Chapter Four
Identify the Competitive Advantage
Step Three of the Proactive Sale Strategy

The central premise of this book is that it is possible to sell an ordinary company for an outrageous price. Let's quickly review what we mean by ordinary company and outrageous price.

Ordinary Company

First, there's no set value to an ordinary mid-size company: it may be at the bottom of the scale ($10 million) or near the top ($250 million). For our purposes, the ordinary company is privately held, but has no particular management structure. It can be co-owned, family owned or sole owned. Ordinary companies do not attract infusions of venture capital, and do not have patents pending on a cure for cancer or miracle diet pill. Ordinary companies operate in any industry, but generally are in industries that are treading water, rather than growing rapidly (e.g. the high-tech sector). Finally, ordinary companies are sale-able, meaning that they possess enough characteristics necessary to attract a buyer willing to pay the average industry multiple.

Outrageous Price

This part is simple: an Outrageous Price is at least two times the prevailing average industry multiple. To achieve an Outrageous Price, we use a two-phase process. The Proactive Sale Strategy (Part I) minimizes the chances that the transaction will fail and maximizes the sale price, and is the foundation for Part II, The Outrageous Price Process. The Outrageous Price Process is the method we use to leverage a competitive advantage so that, a) if a buyer acquires it, the acquisition creates significant gain; or b) if a buyer chooses not to acquire the company with the competitive advantage, the buyer will experience significant pain . . . enough to motivate that buyer to purchase the company to avoid the pain.

COMPETITIVE ADVANTAGE DOES DOUBLE DUTY

In this Chapter, we look at identifying a company's competitive advantage through two prisms: first doing so is a step in the Proactive Sale Strategy and second, the presence of a competitive advantage is a fundamental requirement of the Outrageous Price Process.

Identifying a company's one, or more, competitive advantages early in the Proactive Sale Strategy is critical because understanding the competitive advantage(s) supports the asking price. This understanding gives the transaction advisor—who knows how to use it—a compelling story to tell potential buyers. It also gives buyers assurance that they're getting good value for their money, and it helps owners to focus their energy and attention on what makes their companies valuable. Sellers must know what sets their companies apart from their competitors before taking a company to market. In my opinion, the transaction advisor who goes to market without that information does the seller a profound disservice.

In the context of the Outrageous Price Process, we consider the competitive advantage to be the first of four pillars of the Process. As a sneak preview, the four pillars are:

1. A competitive advantage that can be leveraged to persuade a buyer to pay top dollar;
2. At least one deep-pocketed buyer active in the marketplace who is motivated to buy because of its desire to eliminate the pain a seller causes it or to exploit the gain a seller offers.
3. A seller suited to go the distance; and
4. An advisor who knows how to execute the Outrageous Price Process.

In Part II of this book we describe these pillars and devote entire chapters to buyers, sellers and advisors. But because the competitive advantage is common to both the Proactive Sale Strategy and the Outrageous Price Process, we jump into that discussion here and refer back to this chapter as necessary in the second part of this book.

THE HISTORY OF COMPETITIVE ADVANTAGE

A competitive advantage is the feature (or features) that enable a company to make a product or offer a service either better or more cheaply than its competitors—over time. In the context of the Proactive Sale Strategy, however, we are looking for an existing, or potential fit between the seller's competitive advantage and the buyer's need. Better yet—and absolutely critical to getting an Outrageous Price for your company—we are looking for a way that the seller's company: (1) can (or could, if given time and preparation) meet a buyer's immediate need, or (2) could pose a significant threat to a buyer.

In 1980, Michael E. Porter, a Harvard University professor, wrote "Competitive Strategy: Techniques for Analyzing Industries and Competitors" and further investigated the topic in his 1985 book "Competitive Advantage: Creating and Sustaining Superior Performance." While Porter did not coin the term "competitive advantage," he did inject it into the parlance of students in every business school in America. All newly minted MBAs recognize the term and some have a passing knowledge of Porter's method of identifying one's own or a competitor's competitive advantage.

In Porter's world, the reason to identify and to nurture competitive advantage is to not only maintain, but also improve a company's financial performance in its daily operations. "Competitive advantage grows fundamentally out of value a firm is able to create for its buyers that exceeds the firm's cost of creating it. Value is what buyers are willing to pay, and superior value stems from offering lower prices than competitors for equivalent benefits for providing unique benefits that more than offset a higher price. There are two basic types of competitive advantage: cost leadership and differentiation." (pg. 3 Porter: CA)

As an investment banker, I use the concept of competitive advantage not to improve a company's profits (although if an owner is years away from a sale, we will do that), but as a tool to build maximum sale price.

If you wish to dive into the subject of competitive advantage more deeply, I suggest that you pick up a copies of Professor Porter's books, many published by The Free Press, a division of Simon & Schuster, Inc.

WHAT IS A COMPETITIVE ADVANTAGE?

For our purposes here (understanding how to sell a business for an Outrageous Price) let's use a simple definition of competitive advantage: A company's competitive advantage is the product it makes or service it offers either better or more cheaply—over time—than its competitors.

There are three important components to this definition: differentiation, lower cost and sustainability over time. The first two are exclusive: your company may do something differently than its competitors or it may do or make something more cheaply. Differentiation or cost leadership must each be paired, however, with sustainability. To be valuable to a buyer, the ability to differentiate itself or make something (or provide a service) more cheaply must be sustainable over time.

Before we focus our attention on how one or more competitive advantages cause a buyer pay a maximum or even Outrageous Price for an ordinary company, let's look at the issues that make a company fundamentally sale-able.

Remember, not all companies are even sale-able and therefore will never compete, (without much work and planning) for a maximum, much less an Outrageous Price.

SALEABILITY

I've identified a number of characteristics that buyers look for when shopping for an acquisition. These appear in no particular order as buyers rank them according to their own needs. As you review this list, consider how you rank—and how a potential buyer might evaluate—each characteristic of your company.

Table 4-1.

Characteristic	Low Risk	High Risk	Seller's Rank: 1-6 (1 is lowest)	Buyer's Rank: 1-6 (1 is lowest)
Profitability history	Long, profitable history.	Short or unprofitable history		
Industry segment	Stable or growing.			
Highly profitable industry.	Erratic or declining growth rate. Generally unprofitable industry.			
Special skill or expertise	No special skill required for success.	Requires highly-specialized or scarce skills.		
Location (or lease term)	Location is excellent and can be maintained.	Location is unsuitable and/or requires relocation.		
Relationships	Success is broad-based.	Success depends on limited number of key relationships or customers.		
Labor	Labor is available and relations are good.	Labor is scarce and/or relations are poor.		
Management	Management team is fully qualified, competent and committed to stay post sale.	Management is unwilling to remain and/or incompetent.		
Return of investment	Buyer could liquidate investment for about the same amount as it paid.	Buyer's investment could be easily depleted or is non-liquid.		
Return on investment	Market, economic and historical data indicate a continuation of returns.	Without changes in the company, market or economy, buyer has few prospects for healthy return.		

Characteristic	Low Risk	High Risk	Seller's Rank: 1-6 (1 is lowest)	Buyer's Rank: 1-6 (1 is lowest)
External Factors	Most of the company's requirements for success are within the company's control.	Company success depends heavily on external factors: e.g. interest rates, availability of credit, commodity prices, fashion or style, transportation costs or foreign sources.		
Reputation	Company is reputable.	Company is unknown or poorly regarded.		
Product / service	High-value, competitive and responsive to market demand.	Poor quality, overpriced, unresponsive to market demand.		
Regulation	Not subject to special insurance, licenses, franchises, bonds or governmental regulation.	Subject to hard-to-obtain or expensive insurance, licenses, franchises, bonds or governmental approval.		
Competition	Limited	Intense or increasing.		
Technology	Not particularly vulnerable to changes in technology.	Changes in technology have significant and/or negative impact.		
Resale-ability	Company could be re-sold easily	Company would be impossible to resell.		

At this point, let's assume that your ordinary company is sale-able, but the Million-Dollar Question (or in this case, the Multi-Million Dollar Question) is: Does your company have a competitive advantage that we can leverage in the Outrageous Price Process?

DOES YOUR COMPANY HAVE A COMPETITIVE ADVANTAGE?

I don't know, and if I had to guess, neither do you.

Here's what I do know: buyers are more likely to pay top dollar for a company that enjoys an advantage over its competitors. These buyers will only pay Outrageous Prices if the company for sale has a competitive advantage that will either eliminate a source of considerable pain or provide a source of considerable gain to the buyer. We'll talk about how to relieve (or cause) pain or gain to a buyer in Chapter Six. For now, let's look at how we go about determining a company's competitive advantage.

I call the process that I use to identify a competitive advantage "Hover and Dive." Not terribly technical, I know, but the title gives you a good idea of what's involved in finding the characteristics of a company that we can use to maximize sale price.

The Hover-and-Dive Process

As you may recall, in Step One of the Proactive Sale Strategy, I ask prospective sellers to answer a number of questions contained in a Sale Readiness Assessment. (See Appendix A for the complete Assessment.) These questions cover a broad range of issues (such as an owner's exit goals, relationships with advisors, and competitors), but the lion's share is devoted to a company's operations. Operations-related questions include: pricing, costs, people, sales/communication/marketing, technology, business strategy/business model, industry, customers, and systems. I use an owner's thoughtful—and usually intuitive rather than fact-based—answers to those questions as the basis for detailed and wide-ranging discussions that can resemble the process a physician uses to reach a conclusion about a patient's complaint, condition or disease. Based on training, experience and intuition, physicians start with general questions and then ask increasingly more specific questions in an effort to make a diagnosis.

I use the same process as I search for:

1. An understanding of whether this company is saleable.
2. The competitive advantage that makes this company unique and saleable at great price.
3. Whether the competitive advantage can be leveraged to induce a buyer to pay an Outrageous Price.
4. Information that will help me to identify potential buyers.

I call this process "Hover and Dive" because I first hover at a high altitude to get a feel for the terrain. From 2,500 feet, I look for reasons to narrow the focus of my search until I can dive into a possible solution. If a dive does not yield the information I seek, (and the first dive rarely does) I return to hover over the terrain, asking questions until I can locate another area that might hold the answer to my question: What does this company create or do differently than its competitors?

Like a physician, my role is to ask insightful questions, but also to listen carefully to an owner's intuitive answers. Like a therapist, I ask general questions, but when I hear something interesting I encourage the owner to, "Tell me more about that." Unlike most investment bankers, I engage in this process because I don't assume that I know all the answers. Each company is unique, as is each owner, and each transaction. While there are some patterns common to most, the variation of companies, owners and paths to the closing table is endless.

Know-It-Alls

As the "patients" in this process, owners answer my questions to the best of their knowledge, but most draw heavily upon their intuition. If an owner can accurately answer every single question that I ask as I hover and dive looking for the competitive advantage, it raises new questions about the competency and role of the owner's management team. The first question is, "Does this business owner, who knows all the answers, hold all of the information between his ears" followed quickly by, "Is his management team really managing anything?" Buyers understand that once the everything-between-the ears owner exits, profits, if not the entire company, will likely collapse. For that reason, buyers are simply not interested in owner-centered companies.

Intuition: Fact or Fiction?

As I mentioned, most owners draw heavily upon intuition in response to my hover-and-dive questioning. Doing so is completely acceptable, but I must probe further to determine if an intuitive response is a fact or an untested theory. I am reminded of the owner of a frozen food company who, like most owners, answered my questions intuitively. This company's most profitable product was frozen pizza so I asked him why customers bought from his company. He quickly responded, "Because of its price point in the market."

I had asked this question not only to collect information, but also to test the owner. Was his a statement of fact or an assumption? Could I poke a hole in this statement/assumption to get to what really drove consumers to buy his product? And could I prompt him to think about his product in a different way? My follow-up question was, “How often do you send reps into retail outlets to assess the prices of all frozen pizzas in the case?” This owner’s answer: “Never.”

We both learned something important from this answer. I learned that the owner might be correct, but without further investigation, we really had no idea why consumers were purchasing his pizza. On the flip side, the owner learned that sending representatives into the marketplace to collect some up-to-date data about his competitors, might not be a bad idea.

This owner was quite typical in that he did not know exactly why his customers chose his company’s service/product. Owners of mid-market companies are generally so focused on getting the product out the door that they don’t have a lot of knowledge about their competitors. It isn’t surprising then that they don’t make the connection between their ability to keep competitors out their marketplace and how that ability might influence the price a buyer would be willing to pay.

Know-Nothings

I recall meeting with the owners of a North American manufacturer of circuit boards. Its annual profit was around $20M and it managed to manufacture its product in the United States, both characteristics especially valuable to a European or Asian buyer.

When I asked these owners what made their company different, or why customers purchased from their company, they answered, “We have no idea.”

The company’s expenses were similar to its competitors in the industry, but after about five hours of hovering and diving around various topics I learned that the Chief of Operations and Vice President of Sales had instilled a discipline to replace less profitable sales with more profitable ones. They turned away existing or potential business that did not meet a set minimum gross profit margin.

In addition to setting this standard, the managers stuck to it. In two years, these managers replaced $100 million worth of business. They sought out and brought on board customers willing to pay a higher price because the company focused all of its efforts on meeting their specific needs.

This company had differentiated itself from its competitors based on a policy choice its management team had made about a tradeoff between sales volume and profitability. This company’s management made a conscious decision to serve only its most profitable customers. The team’s willingness to turn away less profitable business cut into its volume, but its discipline in adhering to its choice to outperform its competitors in satisfying highly profitable customers and to market this distinction to customers willing to pay the higher price created its competitive advantage.

Once we identified this competitive advantage, the question was: could we show a prospective buyer how to maintain a customer base with these margins? If so, we held in our hands an important key to selling this company for top dollar.

The purpose of Hover and Dive is to find and make the connection between two dots:

1) What does a company do differently (or more cheaply) than its competitors to make it profitable? And,

2) Can that activity be sustained over time—even by a new owner?

The questions I ask in Hover and Dive are intuitive, but are also based on objective research, my synthesis of "best practices" gleaned from hundreds of business books, and on my experiences with start ups and running my own companies. My experience as an investment banker who has orchestrated the sale and purchase of numerous companies for Outrageous Prices also plays a huge role in how I conduct the process.

To me, making connections between what a company does (or could do) to distinguish itself from its competitors and how we might use that characteristic to entice a buyer to pay an Outrageous Price is like moving puzzle pieces until I can see the design. In this process of analyzing and linking information in new ways I can create a theory (and then a fact-based compelling story) about why a buyer would benefit from purchasing a company. In some cases, linking helps me to see how to show a buyer how not buying a company will cause it significant pain.

Let's look at how several sellers (all based on real-life clients) found one or more competitive advantages to leverage into Outrageous Prices. For now, we'll simply take a snapshot of what we learned through the first portion of Hover and Dive. In Chapter Six we'll look at how we spun the straw of competitive advantage into the gold of an Outrageous Price.

Clearly Buster's business had several (albeit limited) competitive advantages: economies of scale, and location. In addition, Buster had gained valuable experience in favorably affecting legislative action. What Buster didn't have was a sustainable competitive advantage and his business was in a dying industry. These two factors did not make his company un-sale-able, but they eliminate the possibility that he could sell it for an Outrageous Price.

DIFFERENTIATION THROUGH SERVICE PROCEDURES AND PERSONNEL

Ignatius Eberhardt owned Wisconsin Medical Waste (WMW), a highly-successful company for almost 10 years before he got the itch to sell. Iggy started WMW after noticing, during one of his father's long hospital stays, that the hospital's needle disposal containers were constantly overflowing. He decided that he'd start a medical waste company that would replace the disposable containers with reusable ones that his employees would exchange when the containers were half-full.

Wisconsin Medical Waste outfitted its field technicians in crisp, clean uniforms and operated the cleanest fleet of trucks in the business. Iggy hired a former customer service manager from a 5-star hotel chain to train all employees in customer relations.

Ignatius's unique knack for extraordinary customer service helped him gain access to Milwaukee's (and then Wisconsin's) network of hospitals, medical schools and private medical practices.

WMW quickly expanded its customer base from health institutions to medical and dental offices, nursing homes and clinics. Iggy added hospital red bag (non-sharp medical waste) to WMW's pick-up routes. The company grew steadily and profitably eventually saturating its market and driving out all competitors but one. Ignatius held at bay this one competitor (the largest in the industry) by providing his customers with meticulous service. If he had to clean up a customer's biohazard room so it reflected WMW's standards, Iggy did so. Not surprisingly, in its ten-year history, WMW never lost a customer.

DIFFERENTIATION THROUGH KNOWLEDGE AND BACKWARD VERTICAL INTEGRATION

Green Streets was a New Hampshire-based road builder. It was run by its second generation of owners and had grown under that leadership from $3 million to over $100 million in revenue.

In addition to building roads throughout New England, Green Streets had carved out a place for itself as an approved contractor to the National Park Service. Although it was not the National Park Service's exclusive road-builder in Acadia National Park, it was the preferred contractor.

The engineers at Green Streets had developed methods to adhere to the Park Service's strict requirements in road building. For example, Green Streets successfully built roads without moving any dirt more than 100 feet from its original location. Sensitive to the Service's environmental concerns, Green Streets inspected (and if necessary repaired) its trucks on a daily basis to prevent any leakage of oil or other fluids.

Green Streets enjoyed one more, significant, advantage over its competitors: it was the only road builder in the Granite State to own its own quarry. It could control its primary input source (gravel) better than most, if not all, of its regional competitors.

LOWER COST THROUGH DIFFERENCE IN AUTOMATION

Saint Louis Post (a fictional name for a real company) used railroad rails in its production of heavy-duty steel signposts for sale primarily to state highway departments. Its 46-year-old owner, Terry, had purchased the company 10 years prior to our first meeting about planning his exit from his company.

When we first met, St. Louis Post was running about $2 million in sales each year, but Terry had lost his mill (which had re-fabricated rails into bar stock) through eminent domain, leaving him dependent upon competitors for the bar stock needed to fabricate the signposts.

Always a tinkerer, Terry responded to this challenge by developing just one machine, (at a cost of about $1 million) to make signposts for $600/ton. At the time, a division of a major multi-national corporation that we'll call "Goliath" (and Terry's largest competitor) controlled 90 percent of the market, selling posts at $1700/ton.

Terry had already approached Goliath to gauge its interest in buying him out. Not surprisingly, Goliath could not be bothered.

As I probed Terry's exit objectives, I learned that he would happily leave his company if he could get $5 million for it. Terry had achieved a significant advantage over Goliath and all his competitors through reconfiguring his value chain: making a significant capital investment in creating a different, more efficient and less labor-dependent production process. His value chain was quite different from his competitors'. but could we create a strategy to attract this buyer's attention? And did Terry have what it takes to pursue the Outrageous Price? We'll answer those questions in Chapter Six.

LOW-COST LEADERSHIP THROUGH CONTROL OF ONE OR MORE COST DRIVERS

Buster Mann owned Big Man Cig, a low-cost outlet selling cigarettes and beer along the Missouri side of the border with Illinois.

Buster started small: two or three shops. His intent was to put as many shops on the border as he could so each was a no-frills establishment. Each shop was open 24 hours per day and had a drive-through window.

Buster quickly established himself in the best locations, but competitors soon followed. He built as many outlets as possible in the shortest period of time while his competitors followed suit.

When I met with Buster during an initial, no-commitment meeting, we had to look a little deeper to find Big Man Cig's competitive advantage. Buster had maintained a lead over his competitors, but not a significant one, in the number of locations (economy of scale). The value of the advantage of being first (timing) had eroded over time, and his current locations were only slightly better located and maintained than those of his competitors. With these advantages, Buster could get a fair price in the market, but could be get a maximum or even Outrageous Price?

Several months before we met, the Missouri legislature had targeted the tax on cigarettes as a means of raising additional tax dollars. According to Buster, a tax increase (to match those in neighboring states) would, "Suck the life out of my business, one puff at a time." Buster spent almost a million dollars lobbying members of the legislature and sponsoring ads comparing his cause to that of the Boston Tea Party patriots. It worked. The legislature backed down and Buster's business continued to grow.

WHAT IS YOUR COMPANY'S COMPETITIVE ADVANTAGE?

At this point, you may have a good idea of your company's competitive advantage or you may need to refer to one of Michael Porter's books for more ideas. In my experience few owners do have a fact-based grasp on their competitive advantages. Many have a "gut" feeling for why their customers buy from them, and do everything they can to maintain or enhance that reason, but few can express that reason in a sentence or even a paragraph. Too busy running successful companies, owners just do not have time to examine each element of their success.

Taking that time is important if you want to sell your company for its best-possible price, but it is absolutely critical if you plan to engage in the Outrageous Price Process. In the Outrageous Price Process, not only must you know what your company's competitive advantage(s) is, you must understand which buyer it will attract and how to use that competitive advantage to create pain or gain for that buyer. In Buster's case, we could not leverage a competitive advantage that was not sustainable, nor attract a large, deep-pocketed buyer to a business in a dying industry.

So, how to you uncover your company's competitive advantage?

A Google search of "competitive advantage consultants" will yield several million names and firms. I believe that if you intend to sell your business for a maximum or Outrageous Price, you must find an investment banker who knows not only how to identify competitive advantage, but also how to leverage it fully in the M&A market. As you interview candidates for this position, spend time probing their understanding of this important topic.