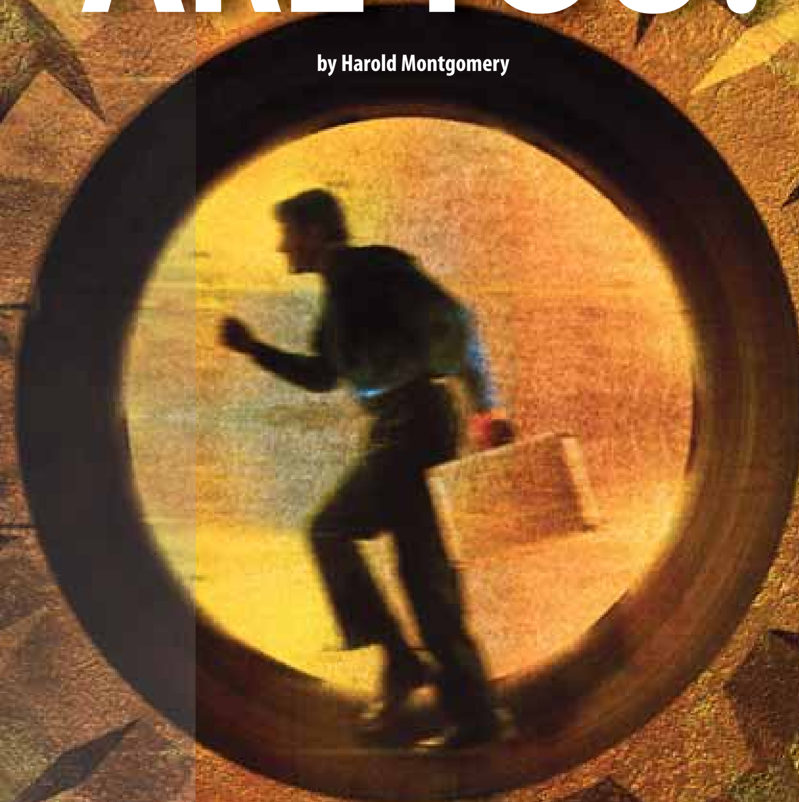
MONEY GUY

WHAT PHASE OF THE LIFECYCLE ARE YOU?

by Harold Montgomery



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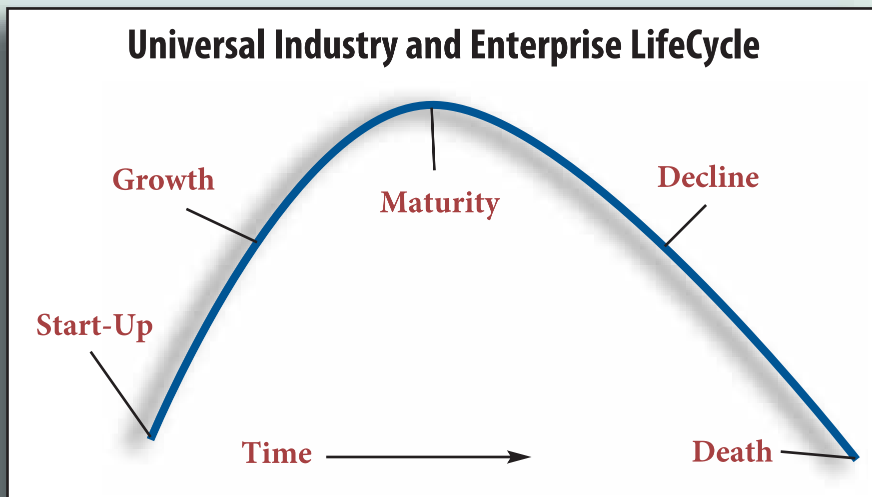
All industries and the individual businesses within those industries follow a universal lifecycle that begins with the start-up phase (birth) leading to the growth phase (adolescence) then stasis (maturity) followed by decline and ultimately death. You'll instinctively recognize this pattern in humans and other biological organisms – it's the cycle of life, and what goes in nature applies in business as well. There's a beginning, middle and end to everything. The time frame of the lifecycle can vary of course, some businesses grow and flame out fast, others can take decades. But there are no exceptions to the general rule that everything has a lifecycle.

For someone participating in a given industry, it's important to know where in the lifecycle that industry is and, where in the lifecycle your particular business is. If you think about the industry as being a river and each business within the industry being a boat, you get the idea of how this all works – some industry participants move faster than others, some slower, but overall, we're all in the same stream headed the same direction.

Here's a diagram of the Universal Life Cycle. Over time, each industry and each business within that industry pass through these various stages.



It's important to know the characteristics that define the various stages. It's equally crucial to understand the relationship between the various stages of the cycle and business valuation and the types (and numbers) of buyers there are at various stages. It's best to time a sale of your business when the currents are favorable to the maximum valuation. Wait too long and valuations may be low and buyers may be scarce. Eventually, there are no buyers at all.

In the beginning, the business is in the start-up phase characterized by promises of growth, optimistic assessments of the future lack of hard data. Funding sources for this phase are venture capital types who can invest in the company based on growth projections, wait a few years and receive their return from increased equity value created through growth. Businesses in this stage don't throw off enough cash to pay dividends or interest so debt isn't an appropriate financing mechanism and you typically don't see banks active in this phase. Valuations can be low during this period since no one really knows what the business is worth and doesn't want to take a huge risk since there's too much uncertainty.

The growth phase is characterized by growing the customer base and often growing gross margins as well. This is the phase everybody loves and wants to be part of – growth is exciting! The business consumes cash during this period as every effort is focused on gaining market share and increasing size. This is the time when valuations of the business tend to be high relative to historical performance, because investors are convinced that the model is proven and the sky is the limit. This is the convergence of the risk/reward trade-off: risk looks low, reward looks high. This is usually the period of peak valuation when all the characteristics are looking good. Sellers often think they left money on the table and, they may have. But in retrospect, they often look back and realize that the main thing was to get a deal done while they could and not wait around for the mythical perfect deal that never comes. No one ever went broke selling a business too early for a profit, but lots of people have held on too long. Have you ever ridden a stock all the way up and all the way down? I have and I swore I would never do that again!

During the mature phase, growth slows down as the market for the product matures. Margins begin to fall as individual firms compete for customers because scale has become important. Why? Large scale allows companies to lower costs. Buyers present in this phase are private equity firms and others looking for steady cash flow and modest growth with most of the return coming from accretive acquisitions, not organic growth. Synergistic industry participants are also buyers because their return on investment is derived from cost cuts related to merging operations. Often cost-cutting and efficiency gains are important parts of the business plan. Commercial banks are present during this phase since earnings are predictable. Multiples tend to be low since cash flows are growing modestly if at all.

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Lifecycle Phase

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"Have you ever ridden a stock all the way up

AND ALL THE WAY DOWN?"

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Next comes the phase called decline. Decline is a period in which business is slow and things begin to deteriorate. While there are numerous classic identifiers of a business in decline, it's often after the fact that decline become obvious. Frequently, leaders of businesses or industries in decline don't know they are in decline because things have become 'comfortable' or 'easy.' One easy way to know that a business is in decline is to ask if it's in the growth phase. If not, the choices are maturity or decline and the longer it's in maturity, the closer it is to decline. If you're not growing, you're dying, it's as simple as that.

Features of decline include lack of growth in the customer base, increasing price competition and increasing costs of doing business. Those last two trends mean falling margins and little pricing power accruing to firms in the industry as customers typically have the upper hand. Increased government regulation is typical. Falling margins mean consolidation as firms try to assemble a stable revenue stream and support their overhead. This becomes increasingly difficult when margins are falling since it takes more and more customers to keep up with the trend. Lack of technological change, static or shrinking overall customer population, companies searching for growth opportunities outside the definitions of the industry – these are all clear signs of decline.

One sure sign of decline is when young people are not attracted to the industry. When industry participants age and do not replace themselves with younger talent, there's a message. Same goes for companies in the industry – if there isn't a steady flow of new start-ups in the space, it's mature.

Financing resources in this phase are often private equity firms who intend to consolidate acquisitions and cut overhead by reducing redundant operations, thereby making firms more efficient. In this phase, multiples for acquisitions are very low since profits are not growing. Compensation is often in the form of stock. During the later stages of the decline phase, there are no buyers at all. Firms are forced out of business or into shotgun mergers to save themselves. By this time, it's usually too late to salvage any real as value peak value has long passed.

The big mistake that companies make in this era is to hesitate. Management teams need to be aware of where they are in the cycle and whether or not their businesses are creating value every day. If they're not creating value, they should sell. There will be few buyers, often industry insiders who know how to unlock value. But there won't be buyers for every seller and prices will drop due to lack of seller alternatives. Competitive bidding that forces prices up may occur, but financial backers like banks won't allow too much of that for fear of overpaying. The phrase you hear in this era is "It's hard to catch a falling knife," means that if the trends are down, it's hard to reverse them. Generally, investors are looking for strong secular growth trends not shrinking possibilities and falling margins and revenues.

This is a tough time for managers to make long-term decisions. The best recipe is to watch your business carefully and evaluate long-term trends. Compare statistical performance of the business from year-to-year for as many years as you have data. If the trends clearly indicate decline, then the value of the company will be declining every day and the buyer pool will be shrinking. Take action quickly to maximize value and don't be one of the laggards left behind. ■