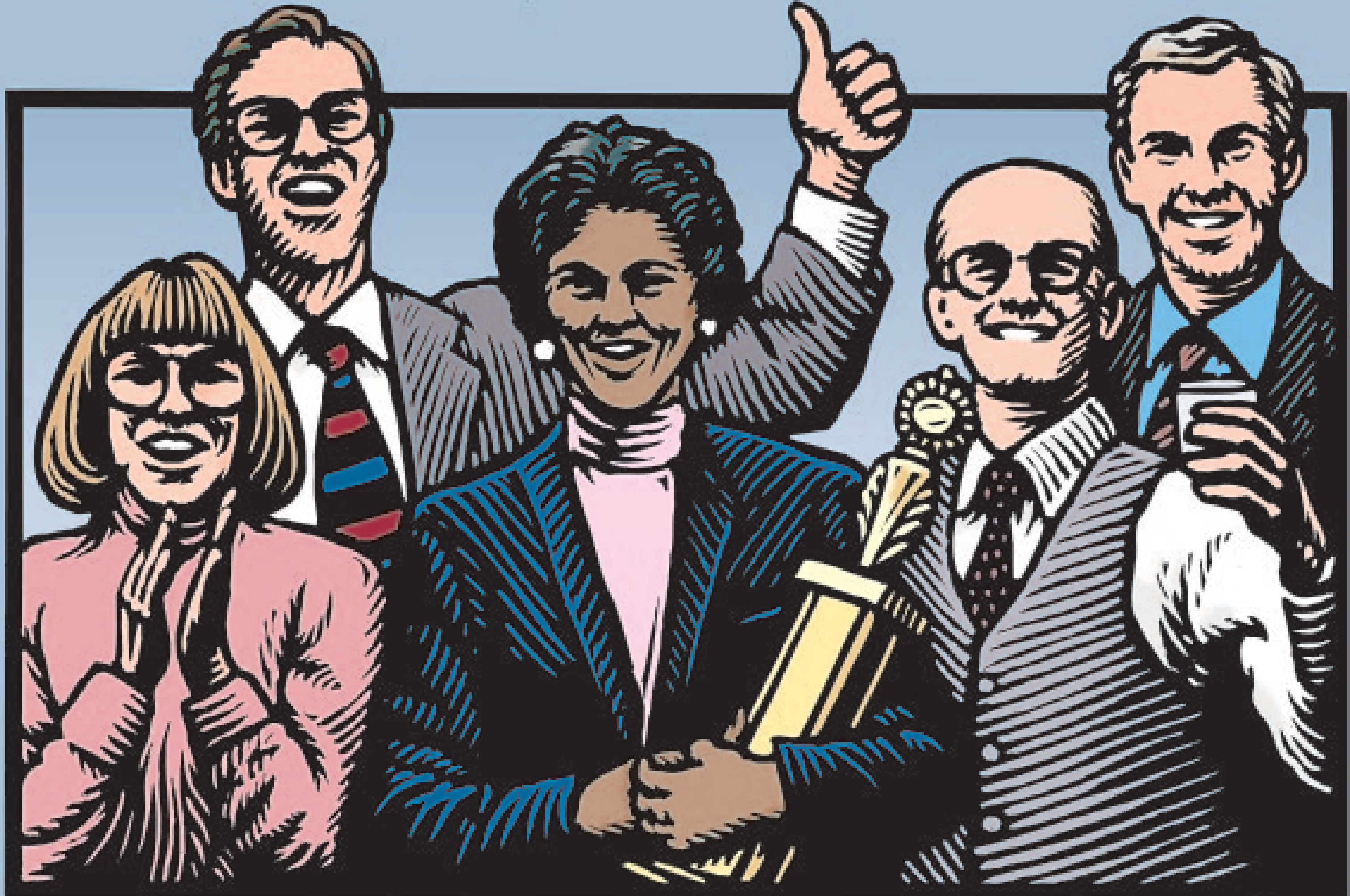
THE SECURED LENDER
January/February 2006

# What Makes a Small, Entrepreneurial Company Stand Up and Succeed?

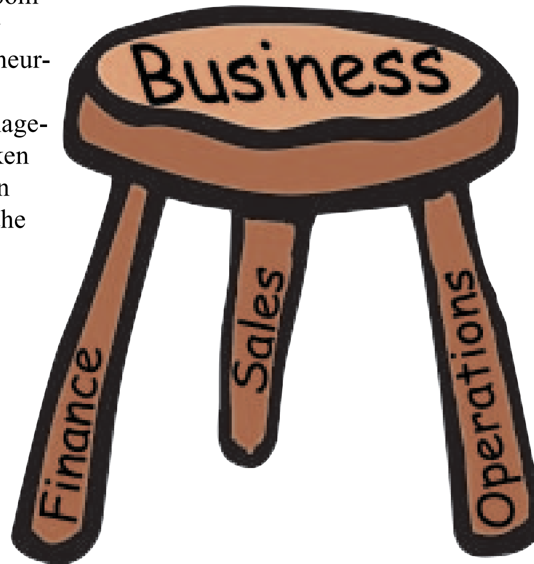


by Mark A. Looft

In traditional universities, the required business school curriculum typically includes a primary focus on three areas: financial, sales, and operational. Real-world experience tells us that business is so much more. There also needs to be solid contributions from purchasing, inventory controls, manufacturing, administrative assistants, information technology, marketing, customer service, human resources, engineering and logistics.

©2006 All rights reserved. For website posting only. Bulk printing prohibited.
To order hard copy reprints, call The Reprint Dept. at 800-259-0470.

Still, these three areas of classroom education directly correlate to the key elements of running a small, entrepreneurial business. They also draw the most attention from investors, lenders, management and directors. One could also liken them to the three legs of a stool. When assembled and maintained correctly, the stool is great. If one leg is shorter or weaker, the stool doesn't work.




In commercial finance, our borrowers typically don't meet some requirement of a more traditional financing source like a commercial bank. We normally aren't called upon to finance companies that are investment-grade borrowers, like IBM and Microsoft. Financial losses, an abundance of debt, a personal or professional bankruptcy filing in the past, weak/negative cash flow, or the loss of a major customer, all typically preclude banks from providing such a company with financing. Hence the impetus for alternative sources of financing.

Particularly in the privately-held, under-$50-million revenue category, we are asked to finance companies owned and operated by one person or a small group of individuals. The business in question often consumes their lives and the lives of their family. One person often makes the majority of the critical decisions facing the business. This is where the stool is tested. Many entrepreneurs possess a great foundation in one area, but lack the comfort and expertise in one or more of the three primary areas. This creates an unbalanced stool. Without another member of the management team shoring up that deficiency, an "event" is waiting around the corner.

One rarely hears about smaller-scale success stories. The decisions made by these business leaders on a daily basis directly drives their businesses up or down. Yet many do not have the balance sheet or the financial wherewithal to withstand a serious misjudgment.

In general, these business leaders are able to lead their companies up to a certain point. In manufacturing companies, the breaking point usually hits somewhere between $10 million and $20 million in sales. In distribution companies, it may be as high as $30 million. Yet all companies have a breaking point when one individual cannot make every decision in those three critical aspects of the company. That leader needs a strong CFO or sales manager, or operation manager to bolster the weaker area of the business.

**XYZ Corp. – Financial expertise more than pays for itself**

XYZ Corp., a ready-to-assemble manufacturer of office furniture, had been in business for nearly 30 years. Family- owned and -operated, the founder (Ron) made virtually every decision including suppliers, product design, customer relationships, packaging and shipping. Ron was the majority shareholder and each of his four kids worked at XYZ, each with a small equity stake. Ron was well-known and respected in his field and considered a great supplier by his retail customers.

Seemingly overnight, Ron discovered that XYZ was struggling financially and the vendors were being stretched. He really didn't want to layoff any employees or shut down one of his two manufacturing plants. Ron felt that he could grow his way back to profitability. Enter Big-Mart, national retail chain and powerhouse. Ron thought he could double his annual revenues rapidly and restore XYZ to its previous glory.

In order to win the Big-Mart sales, he would need to cut his gross margin percentage. He figured the increase in sales would cover all of that and more. Without sufficiently projecting what gross margin percentage he was expecting to get, Ron successfully won the Big-Mart new office furniture sales. Elated that he had saved XYZ, he promised his suppliers that he would soon have them current. Six months later, the vendors were still stretched and his staff was overworked by the requirements of doing business with Big-Mart. Maybe those precious sales he fought so hard to get were not a panacea.

Ron had failed to factor into his projections the extended terms, discounts, promo sales, advertising allowances, authorized (and unauthorized) returns/credits and charge-backs that Big-Mart was taking. Ron thought he was getting 20 percent-plus gross margins, but the effective gross profit margin was less than ten percent. If Ron had a strong CFO, he would have been able to project the real gross margin percentage. Certainly he would have figured it out within 60-90 days. About a year later, the vendors eventually filed an involuntary Chapter 11 and XYZ was sold in a 363 sale about two years after getting the first purchase order from Big-Mart.

**Car Parts Ltd.: Sales are key**

Car Parts Limited (CPL), a manufacturer of aftermarket automotive parts, was founded nearly 75 years ago by Tom Sr. The second generation (Tom Jr.) had successfully navigated the business through a couple of serious economic waves that caused several CPL competitors to fold. CPL responded by acquiring several failed competitors brands at steep discounts. He planned to use the many

brands to differentiate the company in several areas of the automotive aftermarket supply.

Sales were generated by a myriad of customers nationwide that had come to know Tom Jr. and recognized him as a born, dynamic salesman. Tom rarely left a customer's office without an order. This story took a tragic turn when Tom Jr. unexpectedly died at 55 without much of a transition plan. His wife had already passed away and his only son (2 years out of college) was learning the ropes working in one of the plants.

Tom the III was not a "chip off the old block". Not yet comfortable in the ways of the automotive world, he was not particularly fluid in understanding the financials of his new company. Although he had been around it all of his life and knew many of the key employees, Tom III was not as confident as his father or grandfather and he did not possess the required acumen to lead the company.

So he promoted a trusted, lifelong friend of his father as CEO and brought in other good advisors to bolster the ranks and run the three manufacturing plants. They discovered a company buried in debt (leveraged over 20 to 1) and desperately in need of cash flow to pay down the debt burden. At first, Tom III tried his hand at sales and failed miserably. Tom began to learn more about his products and his customers' strengths and weaknesses. He used the charm and confidence he inherited from his dad and used the family name and reputation to his advantage. He worked all the trade shows and traveled across the country preaching the family name and CPL's 75-year reputation.

It worked. CPL trimmed capital expenditures considerably, sold off some old brands and two older manufacturing lines, and improved gross margin percentage by five percent. CPL repaid much of its debt and got the leverage back to < 2 to 1 in a little over two years. Tom III recognized his weaknesses and weathered the storm by bringing in competent professionals and delegating tasks.

**ABC Inc.: Operations/management style can be the difference**

ABC was 100 percent owned, operated and founded by Bill for over ten years. ABC was an importer of its own private brand of widgets from Asia. Bill was always ahead of the curve re product innovation and custom design. The company had over 50 skus that were specially designed and manufactured to Bill's specifics and shipped to the U.S. Over 90 percent of ABC's sales were generated via four-to- five major national retail chains.

His brands were gaining momentum and ABC was building market share in its targeted segments. So focused on next season's products and brand building, Bill often neglected his employees and was considered abrasive by many. Rewards, bonuses, even thank yous were rare. Bill didn't realize that he could not successfully run the business alone.

Despite ABC's solid sales growth, increasing profitability and growing brand awareness, morale was low and esprit de corps was virtually nonexistent. ABC lost its national sales manager and purchasing manager to a competitor. ABC's logistics suffered almost overnight. Import shipments were lost or delayed and customers began to cancel pending sales orders. Bill was shocked when longstanding customers began to question ABC's ability to deliver and meet their needs.

Bill quickly filled both key positions. He spent weeks getting them acclimated and proficient. Bill also added a new COO with great people skills who executed several initiatives to boost morale and give ABC a new beginning. He also gave raises and bonuses to key employees and is considering an ESOP plan.

Bill recognized his shortcomings and identified ways to cure them and learned that managing people is a constant challenge.

Some of these owners did not have all the legs of the stool in balance, but they did have the drive to succeed. Their drive for success – both psychologically and monetarily—energized their companies.

An ex-CEO of a Fortune 500 company was once asked how he came to make good decisions in leading his company to prosperity. The CEO's response: "Previously, I made a lot of bad decisions". Surrounding yourself with good help, listening to trusted advisors and having a clear vision of where you want the company to go are all pillars of successful business leaders. Plan the work and then work the plan.

Some entrepreneurs have the business acumen to take an idea from scratch and create a successful small business or take a fledgling business and turn it into a viable, operating company. These professionals should be recognized for their efforts. But every small business hits a speed bump or two along the way. As previously noted, the asset-based lending situation tends to be "event-driven" and often the need for funding comes at an inopportune time in the life cycle of the business.

As part of due diligence, a lender must fully analyze the entrepreneur's skill set. Then be prepared to make recommendations for ways to shore up that weak leg of the stool to insure the long-term stability of the enterprise. Ideally, you want to make a good loan to a good company with good management. Unfortunately, in asset-based lending, that comes along about as often as Haley's Comet. In lending, sometimes it is better to "bet the jockey and not the horse". If given the choice between lending to a company going through a tough time, but with a strong management team, or lending to a good company with questionable or weak management, I'll choose the former. ▲

*Mark A. Looft is first vice president and senior business development officer for the Western Region of GMAC Commercial Finance, Los Angeles, CA. He has been in the industry for over 15 years with experience in audit, underwriting and business development functions.*

Reprinted with permission from The Secured Lender, January/February 2006
by The Reprint Dept., 800-259-0470 (101200206)