

Teakwood Wisdom

As one of Teakwood's most valued friends and business partners, we would like to express our appreciation for your partnership with Teakwood. In an effort to continue building our relationship with you, we would like to share our thoughts with a small group of people, including you, on a continuing basis.

We plan to periodically send excerpts from our quarterly letters to our Limited Partners. In addition, we may provide additional insight that we gain through interaction with our business partners, limited partners or portfolio companies. Our goal is to provide something that is valuable to you, yet brief.

Please don't hesitate to give us ideas regarding what would be valuable to you or comments on the information we send to you.

Thank you for your continued partnership,

Teakwood Capital

MARKET CONDITIONS

There are wide ranging opinions regarding whether we will see material inflation or deflation or neither. We want to share a story with you to illustrate how we are approaching this environment.

The Assumption: If one believed there was a 50/50 chance of inflation or deflation...

The Story: A man in medieval times made some "questionable decisions" that compounded into real problems and were catching up with him (our current economy). He had been summoned by the local overlord, and his punishment was somewhat left to chance, although he knew a punishment was forthcoming. He had to flip a coin to determine his fate. If heads, someone was going to whack him in the head with a 5 pound hammer (deflation). If tails, someone was going to whack his hand with a five pound hammer (inflation). The twist was that the overlord was advanced in his thinking and did not believe in cruel and unusual punishment. Therefore, before the coin was flipped the man could choose one of two items to protect himself from the blow: 1. A steel helmet 2. A steel glove. What did he choose? The steel helmet, if he was smart. It would fit over both his head

and his hand, although less perfectly over his hand. Choosing the glove would have left him highly vulnerable to one of the outcomes, possibly the worse outcome of the two.

There exists a chance today to prepare for markedly divergent outcomes: inflation and deflation. Neither may occur with enough severity to matter. But either could occur with enough severity to matter. Low leverage bets that don't rely heavily on the consumer to spend are best in deflationary periods. It is critical to recognize that it's possible to move into higher leverage and/or consumer discretionary focused positions later. It is very difficult to move quickly out of those two positions if deflation is the reality.

The Moral: Consider choosing the steel helmet before this coin flip occurs.

RESPONSES FROM OUR TEAKWOOD WISDOM PROGRAM, IN WHICH TEAKWOOD'S SEASONED BASE OF LIMITED PARTNERS PROVIDES FEEDBACK:

Here is the question asked:

What is the best decision you have made for the short and long term benefit of a business during slow or challenging times?

Here are the responses received:

Staff Reductions. Cuts are always difficult to make however the impetus of a slow economy causes us to make these tough decisions. Invariably these decisions are good for the short term health of the business and the long term profitability. Time after time you look back on the hard decisions and realize they should have been made years earlier. Reductions also have the effect of forcing a "top-grading" environment which is healthy for the business.

I haven't been through many downturns, so I'll share a big mistake made during a particularly tough stretch. We were bumping covenants and struggling to control expenses, but we needed to upgrade some positions. We decided we didn't have the funds to afford 'A' players. So we hired two individuals that we thought were good compromises. Terrible plan. While they were mild upgrades from their predecessors, we ended up replacing these individuals. The cost in training, morale and missed opportunities greatly outweighed the premium we would have paid to land true 'A' players. In short, don't compromise hiring decisions based on near term financial constraints. Figure out how to make budget room for the right hire and be patient, or stick with your existing team until you get more breathing room.

Not personally guarantying loans and leases. It really helps in negotiations if the creditor/landlord believes that assets are limited. It would totally shift the leverage if they believed they could go after assets beyond the business.

Be sure management has strong equity incentives and is aligned with the investors. Create an environment of entrepreneurship not entitlement.

Install a system to gather worker productivity information, so I could make informed layoff decisions. The other

key step was communicating continuously with the field to create a sense of shared destiny.

To think outside the box and not follow the crowd. To make thoughtful decisions that may be really tough to make and unpopular with people. To look for opportunity when others view the glass half empty. I also think that you need to be careful not to get too distracted. You need to focus on the plate in front of you. Things will

get better. Keep a positive attitude. Everywhere around you there is opportunity.

short term - redefine success and metrics

long term - secure the best talent

Find creative ways to aggressively pursue gains in market share, and work to improve operating efficiency. These will benefit you greatly when better times, or at least stable times, return.

*MAKE ADJUSTMENTS IN LARGE INCREMENTS RATHER THAN "DRIBS AND DRABS"
REDUCTIONS START AT THE TOP--THE OLD LEAD BY EXAMPLE SO OFTEN FORGOTTEN BY
EXECUTIVES.*

GET GOOD EMPLOYEES (WHO MAY BE UPSET) FROM YOUR COMPETITORS

O.K. TO "BET THE ROOM" OR "BET THE FLOOR" BUT DO NOT "BET THE HOUSE/STORE"

NEVER STOP KEEPING YOUR BANKERS INFORMED AND PART OF YOUR TEAM

P.S.

*GOING TO JAPAN FOR A TEN DAY EDUCATION IN HOW TO INVEST AND LIVE IN A DEFLATIONARY
ENVIROMENT--JUST IN CASE THE UNEXPECTED HAPPENS HERE IN THE NEW USA.*

The best decision we made was to accept the economic conditions for what they were and budget a no growth year and instead focus on cost controls and belt tightening. When we started to look at the reduced budgeted sales it easily led to understanding what needed to be done to reduce costs, which in turn led to a leaner staff which is now far more efficient than we were. The results are that everyone has focused on small improvements which led to positive results in a down economy.

I believe it is times like these when you should focus on customer service and marketing. Seems like most companies downsize the marketing budget at the first sign of distress. By maintaining and even in certain circumstances, growing your marketing budget, allows you to gain prized market share once the market returns to a more normal pattern.

Stuck with core focus, and spent downtime by marketing and fostering relationships in that area.

The best business decision I have made during a slowdown/recession is to remain focused on the attributes that originally attracted me to the company. Since the original model continued to address a market needs, we cut any unnecessary expenses and drove sales like mad. Opportunity abounds.

Revisiting our Strategic Plan and making certain that it remains valid in the face of changing economic circumstances --- or needs revising.

Do not worry about short term performance as long as your investment is healthy and will stay afloat. The long term is where you will make money and have sustainable growth. Everyone is worried about what they will return this year or next. I am planning on looking at my returns in 4 years. If you sold a business in this economy in two years from now you might get an IRR of 10%. If you wait 4 years you will get in the mid 30's.

Not to stop or slow down any marketing efforts! We have found that putting more emphasis on marketing and adding to our efforts in this area has aided us during challenging times. Additionally, "top-grading" talent and picking up people that could not have been obtained in more robust periods economically has aided us in gaining market share and off-setting the falling performance of others in tougher times.

Probably the best decision I have made in economic downturns is recognizing that means company growth plans usually need immediate re-evaluation. If not, the result likely may be that company mid-level managers will have to look for ways to increase profit margins which may involve higher than desired risks. The lesson is, when the economy changes significantly in either direction, immediately re-examine business plans. Otherwise, short-term growth objectives may be achieved with disastrous longer-term results.

If the business produces a lot of cash flow, then growth (especially when the competitors are down) makes sense. You can afford to keep that long term view. Re-investing in internal growth initiatives which is a lot cheaper than buying growth through acquisitions would be the highest priority. If the business doesn't produce a lot of cash flow, perhaps because it is growing too fast, slowing the growth is necessary so cash reserves aren't taxed when financing is either not an option, or too expensive. Focus on tightening up operations that may have slipped when the economy was good and when the focus was on growth.

Find creative ways to aggressively pursue gains in market share, and work to improve operating efficiency. These will benefit you greatly when better times, or at least stable times, return.

A couple of random thoughts...

One of the common things I have seen in challenging times is that once the decision is made to cut expenses (especially people) the cut is often not made fast enough. The tendency is to wait another few weeks or months and see if things will "turn around" ... valuable time and cushion is lost. "You can't save your way to prosperity" ... cost cutting can take you so far ... what is often needed is a reinvention of the company's approach to the market.... frequently with an emphasis on extraordinary customer service.

Create a sense of urgency relative to evaluating employee and sub-contractor performance and changing up the mix of business to focus on more profitable sectors. Re-balancing staff to ensure the business is running mean and lean and focusing on those opportunities that have both returns and the most rapid payback.

Cut costs

