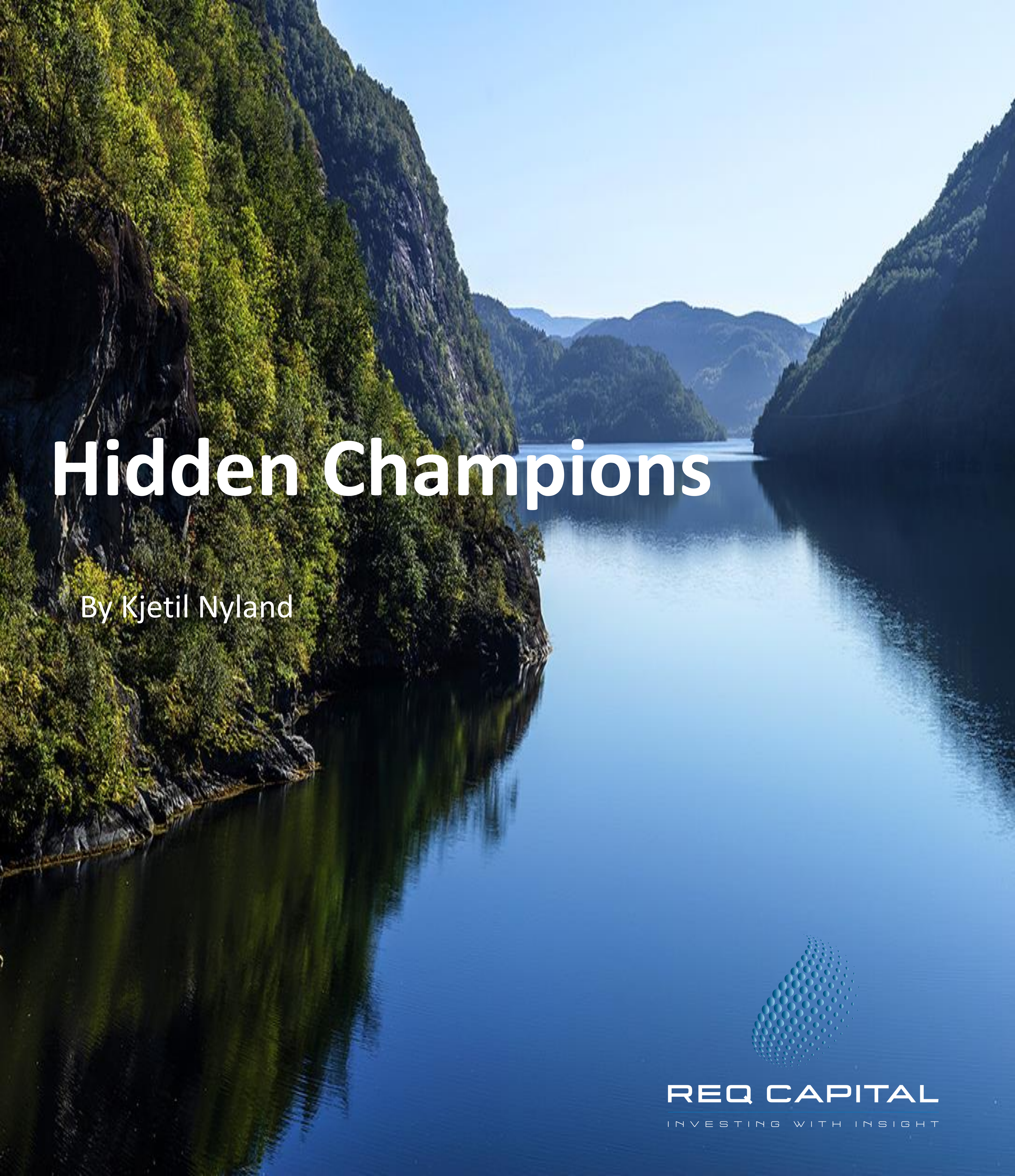

Hidden Champions

By Kjetil Nyland

REQ CAPITAL

INVESTING WITH INSIGHT

Hermann Simon's insightful book, "Hidden Champions of the Twenty-First Century," first published in 2007, highlights lesser-known niche companies that excel in specialized sectors. These businesses operate in the "hinterland" of the value chain, frequently engaging in business-to-business (B2B) transactions by supplying machinery, components, or processes integrated into the final product or service. As a result, they often go unnoticed by consumers.

These hidden champions, commonly family-owned, achieve market dominance by emphasizing focus, global reach, dedication to premium products, and robust customer relationships. To be classified as a hidden champion, a business must meet specific criteria, including market position, revenue generation, and limited public exposure. Examples from the book – some of which have since emerged from obscurity – include Rud, a leading player in industrial chains; Amorim from Portugal, a world leader in cork products and cork flooring; and Jungbunzlauer, a global leader that supplies citric acid for every Coca-Cola produced and sold.

A Decentralized Collection of Niche Businesses

Investing in private niche companies within a decentralized structure presents several advantages. Firstly, their essential offerings grant them resilience against economic fluctuations, allowing them to maintain pricing power and high gross margins. Focusing on a narrow niche can often create an oligopolistic structure that protects incumbents, preserves pricing power, and deters newcomers. These markets are typically too small to attract significant interest from potential competitors.

Secondly, niche companies often exhibit adaptability and responsiveness to market changes, fostering a dynamic entrepreneurial culture through decentralization.

The most successful acquisition-driven compounders collect these specialized companies, building a diverse portfolio that spans products, customers, suppliers, and regions. This combination of different earnings streams provides stability and resilience.

Many of the companies targeted by our portfolio companies share several key traits with hidden champions, which include the following:

• Engaging primarily in business-to-business (B2B) transactions for their products and services.

• Providing mission-critical and often customized offerings at relatively low cost. This approach can generate a lock-in effect, leading to high customer retention and pricing power. To attain the latter, the best-performing organizations frequently employ value-based pricing strategies that underscore their offerings' unique value proposition to customers.

• Focusing on flow products, or consumables, linked to customers' operating expenses rather than capital expenditures. This connection enhances predictability and diminishes reliance on cyclical spending fluctuations.

• Benefiting from a favorable working capital mix and typically limited in-house production results in low capital requirements. This aspect is often further optimized following an acquisition.

The culmination of these factors often results in recurring revenue streams with high gross margins and attractive cash conversion. The allure of these core characteristics is far from random. Maintaining a consistent acquisition pace necessitates both predictability and high cash flow conversion. Additionally, steady revenue streams and strong cash conversion rates are vital for a self-financing acquisition strategy, allowing the organization to maintain financial stability without relying on external funding sources. Consequently, once the onboarding process concludes, cash flow and other return-on-capital metrics become the shared language among these companies.

Consider Heico Corp, a Florida-based enterprise founded in 1957. As a leading technology-driven aerospace, industrial, defense, and electronics firm, Heico is recognized as one of the world's largest independent providers of FAA-approved engine and component parts. These mission-critical parts are vital for their customers, primarily airlines, as they ensure their fleets' operational efficiency, safety, and reliability.

In one of our conversations, Larry Mendelson and his son Eric shared the essential factors contributing to Heico's success since they took over in 1990. Despite its size, which now boasts 6,400 team members and 88 acquisitions of niche businesses, Heico has maintained its agility and responsiveness. With his background as an accountant at Arthur Andersen, Larry Mendelson emphasized the importance of cash flow in Heico's success. He began by saying, "We are not merely an aerospace company, but rather a vehicle that generates strong cash flow through aerospace parts and technology." His former boss's mantra, "GAAP is crap" and "the key is cash flow," shaped his perspective. Consequently, Heico's focus on cash flow and decentralization has produced remarkable results. Since 1990, when the Mendelsons took over the business, Heico stock has delivered 21% annual returns, amounting to a staggering total return of 67,900%.

Decentralization and Customer Focus

Another essential lesson focuses on organizational structure, with decentralization being vital for two reasons. First, agile, entrepreneurial companies collaborate closely with customers to create tailored solutions. Therefore, decentralization is essential for these businesses to continue thriving after being acquired as part of a larger structure. This structure encourages entrepreneurial flexibility, enabling companies to excel in their specialty and remain close to their customers.

Second, a decentralized system is critical for maintaining the acquisition engine's pace of multiple small private transactions. Without decentralization and autonomy within each business unit, the M&A engine falters. It's nearly impossible to sustain an acquisition cadence of 5-10 new companies, if not 100, per year if integration efforts and micromanaging consume management resources. In the long run, this isn't feasible. Thus, the organizational design for these acquisitive companies is a feature, not a bug. We tend to grow skeptical if we observe overly optimistic growth targets with acquisitions factored in, but without a decentralized mindset, in place.

The Ideal Combination

While some niche businesses may not be as glamorous as some SaaS enterprises boasting high growth prospects, their true potential emerges when integrated into a decentralized structure. Limited growth prospects in niche markets can lead to these businesses being less sought after in auctions. However, acquisition-driven compounders remain undeterred, as they offer a reinvestment engine to redirect cash flow into other exceptional niche companies. Therefore, limited reinvestment opportunities and size thresholds that disqualify specific buyers don't hinder them. These factors can be advantageous, as they often deter other investors, reducing competition and, ultimately, prices paid for these businesses.

In Conclusion

The achievements of hidden champions, as discussed in Hermann Simon's book, emphasize the importance of focusing on niche markets, decentralization, and fostering close customer relationships. Investing in specific niche enterprises may entail risk; however, the portfolio strategy employed by acquisition-driven compounders offers diversification and an efficient reinvestment mechanism. With predictable cash flow streams, these vehicles can succeed without rapid growth, resulting in resilience, adaptability, and market dominance.