MidMarketCapital,Inc.

An Alternative to Venture Capital for the Technology Entrepreneur

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If you are an entrepreneur with a small technology based company looking to take it to the next level, this article should be of particular interest to you. Your natural inclination may be to seek venture capital or private equity to fund your growth. According to Jim Casparie, founder and CEO of the Venture Alliance, the odds of getting Venture funding remain below 3%. Given those odds, the six to nine month process, the heavy, often punishing valuations, the expense of the process, this might not be the best path for you to take. We have created a hybrid M&A model designed to bring the appropriate capital resources to you entrepreneurs. It allows the entrepreneur to bring in smart money and to maintain control. We have taken the experiences of several technology entrepreneurs and combined that with our traditional investment banker Merger and Acquisition approach and crafted a model that both large industry players and the high tech business owners are embracing.

Our experiences in the technology space led us to the conclusion that new product introductions were most efficiently and cost effectively the purview of the smaller, nimble, low overhead companies and not the technology giants. Most of the recent blockbuster products have been the result of an entrepreneurial effort from an early stage company bootstrapping its growth in a very cost conscious lean environment. The big companies, with all their seeming advantages experienced a high failure rate in new product introductions and the losses resulting from this art of capturing the next hot technology were substantial. Don't get us wrong. There were hundreds of failures from the start-ups as well. However, the failure for the edgy little start-up resulted in losses in the $1 - $5 million range. The same result from an industry giant was often in the $100 million to $250 million range.

For every Google, Ebay, or Salesforce.com, there are literally hundreds of companies that either flame out or never reach a critical mass beyond a loyal early adapter market. It seems like the mentality of these smaller business owners is, using the example of the popular TV show, Deal or No Deal, to hold out for the $1 million briefcase. What about that logical contestant that objectively weighs the facts and the odds and cashes out for $280,000?

As we discussed the dynamics of this market, we were drawn to a merger and acquisition model commonly used by technology bell weather, Cisco Systems, that we felt could also be applied to a broad cross section of companies in the high tech niche. Cisco Systems is a serial acquirer of companies. They do a tremendous amount of R&D and organic product development. They recognize, however, that they cannot possibly capture all the new developments in this rapidly changing field through internal development alone.

Cisco seeks out investments in promising, small, technology companies and this approach has been a key element in their market dominance. They bring what we refer to as smart money to the high tech entrepreneur. They purchase a minority stake in the early stage company with a call option on acquiring the remainder at a later date with an agreed-upon valuation multiple. This structure is a brilliantly elegant method to dramatically enhance the risk reward profile of new product introduction. Here is why:

For the Entrepreneur: (Just substitute in your technology industry giant's name that is in your category for Cisco below)

1. The involvement of Cisco – resources, market presence, brand, distribution capability is a self fulfilling prophecy to your product's success.
2. For the same level of dilution that an entrepreneur would get from a VC, angel investor or private equity group, the entrepreneur gets the performance leverage of "smart money." See #1.
3. The entrepreneur gets to grow his business with Cisco's support at a far more rapid pace than he could alone. He is more likely to establish the critical mass needed for market leadership within his industry's brief window of opportunity.
4. He gets an exit strategy with an established valuation metric while the buyer helps him make his exit much more lucrative.
5. As an old Wharton professor used to ask, "What would you rather have, all of a grape or part of a watermelon?" That sums it up pretty well. The involvement of Cisco gives the product a much better probability of growing significantly. The entrepreneur will own a meaningful portion of a far bigger asset.

For the Large Company Investor:

1. Create access to a large funnel of developing technology and products.
2. Creates a very nimble, market sensitive, product development or R&D arm.
3. Minor resource allocation to the autonomous operator during his "skunk works" market proving development stage.
4. Diversify their product development portfolio – because this approach provides for a relatively small investment in a greater number of opportunities fueled by the entrepreneurial spirit, they greatly improve the probability of creating a winner.
5. By investing early and getting an equity position in a small company and favorable valuation metrics on the call option, they pay a fraction of the market price to what they would have to pay if they acquired the company once the product had proven successful.

Let's use two hypothetical companies to demonstrate this model, Big Green Technologies, and Mobile CRM Systems. Big Green Technologies utilized this model successfully with their investment in Mobile CRM Systems. Big Green Technologies acquired a 25% equity stake in Mobile CRM Systems in 1999 for $4 million. While allowing this entrepreneurial firm to operate autonomously, they backed them with leverage and a modest level of capital resources. Sales exploded and Big Green Technologies exercised their call option on the remaining 75% equity in Mobile CRM Systems in 2004 for $224 million. Sales for Mobile CRM Systems were projected to hit $420 million in 2005.

Given today's valuation metrics for a company with Mobile CRM Systems' growth rate and profitability, their market cap is about $1.26 Billion, or 3 times trailing 12 months revenue. Big Green Technologies invested $5 million initially, gave them access to their leverage, and exercised their call option for $224 million. Their effective acquisition price totaling $229 million represents an 82% discount to Mobile CRM Systems' 2005 market cap.

Big Green Technologies is reaping additional benefits. This acquisition was the catalyst for several additional investments in the mobile computing and content end of the tech industry. These acquisitions have transformed Big Green Technologies from a low growth legacy provider into a Wall Street standout with a growing stable of high margin, high growth brands.

Big Green Technologies' profits have tripled in four years and the stock price has doubled since 2000, far outpacing the tech industry average. This success has triggered the aggressive introduction of new products and new markets. Not bad for a $5 million bet on a new product in 1999. Wait, let's not forget about our entrepreneur. His total proceeds of $229 million are a fantastic 5- year result for a little company with 1999 sales of under $20 million.

MidMarket Capital has borrowed this model combining the Cisco hybrid acquisition experience with our investment banking experience to offer this unique Investment Banking service. MMC can either represent the small entrepreneurial firm looking for the "smart money" investment with the appropriate growth partner or the large industry player looking to enhance their new product strategy with this creative approach. This model has successfully served the technology industry through periods of outstanding growth and market value creation. Many of the same dynamics are present today in the high tech industry and these same transaction structures can be similarly employed to create value.

MidMarket Capital, Inc., MMC is an M&A Advisory firm specializing in providing corporate finance and investment banking services to entrepreneurs and middle market corporate clients in the high tech, and select niche markets. The firm counsels clients in the areas of mergers, acquisitions and divestitures, private placements of debt and equity, valuations, corporate growth and turnarounds. Dave began Mergers and Acquisitions practice after a twenty-year career within the financial and information technology industries. Contact Dave Kauppi (630) 325-0123
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