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Check Your Strategy and Capital Allocation Aspirations

The reality of running a small business might not be what aspiring entrepreneurs envision

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We are thrilled that so many MBA students now consider and pursue post-MBA careers in small business and entrepreneurship through acquisition (ETA) avenues. These ETA pathways, and all of their adjacent permutations, provide a mechanism for young, aspiring entrepreneurs without capital, an idea for launching a company, or previous CEO experience, a way to catapult themselves into a CEO role immediately after completing their MBA studies. We are proponents because we believe that ETA and search funds provide a structure for intellectual stimulation, rapid skills development, high emotional rewards, time flexibility, and the opportunity to accumulate material economic wealth while at the front end of a career. We have devoted our professional careers to small business entrepreneurship as CEOs, investors, educators, mentors, and advocates. We truly love and are excited about small business entrepreneurship and ETA.

Having spent decades immersed in the small business community in multiple capacities, we are highly confident we know what it feels like to be a small business CEO, what activities and issues capture time, and which do not. We have observed a cavernous gap between what aspiring entrepreneurs perceive as their daily activities as a CEO and what the reality is. This is true for individuals who wish to be CEOs of a single operating company, what might be thought of as a traditional search fund, and those who seek to captain a holding company vehicle.

Holding companies appear to be the flavor of the month for the MBA crowd. These vehicles seek to mimic a Berkshire Hathaway–like strategy of acquiring multiple assets and operating them under an umbrella entity. The acquired assets might be related, and they might be completely disparate. The only certain commonality is ownership. Holding companies aim to purchase and own businesses for decades to enjoy tax-deferred compounding and capital growth. The math in these structures can be very appealing. Serially acquiring cash-generative assets at 5x EBITDA[*], using some leverage, and anticipating a degree of growth and margin expansion can generate seductive figures in an Excel model when they are run out over several decades. It is popular to raise $15 to $50 million of equity to fund these vehicles. These structures have the feel of a family office but are without decades and generations of operating experience. At worst, they can seem like private equity firms without a sell-by date. At best, they can be a way to own and operate cash-flowing companies for decades without a false pressure to exit. What is different about a holding company in the search fund world is its very small initial scale. While Berkshire owns assets that would be stand-alone Fortune 500 companies with highly seasoned CEOs, the assets acquired by search fundesque holding vehicles are Lilliputian and characteristically without talented executives. This typically requires the holding company sponsors to act as the operating company's CEO until it scales, stabilizes, and attracts competent management.

[*] Earnings before interest, taxes, depreciation, and amortization.

Whether a young, aspiring entrepreneur craves to be a traditional search fund CEO or a holding company entrepreneur, we think it is essential to paint a crisp picture of what being a small business CEO entails and how that might diverge from the aspiring entrepreneur's perceptions. In this case note, we will share what students and aspiring entrepreneurs often describe as their vision of a CEO or holding company leader. We will then provide our stark reality of small business CEO life. Our goal is not to dissuade anybody from pursuing an ETA arc; instead, we seek to provide as much information as possible for aspiring entrepreneurs to help them decide whether this avenue is right for them.

The typical perception of being a small business CEO

Youth is wonderful. It is a moment when you are future-oriented, and everything seems possible. Optimism and enthusiasm reign, and the compelling and positive overshadow grim realities. This is one of many reasons we enjoy teaching in MBA programs; being surrounded by intelligent and ambitious young people and their hopeful energy is one of life's fabulous elixirs. MBA students and aspiring entrepreneurs channel their optimism and positivity when envisioning life as a small business CEO. We often hear aspiring entrepreneurs describe what they think their CEO role will look like, and the two most popular themes to emerge are centered around *strategy* and *capital allocation*.

When we engage in these conversations, we restrain ourselves from rolling our eyes or outright laughing; we certainly would not want to be impolite, demotivating, or condescending. But we cannot help but smirk to ourselves when students and aspiring entrepreneurs wax on about strategy and capital allocation in a recently acquired $1 to $3 million EBITDA business.

Before we fully drill into these topics, we will tersely define the terms.

Strategy in a business context aims to answer two key questions: where should a company compete, and how should a company compete? Strategy's purpose is to create a competitive advantage that is capable of generating enduring and superior financial returns. It is the set of decisions a CEO and company will make on how to position their firm and gather and use resources, and what market and customer segments to address and how. It is the integrated set of choices that positions a business in its industry so as to generate greater economic returns over the long run.[3]

Capital allocation follows and supports strategy and is how a CEO and business gather capital resources (issue debt and equity) and deploy capital resources (extinguish debt, buy back equity, issue dividends, and invest in operations). Capital allocation is one of the critical roles a CEO plays and can turbocharge or dilute a company's performance. In the capital allocation role, CEOs establish their cost of capital and must use that capital in ways that generate returns at greater rates than the cost of capital – that is the only way to create economic value.

Why are MBAs enamored with the notions of strategy and capital allocation?

Aspiring entrepreneurs gravitate towards strategy and capital allocation for several reasons.

It sounds sexy and glamorous. Pondering these cerebral topics seems like the type of activity an MBA graduate should engage in. And it certainly sounds better and more appealing than making collection calls to slow-paying customers.

It is what is discussed in MBA programs. MBA programs are comprehensive learning opportunities for students, focusing on strategy and capital allocation topics. After all, we are training students to be leaders and CEOs to address the most weighty and lofty topics an executive will handle.

It is what they know. If MBA students have previous business experience in consulting, investment banking, private equity, or large corporations, they might attempt to translate those experiences to the small business realm – which is very different. Some of those experiences, especially the advisory-centric ones, are excellent training grounds for professionals but are not a proxy for the jungles of small businesses.

It is what they want to do. Nobody pines to be a CEO so they can wallow in the muck we will describe below. Dealing with disgruntled customers and firing wayward employees is neither fun nor rewarding. But contemplating strategy and capital allocation is.

It can dress up even the most mundane business. Many ETA entrepreneurs find themselves running and leading very pedestrian companies with compelling economic characteristics. HVAC companies, dental practices, lawn care services, and bookkeeping firms are all common ETA landing spots. While it can be a bit disheartening to think about a career in lawn care services, at least if the CEO is a strategist and a capital allocator, there is some appeal. This might especially be relevant on MBA campuses where every student is jockeying to position their post-graduation path as relevant, cool, and desirable.

They read Will Thorndike's book. Our friend, Will Thorndike, authored an excellent book, *The Outsiders*, exploring capital allocation themes in a handful of large public companies. The book is a must-read in the ETA community and has illuminated the importance of sound capital allocation philosophies and their impact.

How strategy and capital allocation fit into a small firm

We have good news for aspiring CEOs: strategy and capital allocation are absolutely part of the CEO's job function. The bad news is CEOs just do not do them that frequently. When we speak with students and aspiring entrepreneurs, they envision spending *all of their time on these topics* – which is just miles from reality. We think of strategy as an episodic event. The CEO must establish and craft it every once in a while, but certainly not daily. Once a comprehensive strategy is in place, the CEO and company work diligently on executing that strategy. Frequently formulating a fresh strategy means the strategy is not working – and keeps the CEO's attention away from actually executing a strategy that is viable. We like to think of strategy using a train as an analogy. Strategy is deciding where the train is going, the destination. Execution is working on how the train will get there on time. Once a destination is selected, it cannot, without tampering with execution efficiency, be revisited that often, certainly not daily, or monthly. We embrace the notion of reviewing strategy annually to test and reaffirm it, but there should be no complete overhaul unless the previous strategy has clearly failed. A tenable, well-conceived strategy should endure for at least five years. Anything less than that is an indicator of a subpar strategy.

A CEO's days can be filled with executing the strategy, but endless hours spent contemplating and reflecting on strategy is not reality. When we think of our CEO calendars, they were not populated with or dominated by endless strategy meetings and sessions.

The same is true for capital allocation. While we think this is an essential approach for a CEO, it is a once-in-a-while event and not a quotidian activity. Let's break capital allocation into two buckets: gathering capital resources (issuing equity and debt) and distributing that capital (extinguishing debt, buying back equity, issuing dividends, and investing in operations). We sometimes refer to the gathering of capital as the firm's capital structure; it includes how much equity and debt the company carries and the layers and characteristics of the various securities. While we think this is a very important topic worthy of much CEO thought, this thought does not happen regularly. Once a CEO has a capital structure in place, that job is done for a while. Small businesses do not issue debt and equity regularly as a normal policy; it is done intermittently because it is difficult and time-consuming. We think a capital structure should last for approximately five years. If a CEO touches the capital stack yearly, they are not very good at assessing the company's capital needs or accessing the right capital providers. Managing capital structure is not something competent CEOs need to do frequently.

If we look at deploying capital, a similar situation exists. If a CEO intends to grow the business organically by investing in operations, the decision has been made, and the next steps are to pursue that capital allocation course. We cannot help but chuckle a bit when aspiring entrepreneurs share visions of being capital allocators. We are not even sure what that translates into. Do they think they will arrive at their office and spend ten hours a day, every day, deliberating capital allocation issues? We acknowledge that capital allocation themes can be in the DNA of a firm and serve as a lens for every decision, but meditating on capital allocation perpetually is just not something that a working CEO does. Once again, when we examine our calendars, we never saw a Tuesday 10:00 AM meeting for capital allocation; it just does not exist. It might be periodically codified in conjunction with strategy but does not absorb copious amounts of time.

Before we move on to some of the activities CEOs *do* spend time on, we want to be clear in affirming that strategy, and capital allocation are fun and enjoyable functions that small business CEOs do invest time in, but it is just not that much time. The impact of strategy and capital allocation decisions is disproportionate to the time CEOs spend drafting their plans.

The reality of being a small business CEO

Being a small company CEO is exhilarating, energizing, intellectually challenging, emotionally fulfilling, and, overall, an amazing experience. We are huge fans and have loved serving as CEOs. Despite our enthusiasm for the CEO position, it might not be what MBA students and aspiring entrepreneurs fully expect – and it might be quite divergent from preconceived strategist and capital allocator roles. CEOs do not spend all their time on strategy and capital allocation; the reality of a CEO's life is more about the mundane workings of the business – executing on the strategy and keeping operations on track. For our analysis of CEO time allocation, see our case note On the Nature of CEO Time Allocation in an SME. CEOs also spend time on crazy, random, and unexpected events. We are not implying that CEOs *only* deal with the wacky and surprising, but they definitely deal with it. We will share some of the sobering, funny, and wild things we have dealt with as CEOs. These are all true anecdotes. Our aim is to highlight the reality of CEO life and provide vivid color to aspiring entrepreneurs on *some* of the issues they should expect and be prepared to manage. The businesses we have run are blue-collar in nature, and our experiences reflect the reality of large, unskilled, and semi-skilled workforces.

We share these stories not to strike fear in aspiring entrepreneurs' hearts but instead to paint a realistic picture. Unfortunately, when entrepreneurship is taught in business schools, the room is always 72 degrees, the setting is inspiring with lavish stadium seating and impressive technology, and cases are taught in tight 80-minute increments where everything is wrapped up in a tidy fashion by the end of class. The gritty reality of being a CEO is often glossed over, or at least a more palatable patina is applied.

So, we will now share some of the many things we have spent time on and dealt with as CEOs. Each of these ripples requires days and weeks of CEO time to get back on course. None of this was our intention, nor was the time requirement in our response avoidable – and there was no strategy or capital allocation involved.

In our snow-plowing business, we have served as the backup plowers on the 2:00 AM graveyard shift during a severe winter storm when we were shorthanded on staff. Once our shift was over, we bought coffee and donuts for everybody and rolled into our normal workday because there was still work to be done. As CEOs, we are always the last resort backstop for any crisis, no matter how untimely or inconvenient. It certainly was not our strategy to shovel snow in a bitter cold nor'easter, but we had to fulfill a customer promise, and it did provide a very powerful signal to our team.

A few years ago, a major supplier (think Fortune 1000–type company), representing 90% of our cost of goods sold, sent us a notice on a summer Friday afternoon stating our relationship was terminated. We did not know why the notice was sent. We were in compliance with our contract and thought our relationship was a positive one. We were devastated and left scrambling. The best part was when we replied to the termination email: we received an autoresponder that our key contact and the person who sent the original email would be on summer vacation – for three weeks.

We like to think of ourselves as curious and progressive students of business. We have read scores of business books on how to be better leaders and run evolved firms. Of course, we used our companies as laboratories. After reading one such fashionable book, we began implementing fresh policies and procedures to empower our employees. One key employee reacted negatively to this new empowerment and self-direction. They quit, telling us they did not want to be empowered or think for themselves.

Some time ago, we discovered hard drugs (the type that are not legal even in the most liberal states) in our workplace. When we conducted an internal investigation, not surprisingly, nobody claimed the illicit contraband; it was as if it had magically sprouted from thin air. Cue the lawyers, cue the police, cue the course we did not take in business school to address this near-impossible situation.

Technology can be wonderful, and we are supporters of outsourcing and automating anything that can make our lives simpler and easier, especially when the technology solution and outsourced partner are clearly superior to our abilities. We once selected a nationally renowned payroll processor to help us manage our payroll administering and distribution function. After all, who wants to deal with federal and state taxes, 401K withholding, and deductions for healthcare? Our new, sophisticated partner swept funds for our upcoming payroll twice in the same payroll cycle. In a labor-intensive business, this is catastrophic as we were now operating with no cash. In attempting to get the large payroll company to send us back the inadvertent double sweep, we learned about a new level of bureaucracy.

When we shifted into CEO roles, we were naïve about many things. One excellent example was the realm of wage garnishments. For our fancy MBA students, a wage garnishment has nothing to do with olives, pickles, or a curvy, decorative fruit slice. A wage garnish is typically when a judicial court orders a mandatory deduction from an employee's paycheck to satisfy a financial obligation – think child support. So, we were ordered to garnish an outstanding employee's wages. The result was lower net wages for the employee, who was resentful of the company and ultimately quit to find an under-the-table job.

As a CEO in a small business, there is plenty of opportunity to be by yourself. Come lunchtime, you are probably dining alone at your desk. While we are in favor of interreacting with team members regularly, we are not friends with our employees, and they do not necessarily want to be friends with us. We are certainly friendly, though. This dynamic often results in plenty of alone time – especially at lunch.

We were very intent on building equity when we became entrepreneurs and CEOs. Little did we realize how important debt would be too. When we talk about debt, we are referring to purchasing debt – debt issued by our employees. Employees endlessly approached us for small loans to make rent, a car loan, for groceries, or to pay a delinquent credit card bill. Employees have told us unimaginable stories (most true, some likely fabricated) to justify their need for our money. It is tough to say no to critical employees we depend on when they ask for credit, and enforcing repayment of a delinquent loan is even more challenging.

Unfortunately, we have been victims of embezzlement on multiple occasions. In one instance, a junior accounting staffer added their electric, gas, and water accounts to our shared common vendors. There were no false vendors, just accounts that were not corporate accounts. After consulting with our professional employment organization (our human resources outsourced partner), we called the police, had the employee arrested, and then had to go through the criminal process. When making this decision based on advice from our lawyers, we were fearful of an angry spouse or family member seeking retaliation.

We developed and invested in a door hanger program in one of our businesses. This is a way to acquire new customers. We identified prospective customers, printed advertisements, and hung the advert on thousands of prospects' doors in our marketplace. Our plan was befuddled by a competitor who kindly removed each and every one of our hangers.

We fancied ourselves programmatic acquirers; we planned to gobble up our competitors to build a bigger, more valuable company. Shortly after closing one of our earliest acquisitions, a records management company in Newark, NJ, our largest acquired customer, representing 20% of revenue, notified us that they intended to cancel our contract, despite the multi-year term it included. We planned to enforce the contract, except that the customer was the largest law firm in New Jersey. After months of negotiations and endless hours of time, we managed to derive some lemonade from a basket full of lemons.

Board members and investors can be helpful and supportive partners, except when they are not. We have had board members contact us after we had distributed a quarterly board package, requesting that we cut the data differently and change the formatting. When those words fall upon our ears, we lose half a day. Periodically, investors contact us to talk about the business. Their calls usually fall into the general update category. While these calls might give investors insights, they are often just a time drag for us.

We have had to become pseudo-lawyers and have learned about our state's corrections system. An employee recently called out sick (through a co-worker). After three days of trying to find out how the employee was doing and when they would return, we learned the absence was not really due to illness; instead, it was because they were in jail. In a different situation, we hired a new employee to be a service technician in our Sarasota branch. On the scheduled first day of work, they did not show up. Day two was better; they did show up – only to ask for an advance on their pay. On day three, they called asking to be bailed out from the county jail where they had been arrested for grand larceny.

New England can present weather extremes and challenges. In one particularly harsh winter, we went through a period of heavy, wet snow, followed by pelting rain a few days later, and capped off by bitter cold temperatures. This resulted in large quantities of water on a warehouse roof with nowhere to go because of freezing drainpipes. Water is insistent and found its way into our warehouse. It felt like it was raining inside. We were scared about the irreplaceable inventory and weight on the roof. Our answer: go up on the roof in frigid temperatures and ankle-deep water and slush and chip ice in the drains to provide an escape route for the water. Humbling and terrifying are the best adjectives.

A ruckus and commotion began brewing in the warehouse on a sunny spring afternoon. Raised voices, cursing that would make a sailor blush, and tempers flaring set the stage. We interceded and curiously asked what was going on (our language might have been saltier, but this is a family publication). Neil told us that he was doing his job, but Eddie was getting in his face. Words were exchanged, and Eddie sought to settle the matter by brandishing a knife and informing Neil that he was going to cut him up. After diffusing the situation, we implemented a no-weapons-at-work policy.

Entrepreneurs often contemplate stroke-of-pen risk – what can change the business model and economic thesis overnight when a government official changes some regulation with an effortless signature. We know the pain of this phenomenon. We received notice that the state planned to take our single largest operating center to construct a new on-ramp for a highway system. A taking is a form of eminent domain when a government agency deems it necessary and in its interest, to own and control a property. The government will pay fair value for the subject property, but what constitutes fair value is up for negotiation. We had invested millions of dollars in the multi-hundred thousand square foot property. No compensation could address the pain and dislocation of shutting down and relocating the warehouse, especially while we needed to service our customers. We hired lawyers to represent and negotiate on our behalf, worked with state representatives for approximately three years, and incurred hundreds of thousands of dollars in fees. Surprisingly, the highway on-ramp project got scrapped. The time and fees we bore are our mementos of stroke-of-pen risk.

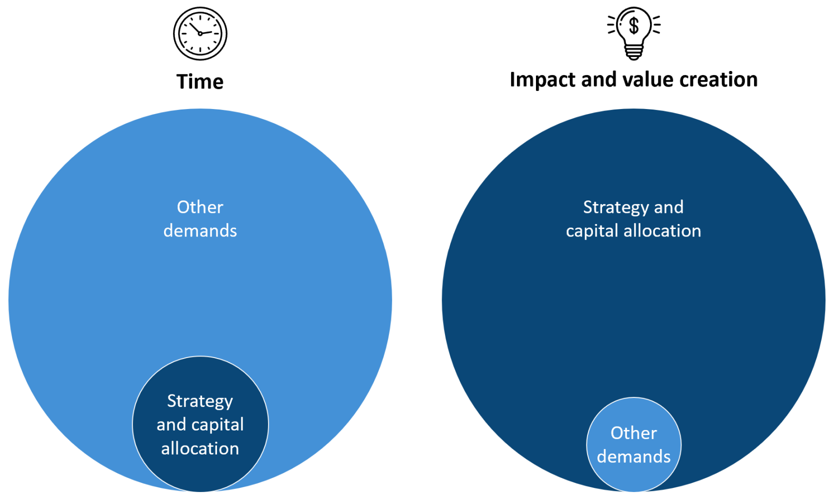
Some aspiring entrepreneurs will resort to a position of delegation. They think they will commission these pesky events to someone else, perhaps their chief of staff – an aide-de-camp role that is increasingly common in search fund land. While some delegation is possible, all is not. When an employee falls down an elevator shaft and ambulances, police, media, OSHA, lawyers, and family members are swarming about, the CEO better be there, too (a true story, and fortunately, the employee was okay). If a CEO does not want to engage in these issues, they should not be a leader; not everything can be delegated to a factotum.

In our recent case note, Exploring Search Fund Entrepreneurship Using Maslow's Hierarchy of Needs as a Framework, we discuss the incredible benefits of being a CEO and ascending to a state of self-fulfillment and actualization. In this note, we seem to be offering a countervailing perspective; that is true. Being a CEO is a terrific experience and can be filled with a glow of serenity and realization; it can also be maddening, infuriating, and a wild roller-coaster ride – at times. How is it possible that we offer these seemingly conflicting images of the CEO role? Well, opposing notions can mutually coexist. If anybody has been married or a parent, they will recognize the joys, sheer thrills, and utter bliss of parenthood and spousedom while concurrently acknowledging the frustrations, challenges, and disappointments. So it is with the CEO role in a small business. It is both amazing and filled with surprises at the same time.

CEOs evolve over time, especially as a business and organization grows. In their earliest days, CEOs are doers in a company, jacks of all trades. They often grow into managers, overseeing the work of others. Finally, they might mature into leaders, providing guidance and direction to a larger team. As doers or managers, CEOs are more susceptible to the unpredictable demands of a company and might get entangled in the situations we describe above. As the business scales and develops with more people and infrastructure, CEOs can be a bit removed and more isolated from the comedy-of-errors drill – but it never quite fully vanishes – and then they might be more able to indulge in the strategist and capital allocator roles.

When we think about strategy, capital allocation, and the crazy situations we describe above, we rationalize this as a *paradox of the and*. CEOs do not bifurcate strategy and capital allocation with everything else – that would be an *or* construct. Being a small business CEO is a jumble of everything – an *and* construct. The absurdity is that CEOs spend relatively little time on strategy and capital allocation, which has an enormous impact and is akin to playing offense. They spend a great deal of time on arbitrary, haphazard things that have relatively no effect but require gobs of time and are mostly about playing defense. **Figure 1** illustrates the time and impact dimensions for strategy and capital allocation.

Figure 1: An illustrative visualization of time requirements and impact and value creation for strategy, capital allocation, and other demands



Justin Vogt (Stanford Graduate School of Business 2020) co-founded Evermore Industries, an Austin, Texas–based long-term holding company. Evermore seeks to create a portfolio of several cash-generative businesses with a multi-decade investment horizon. With his partner, Ed Redden (Stanford Graduate School of Business 2020), Vogt looks for companies with $1 to $5 million of EBITDA and a ten-year operating history with high customer retention rates and happy employees. Previously, Vogt invested in approximately 100 transportation and industrial businesses with Bain Capital Credit in Boston, Massachusetts. Vogt holds a finance degree from the University of Notre Dame.

Ed and I were excited to build a holding company after school. We like the concept of being long-term investors instead of flippers and traders. Buying a good business is hard, so why jettison it after just a few years? We acquired our first company a few years ago. Avuity met our criteria, and we financed the acquisition with equity and no debt. When we were conceiving our holding company and entrepreneurial roles, we dreamed of being capital allocators and spending time on strategy – those are today's buzzwords in the search fund community. That is what all of our peers were chirping about, and investors were selling us that story, too. We fantasized about being Warren Buffett and using free cash to allocate to more investments to build our flywheel. We were utterly naïve since it will take many years before we have the breadth and depth to be full-fledged allocators – in the interim, we are small company CEOs. There is a massive gap between thinking about what you do as a small company CEO and what you do in practice.

We spend virtually no time on strategy and capital allocation, although we hope that will change in the future. Our strategy is simple. Sell more of our services and products to desirable customer segments at smart prices. That is it. How much time can you spend ruminating on that? As for capital allocation, we use whatever free cash flow we have to invest in sales and growth. We are not issuing shares or debt and we are not buying back equity. There just isn't that much allocation to do.

> What we do spend lots of time on now is sales and operations. We are constantly trying to win and onboard customers. We also deal with scheduling and people issues. Coordinating a distributed installation workforce is complicated and clunky. We need to onboard customers well because our recurring revenue streams are so valuable, we do not want to do anything that would jeopardize the customer service. We also deal with all sorts of scattered and arbitrary stuff – often unexpected things that require a quick and creative response. It's a lot of wrestling with alligators and snakes.
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> Being a CEO is not about strategy and capital allocation. It's about getting things done, keeping the business moving, and trying to get a bit better each day. It's really fun and satisfying; it's just not what we thought it would be. Perhaps our roles will change when we get much bigger and have more assets in our holding company vehicle.

Conclusion

We are not disillusioned with our choice to be CEOs; we have relished the role and would do it again in a second. But we were confounded by what we really did as CEOs. There were moments of fascinating and intellectual exploration in strategy and capital allocation, but most of our time was focused on execution and the mundane realities of being a CEO and managing large workforces – and on some somewhat surprising tasks. Despite it all, though, we have found it to be fulfilling and rewarding work.

We encourage MBAs to explore a post-graduation career path as a small business entrepreneur and CEO, or holding company sponsor, but to do so with eyes wide open and a complete understanding of what running a small company entails and feels like. You might want to check your strategy and capital allocation aspirations and embrace the reality of managing people, working with vendors and customers, and being in a problem-solving, reactive mode. It is pretty fun, actually!

Good luck with your small business CEO career, and we cannot wait to hear your description of what being a CEO is like. Maybe your stories will even top ours!

Endnotes

[1] Trish Higgins is a founder of Chenmark Holdings, a long term–oriented holding company based in Portland, Maine, that seeks to acquire and operate small-to-medium businesses.

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[3] Casadesus-Masanell, Ramon. *Strategy Reading: Introduction to Strategy*. Harvard Business Publishing. January 2014. 8097.