arbitrage opportunities present themselves to managers who understand that capital markets are segmented. Capital markets are segmented based on a number of factors. The two most obvious are annual revenues and the return expectations of investors. The following Exhibit depicts this

segmentation. The broadest market segments include the small business market, the middle market and the large company market. Within the middle market, further segmentation is possible into lower-, middle- and upper-middle markets. Each market is subject to different return expectations, as demonstrated by acquisition multiples based on earnings before interest, taxes, depreciation and amortization (EBITDA). Small companies typically sell for two to three times EBITDA, while large companies sell for more than 12 times EBITDA. Exploiting the market's notion that "bigger is better" can create substantial value for a business owner.

Market Segmentation by Sales and EBITDA Acquisition Multiples

Sales ($millions): 5 | 150 | 500 | 1,000

	Small Businesses	Lower	Middle	Upper	Large Companies
		Middle Market			
EBITDA	2-3x	4-7x	8-9x	10-12x	>12x

Suppose a manager wants to realize a higher selling multiple for his company. One arbitrage strategy involves the manager consolidating his or her way there by paying acquisition multiples that are less than what the market would pay for his or her company. Thus, a manager of a middle-middle market company could acquire lower-middle market companies in order to eventually realize an exit in the upper-middle market. This creates an arbitraged return. In the vernacular of public companies, such a strategy would be accretive to shareholders. Not surprisingly, most arbitrage strategies depend on effective use of know-how, also known as intellectual capital.

Conceptual Business Models

Business models — the ways a company plans, organizes, and controls to meet its goals — have also changed in the Conceptual Age. Old-style "traditional" business models destroy wealth if they do not respect the New Rules. Conceptual business models, by contrast, are based on the New Rules. Consider Cirque du Soleil, or Dell, or Southwest Airlines. All three companies reconceptualized prevailing business models and in so doing both revolutionized their industries and created substantial value for their owners.

In these changing times, managers have no choice but to adopt conceptual business models to create wealth. Conceptual business models organize a company's process chain around the realities of globalization and the opportunities afforded by logistics and advanced technology. Simply put, a process chain is the set of activities a firm must undertake to supply its product or service. For example, in a traditional wood-processing domestic process chain timber is harvested by American loggers; American logs are sawed, then kiln-dried; dried boards are then shipped or further processed. This process chain worked well for more than a century. Then, in the 1980's, other countries began shipping finished boards into the U.S., sometimes at a fraction of the American producers' cost. Almost overnight the process chain in the forest products industry changed. Yet, many American owners were so accustomed to the old ways of doing business that they refused to change. Even after they went bankrupt, these owners did not understand the New Rules.

What did Midas Managers in the forest products industry do? They compared their internal costs at each step of their process chain with the new entrants' pricing, and then made a "build versus buy" calculation. At each step where their company could no longer create value for itself, Midas Managers purchased the good from, or outsourced the service to, another company.

In most cases this involved shuttering sawmills and other operations, something an ordinary manager would not do because it would have meant forgoing revenue and shrinking the company. The Midas Manager recognized that reducing the overall sales of his or her company actually increased profitability dramatically.

Control – Don't Own – Your Process Chain

Thanks to globalization, for the first time in mankind's history, everyone on the planet has access to all of the world's natural resources. Europeans, Asians, and Americans can all access Brazilian rainforests, Chinese factories, and rooms full of Indian technologists. What separates the winners if everyone has access to the same resources and thus, the same cost structure? The ability to harness, develop and implement intellectual capital. In other words, whoever creates the most value from the communal resources wins. This is the province of Midas Managers.

An example will illustrate this point. Let's assume that companies in Europe, Japan, and the United States each spot a market opportunity at the same time: a new type of lean-back chair. This potential niche is identified in an article in a leading medical journal that shows a person watching television will suffer less back pain and fatigue if they are sitting in a chair that tilts backwards at exactly 120 degrees. But no such chair is available in the market. All three companies have access to the same materials and cost structure to assemble such a chair. Who will dominate the market? The answer: whichever company creates the most value to the customer.

The Midas approach is to own the intellectual capital but not the entire process chain. For instance, design of the chair is a critical success factor. That intellectual capital must be owned by the company. But all of the manufacturing can be outsourced. All of the distribution can be outsourced. Even

marketing of the chair can be controlled but not owned. The Midas Manager knows that the winning company has a rapid response to the market, at a low cost, but a high value to the consumer.

Conceptual business models can also take advantage of what the market will give you. This is a niche-based approach. A niche not only represents an unmet customer need, it is also a sustainable intra-market business opportunity to create wealth. Niches often appear out of the corner of a business owner's eye. Many Midas Managers have told me that their best niches sprung from off-hand comments made by customers. One manager of an industrial distribution company once heard a contractor mention that it would be great if the distributor could create and supply stock lists from job blueprints. The Midas Manager immediately recognized that this service could create a competitive advantage and would allow him to position his company in a new, lucrative and sustainable niche.

Midas Managers are niche-aholics. To create wealth, business owners should be thinking in niches, too. This is true for several reasons. First, niches are identified through insightful process chain management. Activities such as outsourcing and intellectual capital development reinforce a company's ability to find and take advantage of niches. Second, capital and other resources are highly constrained for most private companies; this prohibits these companies from being all things to all customers. Third, niche-based strategies help private managers align their companies with one of the main realities of globalization: ever-increasing competition.

Over the past twenty years, globalization has caused the average niche size to drop substantially. This is because companies from around the world are now competing for every piece of business, no matter how small. A combination of more sophisticated logistics and the Internet opening up information flows has created niches with less than $5 million in annual sales. Many wealth-creating middle market companies are in fact just amalgams of fairly small niche businesses.

Private Finance IQ

Where does someone learn the New Rules of the Conceptual Age? The intellectual skill sets needed to create wealth are not learned in school. Even our greatest universities have not stepped up to the challenge of teaching the development and implementation of intellectual capital. This is why Midas Managers have had to learn these skill sets in the school of hard knocks. One Midas Manager explained it this way: "The most important learning happens when I get out my checkbook." In other words, you pay for your education whether you're in school or not.

Even with a conceptual business model, however, most managers need to raise their Private Finance IQ's to create wealth. Private Finance is the discipline that helps managers of private companies create wealth by making better investment and financing decisions. The typical manager's Private Finance I.Q. is low. For example, most managers do not know their company's cost of capital, nor do they know why it's vitally important to know it. Capital has a cost and this cost is measured on an "all-in" basis, not just stated interest rates. Moreover, corporate wealth is not created until a company achieves returns greater than its cost of capital. "Until a business returns a profit that is greater than its cost of capital, it operates at a loss," management guru Peter Drucker told *Fortune* magazine in 1998. "Never mind that it pays taxes as if it had a genuine profit. The enterprise still returns less to the economy than it devours in resources. Until then it does not create wealth; it destroys it."

As Chapter 4 illustrates, finance for private companies is quite different from finance for public firms. For example, the typical private company possesses a cost of capital that is nearly twice as high as a large public company. Thus, private firms can not create wealth simply by slugging it out against

their larger competitors. But private owners who adopt strategies that either increase returns or reduce their cost of capital have an advantage over owners with a lower Private Finance I.Q.

In Search of the Midas Touch

I'm often asked, "Can anyone become a Midas Manager?" The answer, I'm sorry to say, is "no." While the strategies herein can be replicated and implemented by any manager in any industry, no book is going to give that manager the Midas touch. Midas Managers are born on life's battlefield, often via some cataclysmic event that occurs early in life. For example, many famous Midas Managers were breadwinners for their families before they turned 13. The rest of us must be content to look over their shoulders and learn their tricks. When it comes to Midas Managers, imitation is not only the sincerest form of flattery, it might also lead to substantial wealth creation.

INVESTMENT BANKER MAN

The secret chant of raising venture capital