



A Valuable View

AN ARBITRAGE STRATEGY

Norris Jetton knew how to create business value. He had already done it twice in his lifetime, once in his early thirties and again in his early forties. He made his first fortune starting and then selling a company that provided printing services to the packaging industry. He made a second starting and then selling a specialty software company.

What made Norris' wealth creation even more impressive was he had done it with small companies. Neither of his businesses ever achieved more than \$6 million in annual sales yet they fetched around \$10 million apiece when he sold them. That success led to a nickname: Norris the Niche.

Now Norris the Niche was at it again, hoping to work his wealth-creating magic a third time. His new company, American Pipe Insulation (API), would install a special line of products for sealing and insulating industrial piping. Norris had discovered the sealants by chance while he and his wife, Sheila, were vacationing in Europe. When he returned home, he bought the rights to use the products in the United States under the name ThermoPipeSeal, a name he chose because of the sealants' ability to hold up even under high heat and intense pressure.

Soon, Norris had hired a consulting firm to study which markets would be most receptive to the product's unique sealing properties. While

ThermoPipeSeal could be used in a variety of industries, Norris the Niche decided to target a couple of depressed markets: coal-burning electrical plants and textile manufacturing factories. Norris' friends were not surprised he would choose customers that everyone else was running away from. He had always gone against the grain, and this time would be no different. He was content to let others sell to high-flying industries like beverages and pharmaceuticals. Competition would force their prices down, leaving them with commodity returns, he reasoned.

The lack of competition and potential for solid returns weren't the only factors that attracted Norris. He also liked the planning and installation cycles of the industries he chose. Fossil-fuel plants typically shut down for maintenance for a week or two in the spring and fall of each year, textile plants during the summer. API would generate nearly all of its revenues during these three times of the year.

The sales goal: \$6 million per year split 60-40 between utilities and textiles. But Norris knew from his prior successes that sales alone did not drive market value. He would have to focus on other issues if he wanted to create wealth once again. To maximize his equity position, Norris needed to institutionalize his intellectual capital. This meant that he had to:

- Organize API around a transparent business model
- Create recurring and predictable revenue and income streams
- Establish a management structure that would quickly make him superfluous
- Implement systems to generate and manage information effectively
- Own API's intellectual capital but outsource most other operations
- Perform a level of service within API's niche that would enable high profits

Norris focused on meeting these six goals. He knew intuitively that he was trying to get API viewed as a middle-market company instead of the small business that it was. This was a valuable view, since it promised better and cheaper access to capital and a host of transfer options at higher valuations if the business could hit those targets. This arbitrated return would give Norris and API the best of both worlds.

Organize Around a Transparent Business Model

Norris believed that the way a company plans, organizes, and controls to meet its goals determines success or failure in business. API's business plan would need to describe clearly how and from whom it would make money. Norris referred to this as business model transparency because he wanted his key managers and other stakeholders to be able to see clearly the critical success factors affecting the business. Norris learned early in his business career that the more transparent the business model you have, the simpler it is to delegate to managers who can then create value.

API's business model was simple and straightforward. Norris identified the utilities and textiles industries as able to benefit immediately from the sealing properties of ThermoPipeSeal. Through some basic calculations he determined roughly how many facilities in the U.S. could be customers. He also determined that the current insulating products available to those customers were far inferior to his. Thus, the value proposition (the value that his service would create for customers) would enable API to create wealth for itself. Because plant shut-downs were planned a year in advance, he even knew precisely when the customers would need his services.

The API business model followed six simple steps:

1. Identify facilities that could use ThermoPipeSeal and market directly to them.
2. Establish API as the service provider at least three to four months before each plant shutdown.
3. Execute long-term contracts with customers.
4. Price API's solution at 15 percent below market (this still generated a 60 percent gross margin).
5. Outsource as much of the work as possible.
6. Constantly refine and improve the installation process.

Following this business model, Norris believed he could meet his business goals.

Create a Recurring Revenue Stream

Thanks to Norris' sharp focus, API quickly signed long-term contracts with six large customers. Although detailed pricing had to be worked out on a job-by-job basis, the company typically experienced no more than a 10 percent variance from revenues it expected on each shutdown. Thus, Norris could estimate API's annual revenues at the beginning of the year and he could grow the business at his leisure (since his model was scalable, i.e., there were no internal constraints to expanding sales). By the end of the third year, API had \$6.5 million in recurring revenues.

Establish an Effective Management Structure

Norris went into every business with the goal of working himself out of a job by the end of the first year. He could probably make himself redundant sooner than that, but he liked living through all seasons of a business at least once before relinquishing day-to-day management.

At the beginning of Year 2, API was essentially being managed by two people. Norris had replaced himself with a seasoned general manager who negotiated all customer and vendor contracts and was responsible for managing the company's working capital (API outsourced most of its financial functions, so it didn't need a full-time controller). The other key manager was the head of operations, who trained and oversaw the supervisors. API employed six or seven supervisors in a year, which meant the Company was generating more than \$6 million in sales with no more than 10 full-time employees.

Norris picked employees who possessed three key traits. First, they had to be honest. There was no wiggle room on this. Second, they had to exhibit a lifelong habit of pleasing customers. Finally, they had to be motivated by money.

To satisfy this last trait, Norris shared the company's profits with all full-time employees. The key managers were put in a key person pool, meaning they received 10 percent of API's operating profits split 60/40 between the general manager and the head of operations. The remaining employees split 6 percent of operating profits based on their annual pay. Norris used operating profits as the measurement because it was a level of earnings his employees could affect. He was responsible for "below-the-line" expenses, such as borrowing costs, his compensation, and distributions. Paying out 16 percent of operating profits assured Norris that all of his employees kept his ownership interest in mind.

Implement Effective Systems

Companies with simple business models usually require simple information systems. API could be managed effectively by reviewing just two reports. First was the job book. It listed every job along with the name of the responsible supervisor. All manpower and resource planning was accomplished using the job book. Second, but no less important, was the job cost report. It showed the budget for each job compared with actual costs. The responsible supervisor had to explain any variances. The information needed to prepare these reports was so basic that API could generate it using an off-the-shelf computer program.

Control – Don't Own – the Process Chain

Norris had no desire to own API's process chain, the set of activities required to supply its service. He wanted to own only the intellectual capital and merely control the rest. The following schematic depicts API's process chain:



Norris understood that the only step in this process chain API needed to own outright was the first one. Marketing and selling ThermoPipeSeal depended on API's intellectual capital, or know-how. Understanding customer needs and how to service them were skills that API needed to develop itself and own independently.

Everything else, to one degree or another, could be outsourced. The general manager negotiated all supply contracts at the beginning of the year based on the job book. Throughout the year, a part-time employee ordered materials on a job-by-job basis. While an API supervisor oversaw installations, local, third-party crews did all of the work. On most jobs, API didn't even own the trucks and tools they used. An outside controller handled all invoicing and accounting. By outsourcing much of its process chain, API was able to employ a highly variable cost structure. Thus, its fixed expenses were quite low, which allowed API to earn high returns.

Make a Bunch of Money

Norris had a philosophy: "Why work hard for \$1 when you can work smarter and earn \$10?" Everyone at API eventually learned the benefits of this credo. Take a look at the company's income statement in its third year of operations:

Insulation Services, Inc.

Summarized Income Statement

Revenues	\$6,500,000
Gross Margins	60%
SG&A	1,850,000
Operating Income	\$2,050,000

API's selling, general and administrative expenses (SG&A) included salaries of \$400,000 for the two key managers and \$100,000 for each supervisor and fringe benefits for all employees totaling \$350,000. Outsourced services and miscellaneous costs, including \$100,000 to rent a building owned by a company Norris controlled, made up the remaining SG&A.

The Payoff

Even after paying bonuses (a total of \$200,000 for key managers and \$120,000 for the seven supervisors), Norris was able to distribute more than \$1.5 million to himself at the end of Year 3. But he was getting restless.

Norris had always been better at building companies than he was at owning them. A different manager would have worried about doubling API's sales or boosting its profit margins incrementally. Not Norris: He was a creator and harvester of value. Now, he had met his goals for the company and it was time for him to move on to the next opportunity. He wanted to sell API, and he already had a buyer in mind: his managers. They had earned the opportunity.

From the beginning Norris wanted API to be viewed as a middle market company. He thought he had achieved that goal, and now it was time for the payoff. As a small company, API would be worth three to four times recast operating profits, or about \$6 million (3.5 times \$1.7 million). However, Norris knew that he had built a company with a transparent and easily understood business model, recurring and predictable revenue and earnings, a lean and effective management structure, a rationalized process chain, and a cost structure that allowed for obscenely high earnings.

Norris settled on a non-negotiable price of \$10 million, which he reached by multiplying \$1.7 million (recast operating profits less bonuses) times six, a common middle-market acquisition multiple. The company had no debt so

the entire selling price (less Uncle Sam's cut) would go into Norris' pocket. Not bad for three years' work.

But could his managers afford to pay \$10 million for the company? Between them they had about \$500,000 in equity. This left them short \$9.5 million. Yet the same reasons that made Norris believe API was worth so much were now working in his managers' favor. A cash-flow lender offered to put up \$6.5 million, which amounted to more than three times the company's annual cash flow. The managers had created a five-year business plan that promised yearly sales of \$15 million and operating profits of almost \$5 million. On this basis, they were able to entice a mezzanine investor to lend them the final \$3 million.

For the third time in his life, Norris received \$10 million from the sale of a business, and he wasn't yet 50 years old. What's more, his managers now owned a great business, the lenders lent to a great business, and the employees worked for a great business. Norris Jetton's valuable view had paid off for everyone involved.

BLUEPRINT

Norris' vision for API started with a niche, a hope and a prayer. He followed it up with smart planning and effective organization that kept the goal of creating wealth at the forefront of everyone's minds. API's story shows that a company does not have to be big to be valuable, and you won't be surprised to learn that Norris is now building his fourth small business in very much the same way.

Arbitrage brought API returns that were greater than its underlying risk. Getting the market to view your company on a lower-cost capital market line can do this. It is possible for a small business, for instance, to be viewed as a lower-middle market company even if it is still generating the higher returns that the small market promises.

How is this best-of-both-worlds scenario possible? Companies that perform at the top of their industry are usually viewed as less risky than their under-performing counterparts. This explains why some companies fetch much higher acquisition multiples or lower-cost capital than their similarly-sized competitors. In other words, investors and sources of capital believe these winners play on a less risky capital market line than might be indicted by their diminutive size.

Here are some specific steps you can take to replicate this strategy:

1. Create a transparent business model for your company. That simply means organizing all of your company's activities around customer needs and filling those needs in an efficient way. When anyone can understand the business, the risk goes down dramatically. To test if a business model is transparent, try explaining it to a 14-year old. If a teenager can understand it, it's probably simple enough to launch.

2. Strive to create recurring and predictable revenue and income streams. If a contractor like API can accomplish this, then most companies should be able to do it. And note that it's not always necessary to get customers to sign long-term contracts; it's often sufficient to get customers "hooked" on your company's products or services such that they could not imagine buying anywhere else. Carving out a place in the market, a niche that you can defend, has this effect. This is why managers of private companies need to be niche-aholics. Just ask Norris the Niche.
3. Think and act strategically. Like Norris, most Midas Managers want to delegate day-to-day operating work to others as quickly as they can. That's because they know they can create more value making and implementing strategic plans than they can installing insulation. To this end, the goal of every business owner should be to ascend to the role of Active Chairman.
4. Information is power, so treat it that way. Unsuccessful companies are constantly surprised — by trends in the market, by changes in customer behavior, by their own mistakes, and so on. Successful owners are rarely surprised. They always strive to have a good handle on information and good systems in place that will give it to them.
5. Rationalize your company's process chain. These words might seem foreign to private business owners and managers, but in an 24/7/365 global economy, everything a company does to provide its goods or services should be outsourced if it isn't adding value. Intellectual capital is always owned by the company; the rest of the chain need only be controlled.

Possessing a valuable view generates value for a company on its own, even if an owner decides never to sell the business. Good businesses are easier and more fun to operate than poor ones and top performers attract top

talent to continue the virtuous cycle. This chapter illustrates the thought process and actions of an owner who starts businesses with a common motive: to create wealth. Regardless of the industry, he achieves his goal because he employs the same strategy each time. The best news: His valuable view and the arbitrage strategy to achieve it can work for anyone.