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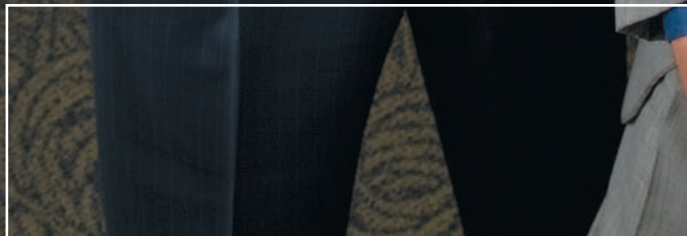
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**BY
RICHARD
STOLZ**

PHOTOS BY TOM SALYER

YOU

Some private equity firms have taken it on the chin lately in the wake of the credit crunch, with jittery institutional lenders pulling the plug on loans to buyout specialists. That pull-back does not, however, appear to have taken a significant toll on the corner of the private equity and venture capital world that invests in lower middle-market and smaller firms, often seeking long-term growth, instead of heavily leveraged financial engineering.

“It hits the [investment] firms that operate on a cash flow or EBITDA [earnings before interest, taxes, depreciation and amortization] basis more than us. We’re growth-oriented; we’re different from a company that’s going to sweat out a couple of million in EBITDA, then move forward,” said John Loftus, executive vice president and a managing director of Safeguard Scientifics, a publicly traded investment firm based in Wayne, N.J.

“We’re looking for good entrepreneurs and helping them accelerate their growth,” said Mark deLaar, a principal with Boston-based Summit Partners. “I don’t think I’ve ever gone into an investment with a particular timeline when we had to exit that investment.”

That doesn’t mean, however, that chief financial officers seeking capital should regard such firms merely as a bountiful source of cash, with no strings attached. But by entering into a marriage with a PE/VC firm with a realistic understanding of the future dynamics of the relationship, the “portfolio comp-

any,” as they are described in the PE/VC lexicon, can greatly enhance its prospects for growth and long-term success.

And the first step towards any productive relationship involves carefully sizing up the field. The PE/VC universe is quite diverse and specialized. Pure venture firms, of course, target early-stage firms, while private equity firms tend to support more mature companies. But there are so many variations and nuances in the investment goals and policies of these firms that such descriptors are of limited value.

THE SHORT LIST

However they are labeled, “There are usually six to 12 players in each industry segment that belong on your short list” of prospective investors, according to Craig Jurecka, the lead shareholder of the PE/VC practice group of CBiz, a national accounting and business services firm.

And the nature of the actual form of investment that the PE/VC firms are prepared to make will also vary. Mezzanine financing, or subordinated debt, “is a more expensive way to finance a transaction than an all-equity transaction,” noted Tom Hiatt, managing director of Centerfield Capital Partners, in Indianapolis. But it may be a company’s only choice if commercial lenders have reached the limits of their comfort zone and the investment firm isn’t comfortable with an all-equity position. Also, company owners may be reluctant to give up as much equity as a PE/VC firm might demand.

However, subordinated debt instruments often have equity-conversion features, Hiatt explained. In addition, a PE/VC firm’s initial investment may include a combination of subordinated debt and stock, in order to make it palatable to all parties. “We may do six, 20, 30 quantitative financial models of a company’s business, and will go through these with the management team to show the cash flow, balance sheet and other implications,” Hiatt said. “We’re deeply committed that everybody should understand with as much detail as possible what the capital structure of the company will look like after the transaction. Our goal is to let the objectives of the company and the realities of the balance sheet combine to help us tease out both the amount of capital and the structure of the transaction, which helps everybody. It’s a highly iterative process.”

THE TEST

Of course, a PE/VC won’t waste its time spinning out financing scenarios if it doesn’t smell a promising investment opportunity at the outset. So what does it take to get into a serious conversation?

The attributes that PE/VC firms look for in a deal vary somewhat, with different emphases placed on varying elements of the equation, depending on their investment objectives, time horizon and risk tolerance. And their assessment of the opportunity before them — particularly for those investors seeking a long-term relationship — generally is

heavily weighted on corporate management.

“We can’t know everything about everything,” said Steve Vivian, a partner with Prism Capital in Chicago. “Ultimately, we’re in the business of backing good operators. We even do a psychological screening on every CEO we back,” he added. “It’s caused us to back away from deals and CEOs.”

And how does a psychologically fit CEO behave?

One informal indicator employed by Summit Capital’s deLaar is the company’s atmosphere when he sets foot in the door. “Is everybody nice and pleasant? You can glean a lot about an entrepreneur from the culture of that organization,” he said. A related, but perhaps more significant, test for deLaar is executive management’s receptivity to being questioned. “Good entrepreneurs aren’t threatened by strong boards of directors challenging them. They welcome that. They want to surround themselves with smart people with experience that can help them.”

There is probably little that a CFO can do to help the CEO pass muster on that level. But PE/VC people also pay attention to CFOs as well — not merely the raw numbers they produce. DeLaar admitted that the kind of CFO that elevates his confidence level is one who “has the ability to synthesize all the data, all the levers of the business, and clearly articulate the things that help that business grow.” And when he suggests a new way to look at some aspect of the company’s finances, he hopes the CFO will be open-minded about it.

David Reuter, a principal with LLR Partners in Philadelphia, understands that CFOs are under pressure to



be in “sales mode” during the courtship phase of a relationship with a PE/VC firm. “Everything is positive and rosy. And when you close a transaction and get back to reality, as with anything in life, there are strengths and weaknesses, risks and opportunities.”

Reuter said that he much prefers dealing with CFOs “who can put their forecasts in perspective, be straightforward about what the numbers have looked like historically, what the drivers were to develop those numbers, how those numbers can be impacted going forward.” That’s because, “The worst thing to do when you get started in a relationship,” Reuter explained, “is to miss your numbers, and then have to point out, ‘Oh, we didn’t mention these things to you that are at risk, and here’s what it means to the business.’”

WHAT’S IT REALLY WORTH?

And assuming the basic numbers furnished to prospective investors are solid, PE/VCS and executives must see eye to eye fairly quickly on the company valuation. Safeguard Scientifics’ Loftus has encountered CEOs who believed that they could base their company’s valuation on that of a publicly held company “with the same business model and idea.”

“The reality,” he says, “is a that small company doesn’t match up.”

Other factors can lead to diverging valuations. For example, CBiz’s Jurecka points out that a company being led successfully by a founder who intends to continue running the company will fetch a higher valuation than a company being run by the children of a recently deceased founder, who don’t wish to remain in that business. In general, Jurecka added, “Entrepreneurs are always very passionate about their businesses and see a tremendous amount of upside. Investors may have different views.”

Of course, prospective investors who don’t share at least some of that optimism wouldn’t be holding a conversation

When MDVIP began to think about bolstering its capital ‘to go beyond the more conservative budgetary approaches we had to take,’ it wasn’t just looking for ‘an undifferentiated financial source,’ recalled **Darin Engelhardt**, the company’s president.

‘Summit caused us to be much more focused and committed to the direction we are on, and reinforced the need for us to really perform everything we had on our plate with excellence, and not succumb to the temptation to spread ourselves too wide,’ said MDVIP CEO Goldman.

with the entrepreneur in the first place. In addition to sharing excitement about the business, PE/VCs and senior executives, once they come to terms on basic issues like company valuation, need to be prepared to be spending a lot of time talking, answering questions and considering new ideas about the business.

Explained Jurecka: “These people coming to the table [with equity capital] want to do more than just get a return on their money. Obviously, that’s their goal, but in the process, they’re going to become involved in the business. They’re going to become advisors. So understanding the investor group’s philosophy is just critical. They should be people you want to hear from, people you respect. Not, ‘Oh no, the phone’s ringing, it’s Bob again.’”

SEEKING A PARTNER

That high expectation was precisely the perspective of the founders of MDVIP, a Boca Raton, Fla.-based national network of physicians whose practices focus on preventive and personalized health care. The fast-growing 120-employee company was founded in 2000.

When MDVIP began to think about bolstering its capital “to go beyond the more conservative budgetary approaches we had to take,” it wasn’t just looking for “an undifferentiated financial source,” recalled Darin Engelhardt, the company’s president. “We were looking for a partner who could assist us in growing the company to the next level based on their expertise.” Engelhardt was MDVIP’s CFO at that time.

Several PE/VC firms were wooing MDVIP. However, all but one of the PE/VC’s presentations “revolved around the dollars, the use of proceeds, the financial aspects,” recalled Edward Goldman, M.D., the company’s CEO and co-founder. The exception was Summit Partners, which “included the philosophy of what we were doing, the direction in terms of how best to accomplish it, an analysis of our management structure, pointing out strengths and weaknesses.” As a result, “We bonded with them because they were giving me information



that helped me run and strengthen my company.”

Added Engelhardt, “The valuations [of all of the prospective investors] were reasonably comparable. It came down to the intangibles of the relationship.” Also, Summit’s investment horizon was “several years longer” than those of the other firms, he added. “We found that to be an important factor for us, because it gave us the opportunity to focus on growing the business.”

Summit Partners’ \$6 million investment in 2005 was in the form of debt convertible to preferred stock. The note was designed to convert to equity “based on a balance sheet event that was anticipated,” Engelhardt said. The unspecified financial milestone has been reached, and Summit’s stake is now in the form of a minority equity position. Summit’s deLaar sits on the company’s board.

And what kind of input are MDVIP’s executives getting from Summit Partners? In the early stages of the relationship, Summit’s brain trust offered the company “a good, neutral perspective in terms of over-arching business principles,” as well as pointers on the company’s human resource and technology infrastructure needs, Engelhardt said.

“Summit also caused us to be much more focused and committed to the direction we are on, and reinforced the need for us to really perform everything we had on our plate with excellence, and not succumb to the temptation to spread ourselves too wide,” added co-founder Goldman.

Summit also gave up one of its own employees — Matthew Hashem — who joined MDVIP as the company’s CFO when Engelhardt became president. Indeed, helping portfolio companies to beef up their executive talent pool is

one of the services that some PE/VC firms are happy to provide. “We add a lot of value in helping a strong management team get stronger,” deLaar said.

The Summit-MDVIP relationship began when Summit initially approached MDVIP. Naturally, that’s better than the other way around, especially if a company isn’t particularly anxious for new investors at the time, which MDVIP wasn’t at that point. Months later, after receiving financing proposals from several PE/VC firms, “We were not comfortable with any of the term sheets, so we politely said, ‘Thanks, but no thanks,’ and my partner and I did the next round of funding,” recalled Goldman. Undaunted, Summit kept the dialog alive. “That resulted in our doing a deal with them a year later,” he added.

THANKS, BUT NO THANKS

But not every company is alluring enough to attract persistent suitors. The unanimous advice for companies thinking about hooking up a PE/VC firm: Don’t wait until you need the money to launch your search. “You should always start the process before it’s necessary,” said Jurecka — and that means start doing your homework and start building the network as soon as you think you may be entering a transaction in the future, he added.

That “network” is the web of lawyers, bankers, accountants and other players who have regular interactions with the kind of PE/VC firms that do deals with comparable companies. It’s acceptable for a company that may be seeking capital down the road to directly contact a PE/VC firm just to learn more about its philosophy and investment targets. “We’re happy to meet with entrepreneurs before they need money,” said Loftus. But it would typically be a serious blunder to directly pitch the firm with a business plan.

“You need to find a way to reference yourself directly into the person who has the money; it’s a very relationship-driven business,” explained Prism Capital’s Vivian. Added Loftus: “We have a pretty tight focus on the types of companies that we think are the best opportunity, but we are also reactive to our network of folks who forward us deals.”

It’s also extremely critical to be well-prepared to respond to the kinds of questions that will be posed if a kind word about your company by a securities lawyer acquaintance to a private equity firm results in an inquiry.

TOP-LEVEL SCREEN

Loftus said that his top-level screen in considering an investment opportunity is what he calls the five Ms — market opportunity, management, business model, moat (a term coined by Warren Buffet, referring to a company or product or service’s competitive differentiation), and momentum (“the traction with customers or revenue or product development”).

Most companies don’t survive a PE/VC firm’s first-pass look. But if the initial look leads to serious tire-kicking, a CFO (and the CEO) can’t be too prepared for questions that will come — although they can be easily anticipated. “You have to have a strong understanding of your business, knowing your financials very well and how they play in terms of your short- and long-term goals,” said MDVIP’s Engelhardt, adding, “There are nuances that come up, so you want appropriate legal advice in terms of an appropriate structure.” (Engelhardt, an attorney by training, also served as MDVIP’s general counsel before becoming its president.) “If questions that come up during the due diligence process surprise you, you’ve not done a good enough job preparing,” he warned.

Still, if the process reaches the stage of formal due diligence, the PE/VC firm probably isn’t hoping to trip up a CFO for the sake of pulling out of an impending transaction. In addition, an enlightened investor won’t try to get too aggressive on the terms of the deal. “We try to drive down the middle of the road, because the last thing you want to do in a long-term relationship is win a whole lot up front,” said Loftus. “I view it as like a marriage; we’re going to be with the company for five to seven years; there’s a lot of give and take.”

However, most PE/VCs will obtain the financial equivalent of a prenuptial agreement, particularly if their investment is too small to give them outright control of the company. Board representation is standard operating procedure — except in some cases where the investment is debt-based, and serving on a board could undermine the lender’s rights as a creditor in a bankruptcy.

That “prenup” comes in the form of “blocking rights,” which give the investor veto power over prescribed actions. “The control of the company really comes more in the rights attributed to the investment, regardless of the percentage of ownership,” said Prism Capital’s Vivian. For example, the new investor may obtain the authority to block such things as acquisitions, the premature sale of the company, or other major events.

Also, the PE/VC may require the ability to bail out. “We need the ability to get out of the company,” said Vivian. His firm derives its own financing from partnerships with a maximum life of 10 years. If the portfolio company hasn’t created a “liquidity event” that enables Vivian to exit in time, “We can ‘put’ our investment to the company. If the company can’t pay for it, we can start to take action to control the company.”

Ideally, that would never happen — which is why MDVIP’s Engelhardt stresses the importance of determining whether there’s a good fit personality-wise with the private equity group. “That’s the difference between a great collaborative environment, and one that could be very stressful and potentially detrimental to the business.” **SMB**