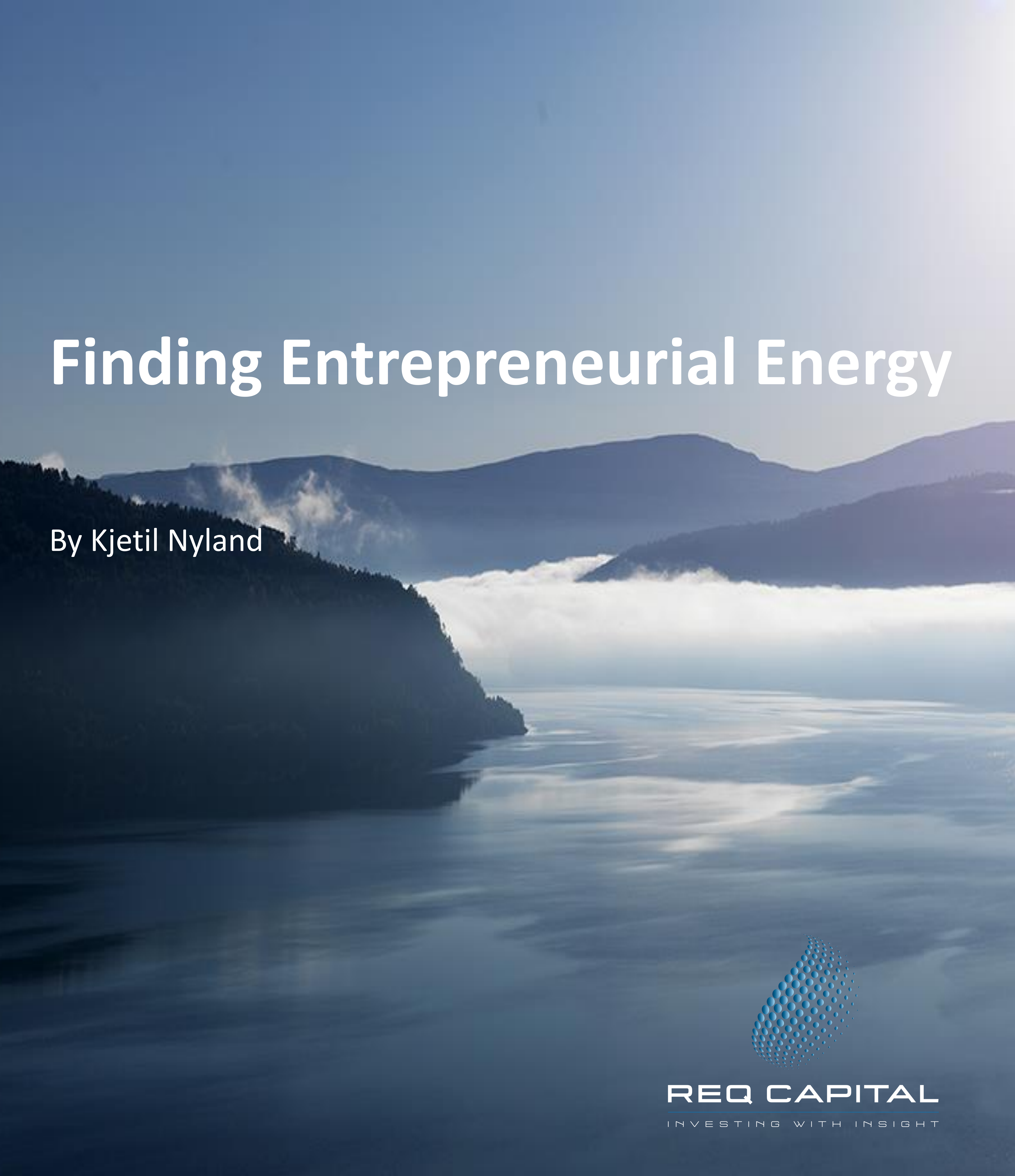
Finding Entrepreneurial Energy

By Kjetil Nyland



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INVESTING WITH INSIGHT

Acquisition-driven compounders can be analytically confusing at first glance. From a 30,000-foot view, what you see might look like a mess. The logical conclusion may be to embark on integration efforts as these businesses seem ripe for serious cost and sales synergies. A closer look at the highest-performing ones reveals a collection of decentralized and autonomous business units, each protecting its entrepreneurial independence. Many of these businesses have distinct cultures, but they all thrive on ownership and autonomy enabled by decentralization. Therefore, finding the right balance between decentralization and integration represent an ongoing battle with temptations and difficult tradeoffs.

The book "Billion Dollar Lessons" has a chapter on deflated rollups, companies rolling up a single vertical of companies geographically or across borders. The author shares plenty of case studies documenting when these rollups failed, lessons from which we can all learn. One lesson that characterized many failed rollup attempts stood out: "Buying a string of rock bands to form an orchestra." The architects of these rollups assumed they could benefit from *both* decentralization and integration. In his study, the author concluded that the rollups could choose *either* decentralization or integration but not both. Herein lies one of our takeaways from spending time in the field; forced synergies rarely unfold as modeled in Excel. The sacred multiplier in these organizations – a vibrant entrepreneurial culture – must be nurtured, regardless of the sacrifice. Hence, the best acquisition-driven compounders often take a religious approach to decentralization, treating the underlying business units as actual owners and giving them a high degree of autonomy, sacrificing efficiency gains.

Brent Beshore, CEO of Permanent Equity, once shared a fascinating glimpse into the ups and downs of integrating small businesses[1]:

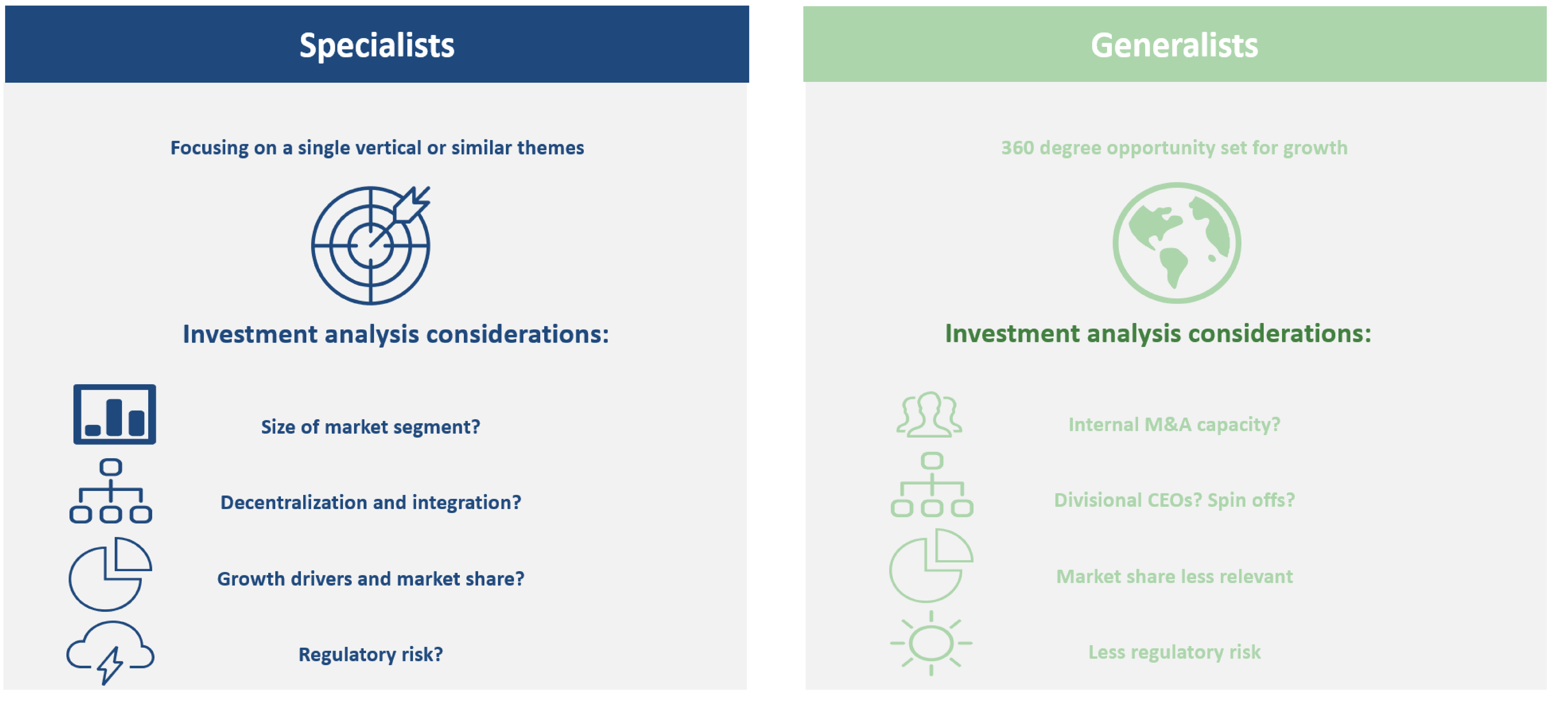
> "All businesses internally is a disaster . . . Almost every operator I know is just trying to go as hard as they can, and you're putting your finger in the leaks and working your tail off all day long . . . If you're putting your head down and you're a founder dominant organization with very little scale, with very little structure, how in the heck do you slam together two, three, four, five of these things and somehow standardize... I mean, it is like the most mindbogglingly difficult thing. You can produce a lot of EBITDA for a short period of time and then the wheels come off."

It speaks to the metaphor of buying a string of rock bands to form an orchestra. It might look good in Microsoft Excel; however, it's hard to model real-life interactions with human beings carrying different personalities in a complex system we call organizations.

In 2006, B&B Tools – a company with a 100-year heritage successfully executing the decentralization playbook – pursued the "One Company" approach, representing a decade-long centralization plan. The aim was to centralize everything hoping to extract synergies from integrating product companies with wholesale and reseller companies in the group. The efficiency gains looked great on paper, but they never materialized. The company – now back to its original name Bergman & Beving, after spinning off assets – has been on a cleanup mission ever since.

Specialists and Generalists

Rollups tend to receive much attention, perhaps due to some spectacular failures over the years. For classification purposes, plenty of excellent and detailed frameworks exist[2]. To keep it simple, we find it helpful to split acquisition-driven compounders into two broad buckets: **specialists and generalists**.



The first type of specialists comprises rollups; as mentioned earlier, these vehicles typically operate with high operational integration, often chasing cost synergies and efficiency gains at the expense of entrepreneurship and autonomy in the underlying companies.

The second type of specialists are those honing in on multiple verticals with recurring characteristics. Multiple verticals expand the growth runway while allowing for domain expertise like a rollup. Among those in the second group we like best, synergies are often welcome but not forced, an important distinction recently highlighted[3] by Fredrik Karlsson, former CEO of Lifco (now CEO of Röko):

> "It's really difficult for some people to understand what decentralization is because they've never experienced that, so they ask about synergies all the time. And it's very difficult to tell them we don't care about synergies. If they come, they come, but it's not why we invest in the company. We buy good businesses."

The Generalists

The generalist bucket allows for even more flexibility. Viewed from the outside, they seem to focus on specific niches; in practice, however, they are not limited by any particular sector. They learn as they move from one domain to a new one. To flesh this out a little bit more: a generalist acquirer like Lifco has three segments; one of them is called "system solutions," with its subset of themes, where they put anything which does not belong in the other two boxes (dental and demolition & tools). Similarly, with Lagercrantz Group and their "niche" and "international" segment which serves the same purpose.

In effect, the segment's name doesn't carry much significance internally as they are – first and foremost – investors hunting for great businesses at compelling returns.

Yearly gatherings and academies sharing best practice on pricing, working capital, and numerous other things help generate organic uplift – an important contributor to overall growth. Simple profit goals related to cashflow conversion and predictability teach everyone that sales growth has to be calibrated with the cost of deploying capital.

Furthermore, among the best, we often see a well-developed pricing culture and a keen awareness of what contributes to cash flow growth and what does not (e.g., discounts). Hence, one typically finds value-based pricing replacing the legacy of cost-plus pricing after onboarding new companies. Moreover, testing and failing are also allowed, helped by the confidence boost you get when part of a larger unit. The aim is to maintain entrepreneurial drive while prioritizing cash flow and a self-funded cadence to growth; striking the correct balance is paramount and a key differentiator.

The level of decentralization among specialists and generalists varies. Some companies practice a decentralized model on the platform level while extracting synergies *within* the platform, adapting to the business dynamics of each particular platform. Moreover, cooperation within and between the various business units also occurs. However, the most successful practitioners let the decision originate from the individual level and not through a top-down approach, as per Niklas Stenberg, CEO of Addtech[4]:

> "We don't push synergies; if you ask me, the decentralized responsibility is more important than anything else. If we start taking too many decisions top down, then we will ruin the whole culture. So that will never happen as long as I'm here.
>
> But, of course, we urge for cooperation within the units since they are working on similar fields, like the battery group with 14 battery companies. They have similar suppliers, similar production needs, with similar R&D. Of course, they cooperate quite a lot. And, also between the companies . . . We gather once a year where all the MDs are meeting and . . . they sit down with gin and tonic or water, whatever, and you can really hear how they are discussing business opportunities and that is because they are driving their own business and are responsible for their own P&L."

A Negative Flywheel of Incentives

A common thread among deflated rollups is a financial engineering mindset underlying a rushed approach to value creation, chasing "deals" not through the lens of great investments and often with aggressive guidance incorporating future acquired sales and synergies. The result is often added fragility throughout the ecosystem of stakeholders. Hence, we often observe a negative flywheel of incentives rooted in the structural size constraints of rolling up a single vertical.

The framework and labels presented here should come with a caveat, however. Companies are organisms in a dynamic environment. Some companies start with a single product niche and gradually expand into other verticals and eventually becoming more of a generalist as they go along. Case in point; in the 1990s, Diploma experienced that their traditional core businesses matured into cyclical, lower-margin companies. As a result, they launched a new acquisition program to diversify into new, more attractive sectors. There was no master plan from the start; it was all layers of iterations as they learned along the way. Similar story with Lagercrantz Group when Jörgen Wigh joined as CEO in 2006; he came in with fresh eyes and saw that value-add distribution of electrical components and telecom had declining margins. Based on this insight, Lagercrantz Group expanded into more expansive product niches diversifying across higher-margin companies with longer product life cycles, owning the IP outright.

Zooming out, despite our efforts in categorizing these types of companies, one realizes that the labels thrown at the best-performing ones are somewhat limited in portraying what happens behind the curtains. The focus tends to be fully anchored on the acquisition engine, while the second engine of growth – the organic growth unleashed by entrepreneurial energy – goes unnoticed by most observers. In effect, we don't fully acknowledge the reasons behind these companies' long-term fundamental track records. The business-building mentality – in addition to a successful acquisition engine – is something we find particularly interesting:

> "Underperforming companies are mostly worse than they look, and good companies are mostly better than they look. We don't have the management time to buy underperforming companies and are not superheroes to change them. We are not a PE turn around company. We are in the technical trade. We love people. We love customers. We like to build." - Ulf Lilius, CEO of Momentum Group

Structure, Cooperation, and Entrepreneurial Energy

Back to Jörgen Wigh, the CEO of Lagercrantz Group, who recently emphasized a perspective on synergies that we are particularly fond of; synergies in the form of injecting energy and structure[5]:

> "What we bring to the table is really two things: it's a structure and its energy. You need to realize that it's usually in sort of a succession sort of phase that we come in as new owners. And we find that sometimes we find companies that have been sort of complacent a bit and they need new energy. There might be some discussions between the older generation and the younger generation and when we come in you loosen things up, you get new energy, you get some professionalism in, so we add energy, we add structure. We have a lot of things going on with the companies but it's not about finding new synergies between the companies, that should come from the companies themselves."

Organizational psychology has a term called "crowding out," which may explain why a singular focus on external rewards for completing an activity might lower the intrinsic desire to perform that task. The crowding out phenomenon underscores the importance of decentralization and a better understanding of incentive structures that work with carrots, not sticks. In the book "The Evolution of Cooperation," Robert Axelrod also shares many of the same lessons regarding human motivation that echo this sentiment: "You provide freedom from the top and get rewarded from underlying companies that feel the freedom."

Summary

We are cautious with pure rollup structures, companies rolling up a single vertical with high operational integration and chasing synergies. Instead, we focus on generalists and specialists with domain expertise across specific verticals with common themes. We prefer vehicles with an industrial mindset and a self-funded route to value creation. The flexibility that both buckets represent creates more of an opportunistic approach, with a small team at headquarters aiding divisions with business development and fostering a culture rooted in entrepreneurship.

Moreover, capital allocation is typically centralized, while operations are fully decentralized, albeit with lead generation – and sometimes small bolt-on acquisitions – initiated from the business units. Synergies are welcomed but not forced. In effect, this is the laissez-faire approach to efficiency gains where the entrepreneurial spirit is the forcing function; cost efficiencies are sacrificed in the belief that the cumulative impact of ownership, autonomy, and entrepreneurial spirit will offset them.

We believe the best generalists and specialists operate with the same ethos as great long-term investors. They provide click-and-buy public investors with intrinsically diversified operations across private markets and long runways for growth.

Sources and further reading:

1. Brent Beshore at Invest Like the Best podcast
2. Scott Management / Demesne Investments / Canuck Analysts / Redeye
3. Redeye panel with Fredrik Karlsson and Magnus Söderlind
4. Carnegie Trading Companies Seminar 2022
5. Serial Acquirers Event March 8, 2023