Insights

Crossing the Chasm

Lifestyle vs. Professional Management: What's the Difference?

Indian River Consulting Group offers consulting services to senior distribution and manufacturing executives. We deliver actionable outcomes that drive real results in mature, complex and competitive business-to-business markets.

To talk with Indian River Consulting Group about your needs:
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“If my wife knew how much debt we were in when I started this business she would have killed me. If she knew how much money we are making now she would really kill me.”

I heard an owner of a distributor say this to his peers in a bar at a distribution trade show. This is the classic lifestyle business management archetype. Starting a business is a risky proposition.

In the beginning, any entrepreneurial business is undercapitalized and chases revenue to create gross margins before running out of cash. Those that succeed quickly react to avoid threats and capitalize on opportunities. The founder and owner of the capital, or debt, is also the senior operating executive. He is much more concerned with avoiding a bad year than taking any big risks to have a great year. They touch everything in the beginning – making decisions and closely supervising staff while working closely with customers and suppliers. They add expenses at the last minute to keep costs low. With a bit of luck, the business gains some scale. By this time, many of these behaviors are deeply entrenched in the culture of the firm. Decisions are made vertically, running them up to the CEO, and then executing.

The underlying assumption is that this transition from a lifestyle business to a professionally managed one is good, and that all firms will eventually do so. The reality is quite different.

Much has been written on this early foundation-building phase, which describes a lifestyle business perfectly. And a lot has been written on best practices in professional management, which typically follows. But there is little of practical value out there on making the leap from a lifestyle business to a professionally managed one. The underlying assumption is that this transition to professionally managed is good, and all firms will eventually do so.

The reality is actually quite different. We have worked with lifestyle businesses that have over $1 billion in revenue, and we have worked with professionally managed firms that have less than $20 million. Size is a predictor but not a decisive one. Here are some of the other indicators of whether your business is a lifestyle or professionally managed one:

- In a lifestyle business most decision-making is vertical. Choices move up the organization for a CEO decision. In a professionally managed firm, most decision-making is made horizontally by CEO direct reports. These executives have access to all financial information, and each carries responsibility for aspects of the firm’s performance. They are managed with post-action controls around budgets rather than pre-action “I’ve got to get permission first” controls.
- In a lifestyle business, the CEO is the final decision-maker. In a professionally managed firm, a board of directors has real responsibility and oversight, even if the firm is 100%-owned by the CEO-entrepreneur. One benefit of this approach: The CEO has trusted advisors who can provide helpful input and execute the CEO’s final wishes if he meets an untimely end.
- In a lifestyle business, the CEO does most of the worrying about risks, the future, and how to grow the business. In a professionally managed business, the load is spread across and carried by the CEO’s direct reports.
- In a lifestyle business, most growth is captured by reacting quickly and responsively to new opportunities. In a professionally managed business, most growth is intentional. It was researched, investments were made, and resources were applied to achieve the plan.
- In a lifestyle business, staff and other expenses are only added when they become critical and the business can’t move forward without them. In a professionally managed business, some expenses are made in advance to prepare the business for growth.
- In a lifestyle business, there is a built-in bias to “this is how we’ve always done it.” In a professionally managed business, innovation and experimentation is

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budgeted, often by functional department rather than a decision by the CEO.

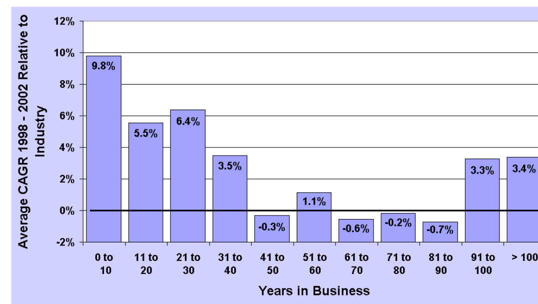
Understand that these characteristics are gradations on a wide scale.

Where Plan B Comes In

Old men always stay too long, and denial is much more than a river in Egypt.

Entrepreneurs will always age out. If they are still the center of all decision-making, and they leave, the business invariably fades and fails. This is the No. 1 driver of making a transition to being professionally managed. Becoming professionally managed creates value independent of the CEO-entrepreneur's direct contributions. This may be to prepare for a transition to a relative or an employee buyout agreement. Or it may be to prepare for the recruitment of a professional employee executive and board for oversight. The alternative is to sell the business to an outsider.

The data below was developed for a research project we conducted for the National Association of Wholesaler-Distributors back in 2003. It shows growth rate relative to the industry as a function of firm age. Growth at 0 on the vertical axis indicates that the firm grew at the same rate as its industry peers between 1998 and 2002. Any values above the line indicate that the firm gained share by growing faster than the rest of their competitors. Below the line indicates share lost as they fell behind.



Firms between 40 and 90 years of age grew slower than their peers, and they lost share. After 90 years, they return to growing faster than their industry peers. We understood the early decline in growth rates as it is easy to have high growth rates when you are very small. It becomes harder to sustain that as you grow. We figured the loss in share years were due to entrepreneurs who aged out and rode their businesses down. We didn't understand the return to share growth after 90 years of age, so we asked those firms why.

The answer: They said they had learned to recognize family members who performed badly as leaders and to change before they destroyed the firm. These older firms were able to do this because they had boards and real executive oversight, a core characteristic of professionally managed firms.

Many aging entrepreneurs don't start thinking about succession until they retire. Remember the genetic bias to react quickly rather than deliberately? This often becomes a fatal flaw as health crises are rarely scheduled.

A shareholder alternative analysis – the fancy term for this aging-out succession plan — really needs to be done well in advance of any change in management. It's a decision that has to be made intentionally, rather than reactively. Helping clients through this has been a part of our consulting practice for decades. Most privately held firms choose to keep the business in their families and usually set up a board and at some point bring in an employee CEO. The transitions of operating management and ownership are very different and need to be handled separately. Advisors who combine these two very different challenges and then optimize business choices to minimize tax liability have destroyed millions of dollars in shareholder value.

At the heart of this transition of operating management is a switch to professional management. The interesting part of this transition is that it can happen when the

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CEO-entrepreneur decides it should, and this can be now or when they are preparing to exit the business.

The other driving factor is that a professionally managed firm is usually worth significantly more than a lifestyle business. In private equity parlance, a platform firm gets a higher multiple of EBITDA earnings, and is professionally managed. The reason is that it is already positioned for significant additional growth. An add-on acquisition is typically a lifestyle business that can be integrated into the platform firm.

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The Obstacles

It is hard for any CEO-entrepreneur to cross the lifestyle-to-professional chasm. It makes sense to create higher shareholder value and value for the firm after the founder exits. To an outsider this seems like an easy decision.

If this is true, why do so many lifestyle businesses fail to make the transition? For some, the answer is that they don't want to cross. Many enjoy what they are doing, they are good at it, and they have achieved more success than they ever expected. It is good to be a king. For others, they decide that their employees aren't entrepreneurial enough or that they are lazy and incompetent. Even worse, some have large egos and will not allow others to be more successful then themselves, especially if they are doing something different.

Several years ago one of our clients had outgrown the lifestyle approach to growth. In a particularly fierce conversation, the CEO said, "Why do I need to change? I've got two airplanes, and you can see that I haven't missed many meals." He sold his business three years later to a consolidator at a lifestyle-business multiple. It was his money, and he was very happy with the way everything worked out.

This exit met the owner's expectations. It is often the exception rather than the rule.

Many other CEO-entrepreneurs know there is something more and they try to cross the chasm themselves. They hire MBAs, consultants and coaches. They go to seminars and sometimes become concept junkies. They end up adopting practices and tools but never confront the underlying challenge of management style. We had a CEO client who went to the Harvard Advanced Management Program (AMP). This is one of the best programs of its kind in the world. When we interviewed his direct reports and asked them what was different, a common response was, "He still makes lousy decisions, but now he makes them faster."

This is a tough transition. Our AMP exec tried to cross the chasm and fell into it instead. If you decide to cross, recognize it's a one-way trip and will take several years.

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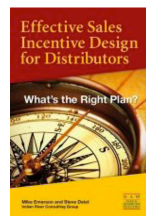

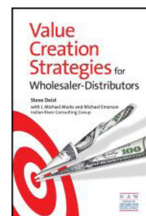

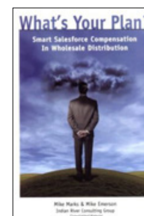

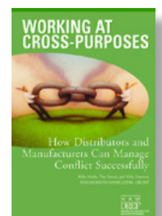

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