

Give & Take

Owners and financiers discuss do's and don'ts to access capital

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by Beth Ewen

ABOUT THE ROUNDTABLE

Upsize invited finance experts from both sides of the table—those lending or investing the money, with their customers seeking and using it—to discuss the best ways to access capital. The result was a revealing discussion in December, the edited version of which follows.

THE FINANCIERS

- Mike Smiggen is a principal with Tonka Bay Equity Partners in Minnetonka. The firm has funded two companies with its second, \$125-million fund, and has letters of intent on four other deals. Its first fund, which closed in 2004, was \$75 million. Among those investments was McCombs Frank Roos Associates Inc., a landscape engineering, planning and surveying firm. Tonka Bay makes "mostly control investments," meaning they purchase a majority interest, mostly in late-stage businesses, often fueling ownership transitions, and often including senior debt in the deal.
- Sima Griffith is managing principal of Aethlon Capital LLC in Minneapolis, a boutique investment bank she founded 10 years ago. "Aethlon helps growing companies secure the financing, strategic partnerships and board members they need to achieve their vision," Griffith writes. Aethlon raised \$1.6 million in equity capital for Restore Products, which sells environmentally friendly cleaning products that are refillable via its patented refilling stations. Griffith says she always looks for firms with proprietary technology, because that helps keep the competition at bay.
- Dion Muchow (rhymes with cocoa) is senior vice president of Venture Bank in Eagan, and he's been with the bank since its founding five years ago. Before that he was with Riverside Bank for 12 years. Muchow says the bank offers "aggressive" commercial financing, from start-ups and business acquisitions to working capital loans, equipment financing and commercial real estate. Venture Bank lent \$500,000 to GovDelivery last summer, which the firm uses to smooth out cash flow.

THE FINANCEES

- Jeff Roos is president of MFRA, McCombs Frank Roos Associates Inc., a professional services firm in Plymouth offering landscape engineering, planning and survey services. Roos and another partner owned 75 percent of the firm, but the other partner was planning an exit strategy. Roos and company hired an adviser, who presented them with multiple buyers. They struck a deal with Tonka Bay Equity Partners and now Roos owns about 10 percent of the firm, making younger partners much happier about the firm's future, and making Roos happier because his holdings are much more diversified.
- Laurie Brown is CEO and president of Restore Products in Minneapolis, which sells environmentally friendly cleaning products and patented refill stations for the products. She's secured just about every type of capital for her company, starting with a government grant, friends and family money, vendor financing, bridge loans, and most recently a \$1.6 million equity investment arranged by Aethlon Capital. With Aethlon's guidance, she's now seeking a strategic investor, that is, capital from a corporation in the consumer or environmental space.
- Darren Gerke is controller of GovDelivery, which started out supplying companies with online forms required by the Labor Department, then adding the hard copy version as well when customers asked. Its other main business is e-mail subscription services for government entities, ranging from the city of Minneapolis to the FBI. Government bodies like to pay once a year, so Gerke says the company's September and October can be fat and its May or June very lean. They sought a loan from Venture Bank to smooth cash flow.

Upsize: I'd like to start with the financiers, the investors or lenders in the room. What are a couple of main things you consider when deciding where to commit your money?

Dion Muchow, Venture Bank: We want the management team to have skin in the game, first of all. Second, a well-thought-out business plan, with projections we can rely on. Nobody ever makes their projections — they're either better or worse. But we're looking for reliability.

Sima Griffith, Aethlon Capital: No. 1 is the quality of the management team. No. 2, is the company's product line unique? Three, how large is the market?

Upsize: And how large does the market need to be, for you?

Griffith: At least \$300- to \$400 million. And four, can the investors make significant amounts of money?

Upsize: Again: How much is necessary?

Griffith: Investors typically want 40 percent per year return.

Upsize: You've emphasized the need for proprietary technology. Why?

Griffith: You don't want the competitors to be able to copy the product or service. I always cite Cirrus, one of the companies we've been involved with, which had proprietary aircraft technology. Simondelivers, another investment of ours, the grocery delivery service, had a proprietary way to deliver groceries. Granite City Food & Brewery, had — and you'll all laugh — fermentus interruptus. They'd ship the liquid wort to the restaurants, where they'd brew on-site. It was much more low-cost than other brew pubs.

And then Restore Products, Laurie Brown's company [at the roundtable] has proprietary refill machines. If she was only in consumer packaged products we wouldn't be in there as an investor.

Mike Smiggen, Tonka Bay Equity Partners: First, a strong management team. If they don't have that we're probably not interested. We'd much rather have a so-so product with a great management team, than the other way around.

The product or service has to be in a niche. The company needs to be doing something that makes them able to grow, or the segment they're in needs to be growing, where customers are flocking to it.

The company needs to be more mature. Our companies are later stage companies. They're EBIDTA positive. They're a little farther along probably than Sima's companies. You probably take pre-revenue firms, Sima.

Sima Griffith: We don't take pre-revenue companies, but I'll take companies that are generating cash but not making money yet.

Upsize: Let's turn to the business owners here. Detail your recent experience in raising capital, how did it go, and what are you using the money for?

Laurie Brown, Restore Products: Since inception in 2001, we received one, a government grant; two, seed money.

Upsize: From friends and family?

Brown: From a friend's friends and family. Three, a bridge loan for \$1 million. Then \$750,000 in Series A; another million-dollar bridge loan. And then Series B. Our financing is a combination of all those pieces.

Upsize: Where did Series B come from?

Brown: That was Aethlon.

Mike Smiggen, Tonka Bay: Where did the bridge loan come from?

Brown: The later one, from an institution in San Francisco.

Griffith: Aethlon came in in July 2006 with \$1.6 million.

Upsize: Laurie, you've tapped many different financing sources. What have you learned about each different source?

Brown: Be prepared in the way you pitch your business. You're selling your company now, not your product. Speak to the listening of the investor. For example, for the high net worth individuals, they care about the environment. When it's a financial investor they want to know about valuation, and so on.

Upsize: So you need to tailor your pitch to the specific audience.

Brown: I must have 200 PowerPoints over the years on our computer. Now we're also targeting strategic partners. Aethlon is helping us with this.

Griffith: I'm a big proponent of bringing in value-added investors. Someone who knows consumer products in this case, or companies in the organic space.

Brown: Back to the bridge loan, the banker who made that told me he looks at one thing and he goes by his gut: Will the entrepreneur have integrity and do everything it takes to pay him back?

Upsize: Jeff Roos, tell about your financing arrangement.

Jeff Roos, MFRA: As a professional services firm we were internally owned. We had grown, and had a strategic plan, with aggressive strategies. We wanted to grow geographically and add specialties.

I was one of two senior partners, and we owned 75 percent of the firm. One wanted an exit strategy. We hired an adviser, and we looked at, what can they do besides just provide financing.

We received \$12 million in capital. That allowed the one senior partner to leave, and with Tonka Bay as a financial partner, that gave us expanded options. We've put on hold adding a division; now we'll do an acquisition or more than one.

Upsize: How does it feel to have these new owners?

Roos: We had a line of credit before, with lots of personal guarantees by the majority owners. In that situation, it lessens how much you can do personally, because everything you have is tied up in the company.

Upsize: What kind of an adviser did you hire?

Roos: We hired an investment banker that was part of an accounting firm. It's given excitement to the younger partners now. Before they could see, how are we ever going to buy out those senior partners? That's taken care of now.

Upsize: What percentage do you own now?

Roos: 10 percent. I feel more comfortable with it because I'm more diversified in my investments.

Upsize: Are you close to making an acquisition?

Roos: We're in conversations with two potential companies.

Mike Smiggen: It's too early to say what will happen, but we'll pursue these opportunities in 2007.

Upsize: Darren, what financing options have you pursued at GovDelivery?

Darren Gerke, GovDelivery: We started about a year ago with Venture Bank. We had an SBA loan, Small Business Administration; it was a safety net. We had it but we didn't use it. We looked around at Venture and other banks. Venture took the time to understand what we do. Some of the others couldn't fit a square peg in a round hole.

We took out a line of credit, \$500,000, to get flexibility. It's worked out great; we had a great year.

Upsize: Was that an SBA line as well?

Dion Muchow, Venture Bank: These guys were qualified conventionally. They're well capitalized. They raised equity before.

Gerke: We went out to individual investors, four rounds of financing from angels, that we found through networking.

Upsize: Why was GovDelivery able to qualify for a conventional loan, rather than SBA?

Muchow: Maybe someone who's not quite profitable, we'd look at an SBA loan. With SBA you can spread out the amortization for 7 or even 10 years.

Sima Griffith, Aethlon Capital: I always counsel entrepreneurs to get bank debt if you can. It's the cheapest money, and you don't have to give up ownership.

Is it a match?

Upsize: People have said it's smart to match up the type of company with the right type of financing. What does that mean from each of your vantage points?

Mike Smiggen, Tonka Bay Equity: Each financier has a niche they're looking for. It can be industry focused, but here we're talking about the stage of business, where they're comfortable with the risk.

In the very early stages it's friends and family. For one reason because you're not looking for enough capital to interest the venture capitalists.

As the company matures and becomes more profitable, it moves up the food chain.

Dion Muchow, Venture Bank: Banks look at deals that are cash-flow positive, well-capitalized. We're financing an asset that will help the company grow.

Griffith: The type of capital you raise depends on the stage. First, friends and family. Two, venture firms, and if you're growing really fast, an IPO or PE, private placement. It depends on what industry you're in. If you have a revolutionary medical product, you're going to consume a lot of capital.

Laurie Brown, Restore Products: We're looking at who can benefit from our technology. That's why we are looking at key strategic partners now. We're working with Aethlon. Sima's team has many, many contacts in the consumer products industry.

Upsize: And how is that new effort going?

Griffith: Part of the frustration when you're dealing with billion-dollar companies, they take a very long time to decide. When you go to a business owner/investor, he can write a check that day. A corporation may take 12 to 18 months.

Jeff Roos, MFRA: The need for capital dictates where you go. If we had just wanted to grow, for example, we would have gone to the bank.

Upsize: But you had a partner who wanted to exit.

Roos: Our initial discussion was, everyone said let's just look at a business partner. We were surprised when we talked to our adviser, that there were 15 groups interested.

Upsize: You didn't think you'd be so popular!

Roos: It was a pleasant surprise. We did some good groundwork, went to seminars on professional services firm valuations. We could choose the direction we wanted to go.

Upsize: Darren, you also said you had your choice of offers from banks. What did you think about when selecting?

Darren Gerke: It goes back to the understanding of what we do, and why we needed the money. It was to smooth our cash. This was to help us through the peaks and valleys. Especially with the government, they pay once a year, they want to pay in September or October. In April or May it gets difficult.

Upsize: I'm sure May is much more stressful than you're saying now. You seem so calm when you describe it. Were the several offers you received markedly different from each other, in terms of amount or type?

Gerke: We were clear cut with what we wanted. We weren't on a fishing expedition. And then we went out and told our story and we told the same story. That made the process more streamlined, absolutely.

Upsize: How big is your company now?

Gerke: Our annual revenue is \$3.8 million to \$4 million.

Upsize: Dion, is that where a company needs to be to attract conventional bank financing?

Dion Muchow, Venture Bank: It's not the revenue side, it's the cash flow.

Gerke: One important reason for getting our loan, we invest a lot back into the business, so we said, here's where we can cut if we need to, so they can be assured they'll get paid back.

Muchow: Having the plan B is important.

Mistakes to avoid

Upsize: Are there any common mistakes that you see people seeking financing make?

Mike Smiggen, Tonka Bay Equity Partners: When a couple of owners are ready to retire, we often see they haven't taken the time to develop the management team. There's no one to run it when they're gone. The alternative we're left with is, I'll buy a part of the company, but you as the owners will have to stay and do that final piece, training the new team.

Sima Griffith, Aethlon Capital: A lot of the entrepreneurs are overly optimistic. They don't anticipate how long things may take.

Dion Muchow, Venture Bank: Be realistic with your numbers.

Griffith: Have a Plan B.

Upsize: How about you business owners? Any common mistakes you've seen or maybe made?

Laurie Brown, Restore Products: I've been a Springboard finalist twice, that group that coaches women-owned businesses on how to gain venture funding. We go through this boot camp. Entrepreneurs have started their business because they have expertise in something, that may not be pitching to a group of investors. They have a hard time getting out of their business jargon and getting to their value proposition.

Jeff Roos, MFRA: Especially in the professions, lawyers, doctors, engineers, they tend to think they know everything. They're hard to give advice to. That was our eye-opener when we did this. Wow, there was a lot out there we did not know.

Our first step was to go to our bank, M&I, and get advice. They pointed out a lot of things to us, and contacts.

Darren Gerke, GovDelivery: One thing I see, not with our company but with others, friends who had an idea. They got shut down once or twice, and they give up. I say, take the advice, use it, and improve your idea. You need the guidance.

Upsize: Mike, your partner wrote an article for Upsize about red flags when your firm is considering an investment: when one of the companies you are potentially going to invest in goes out and buys an airplane.

Mike Smiggen, Tonka Bay Equity Partners: They had just bought themselves an airplane for the company. It's not to say an airplane is always a bad idea, but we look at this as a sign that you may not be ready for private equity.

Sima Griffith, Aethlon Capital: Add to that list lavish office space.

Smiggen: One time we got shown around someone's offices, and there was one large empty office. We asked what that was for. And they said, oh this is for my 12-year-old son when he comes down. We said OK, goodbye, have to go now.

Upsize: Wasn't this type of thing typical in the late 1990s? Perks and toys?

Griffith: Investors are a lot more discerning now.

Smiggen: There are plenty of investors that saw the dark side. They're going to look a little more closely at things like airplanes.

Dion Muchow, Venture Bank: I think the management teams are wiser too.

Jeff Roos, MFRA: When you have a professional firm with multiple owners, it's Pandora's box. The CEO doesn't do it because then everyone would do it. You can't buy one fancy car for the CEO, because then you'll have a whole fleet.

Griffith: You evaluate how judicious the CEO and CFO are with spending their money. Have they plowed through \$50 million and have nothing to show for it?

Best practices

Upsize: Darren, what's a best practice in your mind, for raising money?

Darren Gerke, GovDelivery: Put together a well-thought-out plan. You have to be realistic. That's the place where we're the strongest. All our investors and lenders, they never come to us and say, you didn't do what you said. It makes life a lot easier because you stick to the plan.

Laurie Brown, Restore Products: At a start-up stage your best practice is to watch the cash. Not only will investors look at you dimly if you don't, but you're going to go out of business.

Raising equity is time-consuming. Bridge loans are very expensive. You have to learn how to make something from nothing.

I recommend using vendors as partners, including as shareholders. Some vendors I have been very late on their invoices, but I've always come through. Being honest. Being your word. Integrity is key.

I brought in a vice president who had been with Toro and Caterpillar, and he'd say, 'I can't stand being in the back seat with my vendors. I'm used to being in the driver's seat.' Creating vendors as partners helps. When you start out you are not that attractive to vendors.

Sima Griffith, Aethlon Capital: A vendor who's a shareholder has a vested interest in your success.

Upsize: Dion, what's a best practice in your view?

Dion Muchow, Venture Bank: Projections.

Griffith: Especially the monthly cash flow projections.

Mike Smiggen, Tonka Bay Equity: Understanding that the income statements isn't what you should focus on, it's the cash flow statement. You can generate the revenue, but you might not be paid for that until months later. A lot of companies don't put the focus on cash flow, but that's where it needs to be.

Griffith: You need to build in a cushion.

Smiggen: The last place we want to be is to wake up one day and say, we're out of our line of credit. Try to make sure you project some of the downside scenarios. You need to have a back-up plan and structure financing accordingly.

Jeff Roos, MFRA: The monitoring capabilities we have are so great now. Put together as accurate a plan as you can, then monitor it so close. We do it monthly. We have a metric system in place.

In the good old days, when we were a partnership, we'd get together about now every year, and say, how much money did we make this year?

Mike Smiggen, Tonka Bay Equity: We say, have a strong financial person. That's one area often overlooked, but it can be invaluable for the management team to say, here's what happened, here's why, here's how to fix it or here's how we do it again.

Dion Muchow, Venture Bank: One of our frustrations is business owners who don't have any financial statements.

Upsize: How often does that happen?

Muchow: You see that all the time. They manage by the checkbook. If there's still money in it, they think they're fine. I look at our balance sheet each day. That might be too much, but every business owner needs to know where the business is, and adjust. Are receivables extending out? Do I need to make some more calls to get paid?

Debt is your friend?

Sima Griffith, Aethlon Capital: Surround yourself with value-added investors, and a strong board can help you make the right decisions. And spend your cash wisely. Make each dollar go a long way.

Laurie Brown, Restore Products: Financing your business is a marathon, not a sprint, and eventually it becomes a relay. It's not going to go until the time is right. We were 15 years ahead of our time. Now we're at the nexus of all the trends.

Be able to slug along during the marathon. Take care of yourself. Support yourself. Be frugal.

The relay part comes in when eventually you have to get to transitioning the business. You have to start to emotionally prepare to hand it off.

Upsize: Darren, what's one thing you've learned about finance, that you could share with others?

Darren Gerke, GovDelivery: Be flexible. Be open to the ideas out there that people might have. Rely on the experts out there. Be willing to have an open mind.

Upsize: Jeff, how about you?

Jeff Roos, MFRA: Properly structured debt is just fine.

Upsize: You never had debt before?

Roos: We stayed in the black. Culturally it was a big change for us. At first we were so focused on, how fast can we pay

this off, like it was a car loan.

Upsize: And now you believe that debt is your friend?

Roos: Properly structured debt is just fine.

Mike Smiggen, Tonka Bay Equity: Done properly, it can be your friend!