Jim Scott's Secret

The management approach that turns SMEs into gold.

Jim Scott, former corporate high flyer, chief executive of Air New Zealand, senior manager at Carter Holt Harvey, senior executive with United States-owned Northwest Airlines and strategic planning consultant, thinks he has discovered the secret to successfully managing small to medium enterprises (SMEs) and unlocking the riches within. By taking the top-end of the corporate world and the bottom-end of the SME marketplace, Scott's small businesses are delivering annual net profits of more than 20 percent. How does he do it, and what has he learnt about leadership and management along the way?

AQUILINE HOLDINGS: A SNAPSHOT

Through additional equity from new shareholders and new banking arrangements, Aquiline Holdings is now acquiring larger and better quality companies. The company's subsidiaries include:

- Clark Products (importer/distributor chemicals and cleaning products) and Alpha Inter-Trade (importer/distributor chemicals and mineral products) in Napier.
- Bayside 4X4 Spares and Commercials (importer/distributor automotive parts for four-wheel drive vehicles) in Tauranga.
- Lichfield International (importer/distributor men's shirts) in Christchurch.
- Paint Aids (leading painting accessories manufacturer/distributor), Walker Textiles, Wales and Mackinley (leading importer and distributor of textiles) and Marsanta Foods (leading importers, stockists and distributors of food ingredients) in Auckland.

The introduction of the Capital Register from July 1, 2001, means Aquiline can call on cash for new investments close to the time it is required, rather than building cash in the balance sheet. The company has positively identified more than 100 import/distribution sectors that would benefit significantly from AHL ownership. Scott expects Aquiline Holdings to consist of up to 25 separate companies by 2005, each with an average turnover of $10 million annually. The three most critical ingredients required to achieve this objective are:

- The rate of availability of additional equity capital.
- Suitable independent import/distribution SMEs available for purchase at competitive prices.
- Finding, training and retaining the general managers capable of operating under strict business franchise requirements.

Scott's plan is to build a network/cluster of businesses bound together by a business franchise formula that gives top priority to strategy and financial guidance. He believes that Aquiline's tight internal control mechanisms, cost of capital minimisation programmes and the increasing use of economic value added (EVA) criteria, provide a competitive advantage.

"The SME environment is enormously stimulating because there is a strong linkage in the business cycle from go to whoa. The challenge for most traditional owner/operator SMEs is acquiring effective leadership, sound strategic planning, high-quality financial planning and above all – a good macroeconomic appreciation of their trading environment," he says.

WHEN YOU ARE CEO of the country's only big, truly international business at age 44, your next career move is likely to be something quite different, and so it was for Jim Scott.

After leading Air New Zealand's change of direction and then re-thinking his Asian-based management assignment with America's Northwest Airlines, he returned to Hawkes Bay to do his own thing. Little did he know it, but his journey into the heartland of Kiwi small business would take him full circle. Ironically he's back, brimming with enthusiasm and smiling incessantly at the prospect of running another large company. The difference is, this time it's a large company of highly profitable small companies.

Scott has consciously removed himself from Auckland and the limelight. Nevertheless, his reputation for buying lowly-valued small businesses and providing shareholders with abnormally high rates of return, has not gone unnoticed. Scott is founding shareholder and governing director of Napier-based Aquiline Holdings, a private management and investment company comprising eight small businesses. By cherry-picking the best aspects of corporatism, he's successfully unlocking the power waiting to be realised within good companies, usually employing 50 people or less.

"I am the manager of the Aquiline Holdings strategy, raising equity and debt to fund acquisitions. It's also my job to implement a strict regime of strategic planning, budgeting and reporting of a network/cluster of 100 percent independently-owned SMEs," he explains. So what are the worst characteristics of large corporates that Scott will deny Aquiline Holdings? "Large corporations are too big and cumbersome. A single CEO has only a superficial view of things and the group results. All other employees struggle for recognition and to ascend the pecking order."

While individuals within corporates look after number one first – SMEs only work successfully as teams with shared duties and responsibilities. "SMEs are less structured, more multi-skilled and reward according to the individual company's ability to pay. For SMEs the bottom line is the real world, reality is in their faces all the time," says Scott.

Scott plans to boost aggregate sales of Aquiline Holdings from around $60 million this year to over $250 million by June

2005. He aims for 10 percent annual organic growth from all subsidiaries – with incremental growth coming through acquisition. Perennially on the acquisition trail, Scott & Co look at between 30 and 40 small businesses a year.

Assuming Aquiline can achieve its targeted 10 percent EBIT (earnings before interest and tax)/sales, Scott hopes to see a profit performance in 2002/03 of around $6 million EBIT and $3 million net profit after tax. If these SMEs have anything in common it's twofold: they're under-valued and over-capitalised. Far from resembling corporate structures, these firms operate more like small teams, and usually from a single site.

Corporate disciplines

Scott's skill is his ability to transform the performance of these small units by implementing corporate disciplines. By tackling over-capitalisation, wasted stock and the debtor's ledger through corporate governance, financial reporting and strategic planning – it's possible to double their annual EBIT-rate.

"The businesses we own and oversee are at the very foundation of the old economy. Most of them didn't bother with budgets, even fewer understood the cost of capital. We perform a major strategic review annually, and impose a strict quarterly reporting regime. As owner/operators there's never been a higher authority challenging their decisions. But under our structure, we're onto them like a tonne of bricks if they're not abiding by the business franchise disciplines."

Aquiline Holdings has established itself as the operator of a specific business franchise, focused directly at re-engineering and optimising the performance of a wide range of family-based companies. With annual revenues of between $10-$20 million, each company imports critical consumer products.

So why buy these companies in preference to starting new ones from scratch? Aquiline is paying goodwill for established company names. Mostly, Scott and his team are interested in leading players, companies recognised as reliable suppliers within their respective markets. After over-laying a new business franchise structure, and hiring a new general manager, Scott aims to make these businesses the number one or two market player within two years. "Many subsidiaries are operated as basic trading operations with little added value between importation and distribution. However, several of our subsidiaries have added-value operations whereby imports are further developed and customised in order to meet more exacting market requirements. These added-value operations range from re-packing and/or barcoding through to quite significant physical changes to the imported product's appearance and characteristics," says Scott.

Owner/operators want out

But an interesting pattern has emerged. With the next generation reluctant to take over the family business, owner/operators are forced to realise the value of their life's work – through a total exit strategy. Former owners are generally required to remain involved for up to four months while the company undergoes the business franchise transition.

In the past two years, Scott has appointed transitional managers to run the firms while a new general manager is found. He adopted this tactical approach after mistakenly assuming that good corporate managers (newly hired) could successfully run the businesses. "We couldn't have been more wrong," says Scott. The assumption that a good corporate manager can manage anything is dead wrong.

Corporate managers' struggle

Scott now thinks that 90 percent of the managers who come out of the corporate world can't cope in the SME environment. Very few of them have ever been responsible for "absolutely everything" and those whom Scott hired to run SMEs, found it extremely stressful. Aquiline on the other hand is "a strategic investor, not a hands-on manager. So [his strategy] requires that approach, rather than the big hierarchical staff structure."

At the outset, Scott hand-picked two young, well-qualified graduates and nurtured them as the major stakeholders in Aquiline's master strategy. They develop and deliver the master-plan for each new company, then appoint a new general manager with the responsibility to deliver the new culture and direction.

Because corporate managers are more lifetime employees than owner/operators, Aquiline Holdings now employs younger graduates with a different attitude. Scott believes they can be groomed for life running an SME because they are less set in their ways. "When I think back to when I was Air New Zealand's CEO and spent some years rising through the ranks of Carter Holt Harvey, I thought I knew and understood what was needed to fill the CEO role. I was found wanting in several critical areas. If it hadn't been for my strong strategic appreciation and grasp of company planning, I doubt I would have lasted.

"Talking the talk as a result of learning via osmosis is quite different to sitting at the top desk where the buck really stops. This helps explain why many good corporate managers find it difficult to step into an SME general manager's role," says Scott.

What makes managing SMEs more difficult? Having to learn everything about the business. "You can't rely on delegation because there are no support staff available to supplement the individual's narrow skill base," says Scott.

Are there any lessons large corporates can learn from SMEs? In small businesses everyone understands the specific goals and that means a stronger focus on delivering results, according to Scott. "Corporates work in tight staff groups like secret societies. The rest of the organisation is excluded for security reasons." Top level corporate management might be good but the communication invariably in large entities gets confused and contradictory signals travel down the line. "Size weakens focus and resolve," he adds.

Scott doesn't miss the corporate world but he's also relaxed about taking Aquiline Holdings full circle and creating yet another corporation. "I am now practising the real life education experience of the corporate world. I'm totally focused on delivering superior returns to my growing following (60-plus) of long-term shareholders."

If SMEs are under-valued (relative to larger businesses) is this a management problem or a resource issue? The market views SMEs as high risk because of perceived high failure rate. In Scott's experience, failure has less to do with the nature and size of a business and more to do with poor all-round management and the narrow, fixed views of many owner/operators.

"We are working to bridge the gap between the values as set by the market. The doctrine promoted to the community that 90 percent of SMEs fail is nonsense. The cost and value of failures in the corporate world, most of which are covered up in the big picture, would be much worse. They are nowhere near as efficient at delivery as well run SMEs," asserts Scott.

The strategic financial model that Aquiline Holdings applies to its SMEs, forces them to plan, report and analyse. In the past, and without exception, they would have said they were too busy to bother, says Scott with a smile. "The consultancy business taught me that outside advisers are primarily employed to confirm management's (already held) opinion. They also provide an independent report that can accompany an application for board approval," says a sceptical Scott. Boards invariably implement the 75 percent soft options and defer the 25 percent of really strategic decisions. "My period of coming to grips with how SMEs operate identified for me their potential and their major areas of weakness."

What are those failings? Put simply, reporting and corporate governance disciplines. "We cut through and improve systems and make time so that managers run the business instead of the business running them," says Scott. **M**

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SMEs – WHAT'S THE ATTRACTION?

After 30 years in the foreign exchange earning, corporate export and inbound tourism industries where mother nature, politicians and exchange rates pay havoc with business plans, Jim Scott finds the strong defensive qualities of SMEs and their potential rewards much more appealing.

Get the management right and Scott believes SMEs' ability to deliver greater stability to stakeholders and better investment returns to shareholders, makes strategically focused networks or clusters of small businesses more valuable than their larger counterparts. "Well managed SMEs are valued at between three and five price earnings (PE). Large corporates by comparison are inflexible, inefficient and hopelessly over valued, yet often sell at multiples of between 10 and 30 PE," says Scott.

Why import/distribution sector?

That said, why does he see import/distribution as the "hot" SME sector? From a management perspective import/distribution represents greater stability, certainty and opportunity to deliver consistent and sustainable performance levels. Categories within this sector can generally be regarded as marketing essential products either for added-value production within New Zealand or for local consumption. "The import/distribution sector is almost universally undervalued and misunderstood," says Scott with unrestrained enthusiasm.

"When the economy is in balance, imports equal exports, yet 95 percent of the attention and focus of the nation is on improving the more glamorous foreign exchange earning, export sector. Having an efficient and cost-effective import sector is in my view, just as important."

Biggest isn't always best

Scott's move from corporate management to managing a network/cluster of small enterprises was a two-stage process. After leaving Air New Zealand he consulted on strategic planning. But it was the role that followed which focused his attention on the enormous inefficiencies and political agendas of the corporate world. He spent 18 months in Tokyo heading up the Asia Pacific region for Northwest Airlines, the world's fourth largest airline.

"The Northwest experience and especially the American corporate culture brought home to me the critical mass approach of the big and powerful corporations. They espoused the merits of the free market while keeping on with their big-is-best philosophy," he says reflectively. He returned to New Zealand and purchased Napier-based SME Clark Products, and simultaneously re-entered the world of strategic planning consultancy. This completed his transition into the new world of SMEs. The Clark Products' hands-on experience, combined with the frustrations of people skipping over the tough calls in the consultancy areas made the move obvious.

Delivering on strategy

With many gaps in its implementation plan, Aquiline Holdings was formed in 1996 to create a network/cluster of SMEs. Scott aimed to bring together the strategic, financial and leadership skills learnt during his years in the corporate world. He expected to add considerable value to the highly competitive qualities he'd spent nearly two years studying and working with at Clark Products.

"Having a controlling ownership of the network/cluster of SMEs gave us the ability to deliver 100 percent of the strategy. It was in stark contrast to my experience with two periods of consultancy." As a management and investment company Aquiline Holdings focuses on wealth creation. The balance sheets of the SMEs under its wing have been restructured, with cash flows and working capital requirements under constant and close scrutiny.

"We have also instilled into management the fundamental requirement that all businesses must be profitable if employees and all other stakeholders are to have a long-term secure relationship. Businesses must aggressively work hard at the full range of management criteria, not just volume selling at any price," says Scott.

Aquiline's corporate disciplines are working. Shareholders are rewarded with between 15 and 20 percent after-tax returns on equity. According to Scott the stability and certainty provided through the application of corporate disciplines means everybody directly and indirectly associated with the Aquiline Group understands their relative position and what's expected of them. "We have absolutely no corporate politics or confused boundaries or roles. Celebrating success and improving your overall management performance is far superior to continually explaining away failures often created by forces completely outside your control."