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## Should You Buy Into An Investment Firm?

By SUZANNE MCGEE

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Like tens of thousands of other business owners looking to raise money every year, Brooke Savage and his wife, Melissa Mabon, recently had a choice: Should they try to raise a new round of expansion capital themselves, or should they hire an outside adviser, such as a boutique investment bank, to help them out? The question is especially germane today: Literally thousands of new boutique investment banks have set up shop in the last couple of years (there are now as many as 10,000 investment banks in the nation, industry insiders estimate), and they are marketing their service to business owners looking to raise anywhere from a million bucks on up. There are, in fact, so many investment bankers now in the business of arranging private financings that growing companies who do decide to use an investment banker are in a buyer's market for such services.

No longer are investment banks just for IPOs and raising large amounts of money in the public markets. With the stock exchanges still in the dumps, investment banks in need of work have aggressively been courting profitable companies seeking private, rather than public, financing. Their big selling point: Money is still out there, but you need us to tell you how to get it.

Boutique investment bankers often have extensive contacts in the tightly knit world of VCs and private-equity investors, as well as with wealthy individuals and potential strategic-partner investors. Plus they're able to understand and negotiate away the complex and draconian conditions that some investors now demand. The complexity of the terms being sought, and the effect on the valuation of a company, are such that the up-to-the-minute understanding a banker can provide may very well determine who ultimately controls a company.

But are boutique investment bankers worth the fees they charge? Like anyone who brokers deals, investment bankers can have a self-interest in completing transactions and collecting a fee rather than walking away from bad terms. Not all are experienced. Neophytes to small private financings (even if they previously did multi-hundred-million-dollar deals on Wall Street) can tie up a company for months in a fruitless search for capital.

Many of the new boutique investment bankers are Wall Street veterans laid off in the last three years by big firms such as Goldman Sachs. The new boutiques sell themselves to the so-called middle market: privately held companies that are at least two years old; have a real product or service, and customers and revenue.

How much a business owner ends up paying a boutique investment banker can vary wildly. The typical company can expect to shell out an up-front retainer ranging from \$25,000 to \$125,000 and then fork over from 3% to 7% of the proceeds of a financing round. In general, the larger and more established the investment bank, or the more complicated the financing, the higher the fee. A company can negotiate for lower fees or demand that no up-front retainer be charged at all, especially if more than one investment bank wants its business.

An investment banker also may demand a piece of the company in return for securing financing. Lloyd Greif, who founded Greif & Co. in Los Angeles a decade ago, typically takes a warrant allowing him to acquire up to 10% of the stock issued in a transaction, or 5% of the overall company, as part of his fee. Other firms, like Headwaters MB, a merchant bank in Denver, co-invest with the fund that they bring to the party. (A merchant bank typically uses much more of its own capital in a deal than would an investment bank.) "We don't take on a fund-raising assignment unless it's of a quality where we're willing to invest ourselves," says Dave Maney, managing partner of Headwaters. "That's part of the upside for us over the long haul."

For Savage and Mabon, the answer to the question as to whether they needed an investment banker turned out to be yes, despite the many years they had spent learning to be successful business owners. In 1995, Savage and Mabon sold their first piece of software, which enables salespeople to prepare everything from proposals to follow-up letters, for \$199 at a Boston trade fair. Six months later, when they landed a \$20,000 order from a Midwestern bank, Savage knew the company would survive.

After that, sales -- to companies like Motorola, JPMorgan Chase and Hewlett-Packard -- grew steadily. Pragmatech has now become a bona fide success story: It has 71 employees, \$10 million in revenue, and a 10% margin. To maintain that rate of growth, Savage and Mabon estimate they'll need to raise \$12 million. The funds would allow them to expand the company's product range to include software for manufacturers and for companies trying to win government contracts. If successful, they hope to have annual revenue of \$50 million within five years.

The financing landscape, however, has become more complex and perilous than ever before. Ferreting out private capital and negotiating fair terms require technical expertise that Savage and Mabon don't have. Today, even company owners who are sophisticated about raising capital are leaning heavily on investment bankers to help them navigate the latest deal terms, such as milestone financing and liquidation preferences, which have sprung up as investors try to shield themselves in response to the disastrous meltdown of the boom years.

Every term in a financing round is negotiated, and negotiated down to the tiniest detail, says Brooks Dexter, senior managing director of USBX Advisory Services, a boutique investment bank in Los Angeles. "There are some terms and conditions that even the best company is going to find in a term sheet that they aren't going to like, but that they'll

probably end up having to accept in some form, because otherwise the capital will just disappear," he says. The trick is knowing where that threshold lies and how to haggle over the fine print.

Often a company will undertake a search for financing on its own before concluding that it needs an investment bank. Savage and Mabon, while in the enviable position of having profits and blue-chip clients, couldn't get in to see all the private investors they wanted to meet. So rather than continuing to pursue funding on his own, Savage decided to hire a boutique investment banker. "I knew we couldn't afford a misstep," he says. After checking out three boutique investment bankers, Savage opted to hire Charlie Manuel. Manuel worked for Dillon Read and NatWest Securities, among other banks, before hanging out his own shingle in November 2001 as Black Point Partners. Manuel's firm came highly recommended by a VC Savage knew.

"I liked his background and the fact he was running a boutique firm," Savage says. "I knew I wasn't going to end up in a mass-production line, and I'd get good advice from someone who had specialized in technology companies."

Manuel charged Pragmatech a \$25,000 retainer and will take at least 3% of the proceeds eventually raised. In return, Manuel has helped Savage and Mabon sort through the vast number of possible sources of institutional capital. Manuel had no difficulty arranging meetings between Pragmatech's management team and top-tier venture firms in the Boston region such as Charles River Ventures.

Ronald Darata, founder of Concepts in Optics, an eyewear company in Florida, attributes the very survival of his business to his decision to turn to an investment bank. Darata started his business in 1998 with an ill-fated acquisition of a business whose assets proved to be of poor quality. He had financed the deal with debt, and by 2000 he knew he had to refinance if he was to stand a chance of expanding his business. After his banks turned him down, he begged his lawyers for help. They referred him to John Gullman of the investment bank USBX Advisory Services. "He was a miracle worker," Darata says. Financial companies that Darata hadn't been aware of -- or previously would not take his calls -- suddenly were available. USBX had become Concepts in Optics' "Good Housekeeping Seal of Approval."

Three months later, Gullman had presented Concepts in Optics to 15 possible investors and had 3 of them eagerly bidding for the business, which took the shape of a hybrid debt financing. A year later, Gullman helped Concepts in Optics restructure that financing again. Now the entrepreneur says he's ready to turn to the banker for help with the next step: turning Concepts in Optics from a company with about \$7 million in revenue to one with \$30 million within five years. "You find the right professional counsel, you put yourself in his hands, then you can come through this process a lot more smoothly than would otherwise be the case," says Darata.

In exchange for USBX's help in landing financing, Darata paid a percentage of the amount raised, a figure he says is closer to the low end of the typical 3% to 7% range. The fee agreement also included a provision under which Darata would pay a modest fee of less than \$10,000 if USBX's efforts to find financing failed -- a sum that would cover the bank's time and expenses.

Of course, not all business owners feel comfortable shelling out even that much money.

Others resist relying on an outsider to take such an active role in charting the future of their companies. "It's easy for an entrepreneur to say, 'Well, I've got a great company, and I should be able to raise money,'" says Dan Gardenswartz, of the Sage Group, a Los Angeles investment bank. "But you have to know how to present your company properly, so it doesn't get dismissed out of hand in the crowd. And you have to persuade potential investors that you're a credible company. The bottom line is, no matter how well people know their business, they're not going to be experts on all the options that are available to them. Without the right adviser, they run the risk of spinning their wheels and wasting time."

There are certainly cases, however, in which a company seeking midlevel financing can afford to go it alone. If the businessperson knows that a particular individual or fund is the only investor that he or she will be happy striking a deal with, there's obviously little point in paying a banker. Still, an experienced securities lawyer should be retained to advise on deal terms. There are also many cases in which a lawyer, accountant, or industry consultant -- instead of a banker -- can provide introductions to sources of private capital. While lawyers can also negotiate specific deal terms, other noninvestment bank consultants may be barred by securities law from participating in structuring a deal. Instead, they provide introductions, then often must sit out the negotiations.

These days, some skittish VCs rely on trusted investment bankers to thoroughly prescreen deals, often refusing to even consider a company that hasn't already been vetted. This is in stark contrast to VCs' traditional hesitation to enlist expensive investment bankers for early and mid-tier private financing rounds. "All they do is put together really pretty pitch books that no one reads and collect a fee," says Lawrence Goldfarb, reflecting the conventional attitude of VCs toward bankers. Goldfarb is a managing partner at BayStar Capital, a San Francisco based hedge fund and private-equity investment firm.

But offsetting the traditional reluctance of many VCs is the eagerness of investors to see the best deals available. "They view us as a necessary evil, since they're not going to find every viable company out there," says Kevin Jolley, of Boston-based Adams, Harkness & Hill, a bank specializing in emerging companies.

There is a growing recognition that more promising deals are likely to come via banks as entrepreneurs turn to investment bankers for help in leveling the playing field, especially given the new array of harsh terms that investors are demanding. Even in tough times, a well-connected investment banker can drum up enough interest from different investors to help chip away at some of the more onerous terms and conditions. "If you've only got one term sheet on offer, you're at their mercy," says Jolley.

Business owners looking for a banker can turn to anything from very small shops, like Manuel's Black Point Partners, to Wall Street behemoths, such as Citigroup's Salomon Smith Barney, to help them find their way through the financing minefield. Bankers help position the company, doing everything from refining the business plan to drawing up a PowerPoint presentation. They'll assist a company in setting the right valuation for the business, taking into account myriad internal and external variables.

Matching a company to the right fund is perhaps the most important task an investment banker performs. "It's amazing to me how bad the information flow really is in this world, where everyone is supposed to know each other," says Monish Kundra, a Headwaters

director. Headwaters recently introduced a food manufacturing company outside Chicago to a Chicago-based VC that invests in food products companies. "They were in the same business, established, and less than 10 miles apart, but they had never heard of each other," says Dave Maney, Headwaters managing partner.

So how, exactly, can a company find the right investment bank? With so much at stake, entrepreneurs need to do the same level of due diligence that their prospective investment bankers and investors will undertake regarding them. The National Association of Securities Dealers will provide companies with lists of registered investment bankers -- and it will also run background checks. One smart tactic is to ask for the names of an investment banker's last 10 clients -- that way the banker won't be able to cherry-pick the best deals. A company should also call private-equity investors with whom the investment bankers say they have relationships.

In the end, a company that chooses well is likely to end up with more financing choices than it would have had out on its own. "Our job is to generate options for the business owner, ranging from a small financing to a sale of 100% of the company, to everything in between," says Gardenswartz, of the Sage Group. "Ultimately, it's the owners' decision which of those options is the right one for them, but we put the picture together for them in an honest, straightforward way."

-- Ms. McGee is a former reporter for *The Wall Street Journal*, most recently covering corporate finance out of New York City.

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