Sionna~ Investment Managers®

INSIGHT

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Decentralization: A Tug of War

Start-ups typically begin with a vision and entrepreneurial spirit, but little attention to structure and processes. As a business grows, processes become critical to efficiency and the ability to expand effectively. Entrepreneurs often resist structure, claiming it restricts their agility and dilutes their culture. Throughout a business's life cycle, this back-and-forth between autonomy and appropriate structure is a constant tug of war.

As long-term investors, we spend time thinking about the structure of an organization to answer such questions as:

- Is the structure appropriate for where this business is in its life cycle?
- Will the structure protect the core business?
- Will the structure incent the right behaviours and allow an organization to maintain or expand its competitive position?

In assessing structures, Sionna has noticed that the decentralized business model stands out as an effective form of aligning incentives at the ground level while allowing an organization to grow efficiently. At its core, a decentralized business provides autonomy to several distinct units rather than centralizing all decisions at the top. However, while decentralization can be the start of a strong foundation, it doesn't ensure success on its own. Inevitably, management teams must decide what processes are needed and what aspects should be centralized. Sometimes structure will be needed in a specific business unit and sometimes across the entire organization – regardless, some structure is essential to avoid redundancy and increase cooperation between business units. Where and how it's implemented requires a thoughtful and adaptive approach.

Badger Daylighting

One example of a business that has successfully evolved with a decentralized structure is hydrovac operator, Badger Daylighting (Badger), a long-term holding in our small cap portfolio. For growing small-cap companies in particular, we pay attention to their ability to maintain the entrepreneurial principals they were founded upon. Badger originally started with a franchised model, but the business was not able to grow as quickly as desired and recognized it had to change its approach. Typically, we are fond of the franchised model, which is the ultimate decentralized operation, but in this case, it was stifling growth; owners with different objectives made it difficult to expand the business. Management found that shifting to decentralized corporate structure helped them control their strategic direction.

The company wanted to maintain the benefits of an entrepreneurial culture and aligned incentives, so it implemented a structure where operating managers receive 5% of their location's profits as part of compensation. Badger went one step further, identifying that asset utilization was critical for its business, it encouraged the movement of underutilized hydrovac across locations. This made perfect sense: a manager for a given location should happily pass along underutilized hydrovacs, especially since the depreciation charge for the vehicle moves with it – essentially increasing the profit for your unit and your own bonus.

Today, Badger is a significantly larger company and still evolving. In its current stage, Badger has recognized it is leaving money on the table by not centralizing certain functions. For example, the company discovered it had been purchasing safety supplies from 800 different providers and not coordinating the purchase of basic items such as fuel and tires. Badger is currently in the early stages of working through these opportunities. Once fully implemented, this will lead to certain elements being centralized, but we have no doubt that the decentralized model is still core to the business. The company's culture is still rooted in the idea of pushing decisions to the local level, which has helped foster the entrepreneurial spirit so critical to its success. Badger's organization chart is a simple reminder of this: an upside-down pyramid with the customer at the top and executives at the bottom.

Alimentation Couche-Tard

Convenience operator Alimentation Couche-Tard (Couche-Tard), a holding across many of our portfolios, is a company that is well known for its decentralized model. Its model allows store owners to respond to the local needs of their customers, despite the company's global footprint. The company credits its decentralized structure with helping it make the right decisions in each market, since a one-size-fits-all approach does not often work. One example is the company's initiative to bolster its coffee offering across its convenience store network. An espresso-based coffee machine that worked well in Canada and Europe was rejected by its U.S. store owners, who claimed the machine did not resonate with customers. Despite the instruction from head-office, store level managers were empowered to say no and provide valuable feedback. Couche-Tard heard the feedback and revised its approach. It turned out that U.S. customers preferred brewed coffee and needed a simpler offering. This sounds relatively small, but for a low-margin business like retail, these small decisions can have big impacts.

While the decentralized model is a strong part of the company's DNA, Couche-Tard has increasingly seen opportunities to centralize certain functions within the organization. One example is its in-store food offerings category, which has underperformed its peers and management has sought to improve. Following its recent acquisition of convenience operator, Holiday Stationstores (Holiday), Couche-Tard was quick to recognize that it could learn from Holiday's success in the food category. Couch-Tard realized that Holiday's success was based around a centralized food commissary, where food is produced in one location, sparing each convenience store the need for duplicated efforts. Couche-Tard is in the process of piloting and implementing these learnings across its network. Adopting practices like this is just one example of Couche-Tard's flexible approach. The culture of the company is such that it doesn't get stuck thinking one way is the right way; rather it learns from best practices across its units.

Moet Hennessy Louis Vuitton SE

Luxury goods company Moet Hennessy Louis Vuitton SE (LVMH), a holding in our global fund, has grown from a single brand into a luxury conglomerate across several categories. Today, LVMH offers everything from champagne, cognac, handbags, jewelry and even hotel experiences. A critical component of its operating model is maintaining a decentralized structure where creative directors of individual business units have the autonomy to innovate freely and maintain the cultural identity of each brand. On the other hand, LVMH provides centralized support with certain decisions such as real estate, marketing spend and procurement to obtain the benefits of scale. As LVMH adds brands to its group, it simply plugs them into the existing structure but allows them to maintain their own identity, creativity and autonomy. LVMH seems to have found the right balance.

Waiting for the Big Pull

Sionna advocates for the alignment of incentives and admires companies that successfully implement decentralized models and seek to maintain their entrepreneurial roots. We believe it contributes to responsive and resilient businesses for the long term. There will always be pressures to centralize as a business grows, but a good culture can reinforce entrepreneurial behaviours, even while putting some structures in place. Badger, Couche-Tard and LVMH have managed to use the tug of war to strengthen their competitive positions and build strong long-term track records. Through our rigorous fundamental analysis, these businesses were identified as stocks we would own at the right valuation. Eventually, short-term pressures gave us the opportunity to purchase each of these companies at discounts to our estimate of their intrinsic values. Our patient approach allows us to capitalize on these types of opportunities, supporting our goal of downside protection and long-term outperformance for our clients.

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