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INSIGHTS

IS YOUR COMPANY READY BEYOND THE IPO?

By Bennett E. McClellan with Henry DeNero and Kevin Ventrudo of HighPoint Associates

OVERVIEW

While the IPO market has not recovered to pre-recession levels, the number of IPO filings over the past 24 months is more than double that of the previous 24, and the trend may continue. This looks to be good news for investment firms with stakes in recovering or growing enterprises. Or is it?

In this article, HighPoint Associates' Senior Advisors Henry DeNero and Kevin Ventrudo talk with Bennett McClellan regarding tips and lookouts for executives and investors considering taking their companies public. Our experts caution that a company planning to go public needs to be ready on all fronts. The assessment of readiness begins with asking whether the company is organically ready and whether the management team is up to the task of running a public company. If yes, potential IPO candidates must then consider whether the appropriate governance structure is in place to keep the company on course for the decade ahead.

THE CASE

The directors of a Private Equity (PE) firm recently approached us for advice. The PE firm was contemplating taking one of their investments public. The firm had acquired a controlling stake in a specialty retailer six years earlier. Following the investment, the retailer expanded from a few to dozens of outlets across North America. Sales per square foot exceeded the industry average several times over. The retailer's management believed the company was poised for a major expansion and wanted to access the public markets to fund their efforts. Not surprisingly, the PE firm's bankers, accountants and other transaction-based advisors were 'on board' with the idea.

Before launching into that whirlwind, the directors wanted to understand, "Are we really ready to go public?" That encounter started us thinking about the kinds of questions investors need to ask prior to initiating an IPO. This article highlights the factors we believe merit careful consideration before launching a public company.

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HOW CAN YOU TELL IF YOUR COMPANY IS IPO READY?

One in two companies that goes public is ill-prepared to meet the demands of operating as a public company. Research has shown that only about half of all IPOs succeed on their own five years after their IPOs. A little over a quarter of IPO companies end up being acquired by other companies, often at a steep discount from their initial share price. The remaining IPO companies either cease operations or are delisted for other reasons.

Too often the scramble to fully prepare a company for its IPO occurs after the stock has floated. Profitability typically tumbles as these companies spend literally millions of dollars on high-priced legal, financial, and management support to accomplish tasks that should have been completed prior to the IPO. The resulting missed forecasts or mistakes in executing strategy may set the company back years. Such setbacks decrease the company's value and damage its reputation with investors. In some cases, such mistakes prove fatal.

The takeaway here is that preparing for an IPO, and being rigorous in assessing whether the company is ready for public ownership, translates into time and money well spent.

What are the criteria that investors and CEOs should use in assessing their company's readiness to succeed beyond their IPOs? We typically look at the following three categories of questions to gauge IPO readiness.

1. Is the business ready?
2. Is the management ready?
3. Is the governance ready?

According to Henry DeNero, "If the business isn't ready and you don't have a management team that can run it as a public company, then it's a complete non-starter." If both the business and the management team are ready to make the transition to operating as a public company, then the focus of the evaluation changes to issues of governance. Questions of governance – both immediately after the IPO and longer term – are easily overlooked, but constitute one of the three pillars of IPO readiness.

BUSINESS READY?

When a company is headed toward an IPO, DeNero suggests that managers ask, "Is it big enough? Is it developed enough? Is it successful enough in terms of the consistency of revenues and profits?" Henry asserts that there are a lot of factors that go into the consideration of company readiness, but certain big tests must be met for the others to matter. The following considerations emerge from experience and research as significant factors that correlate with IPO success:

- Is there a clear, differentiating business strategy in place to serve customers?
- Do products and services provide demonstrable value to customers?
- Is there strong evidence of a growing market so that the business can continue to scale up to support growth requirements?
- Has the company operated long enough to establish its competitive viability?
- Does the strategy in place make the company money, as evidenced by continuing quarter-to-quarter profitability improvements from operations?
- Does the company have the capacity for expanding its offerings rapidly or will more capital investment be required?
- Is there significant under-utilization of financial systems and are they robust enough and in full compliance with regulatory requirements?
- Is the company successful enough so that management consistently meets their financial forecasts?

MANAGEMENT READY?

Ventrudo opens the discussion of management readiness by asserting that there needs to be agreement between management of the company and the equity investors about becoming a public company. Kevin asserts, "The worst possible situation for management is to be stuck running a company they did not want to take public in the first place."

The assessment of management readiness involves more than an assessment of skills. Of course, one must determine whether the team that brought the company to the IPO has the right skills to move the company forward. But one also needs to understand if management is going to be comfortable meeting the demands of a public company. Capability and inclination do not necessarily run together.

Here are some critical factors to gauge whether management is ready:

- Are all key players aligned around the purpose of the IPO (including how to spend the IPO money)?
- Have all concerned agreed on the criteria used to gauge success post-IPO?
- Is the organization structure consistent with the strategy of the business?
- Is the CEO committed to continuing operations, and does s/he have a clearly defined post-IPO role?
- Is capable second-tier management in place, including depth of talent on the management bench, or is this a "one pony show"?
- Has management shown an ability to assess risk and respond to changes?
- Does management have the requisite experience and skill set to run a public company?
- Do the people down the line reflect confidence in their leadership?
- Is management compensation sufficient, but not excessive?

GOVERNANCE READY?

DeNero observes that "Board members are often major shareholders and may be seen as being in the business of 'getting rich and getting out.' As such, their horizon is often far shorter than that needed to ensure the creation and protection of shareholder value over time." The short-term approach may work a few times, but in the long-term it's a self-limiting formula.

Ventrudo emphasizes that private equity companies have a responsibility toward the shareholders they ultimately attract through public offerings. Specifically, Kevin notes that, "It's about maximizing the investment for management and shareholders over the long term." Those firms that are good at it reap rewards in the form of premium pricing for their offerings as investors see such offerings as less risky.

Here are some tips for assessing the readiness of your governance structure:

- Verify that there is agreement between the equity holders and management about the goals for taking the company public.
- Identify functional skills, industry skills, and unique skills the company will need to keep growing by creating a skills matrix to assess the skills of those expected to remain on the board against the company's need for expertise.
- Work toward creating a vision of what the fully developed board should look like post- IPO, including a fully independent board membership.
- Make sure the SEC-required 3 independent directors are truly independent (and not just the friends of the PE or VC investors) and that they bring complementary skills to the board.
- Establish a transition plan for the remaining equity board members to turn over their seats to independent board members within a reasonable time.

Bottom Line: Meet all readiness tests to reduce the risk of post- IPO flameout.

Equity investors and management teams often do not give enough thought to how a company is going to run after the IPO. Those involved understandably focus on the financial aspects of the deal. But ignoring the other essential facets of preparing a company for life beyond the IPO greatly reduces the company's probability for long-term success.

The message is clear. Spend the time and money needed to fully assess readiness. Look beyond the planned IPO to determine whether the company has the strategic vision, infrastructure, human capital, and governance structures needed to survive as a public company. If not, then take the time and make the investments to get ready to succeed before proceeding with an IPO.

Q&A WITH HPA ADVISORS DENERO AND VENTRUDO ON CONDUCTING AN IPO READINESS ASSESSMENT

By Bennett E. McClellan with Henry DeNero and Kevin Ventrudo

BEM: We're discussing the question of how a Private Equity firm or Venture Capitalist can tell whether an investment company is ready to be taken public. You have framed the question in terms of "It's not whether a company can achieve an initial public offering, but whether it should present itself for sale to the public." What's behind that perspective?

HD: It is our belief that a significant percentage of companies that go public are ill prepared for the IPO process and for the realities of operating as public companies in their early years. As a result, management and the board of directors are forced to scramble in preparing for an IPO and for years afterwards in a continuing effort to catch up with the demands placed on the company as a public entity.

BEM: What do these "catch up" activities typically involve?

HD: They could include a whole raft of things, including upgrading management, building organizational skills, refining strategy, upgrading systems and procedures, adding required board members, meeting numerous legal and regulatory requirements, and carrying out "first time" public company tasks such the Sarbanes-Oxley Act Financial Controls Review. Most unnervingly, this scramble typically occurs at the very time that the company is often most vulnerable – in terms of the clarity of its strategy, the strength of its competitive position, its management skills, its underlying systems and procedures, and its ability to deliver strong financial results as a newly public company.

BEM: What factors should a PE firm or VC consider before taking a company public?

KV: There are basically three categories of questions. First, is the business ready to go public? Second, is the management ready to go public? And third, is the governance system ready to go public?

BEM: Is one of those more important than the other?

HD: If the business isn't ready and you don't have a management team, then it's a complete non-starter. Those are the two most important questions. The variables to watch for are predictability, critical mass and the risk of flaming out. Most savvy investors focus on these factors, of course. But then there is the third question of whether the company's governance system is set up to keep its growth going after the IPO. Investors should be thinking about making sure the firm is thriving ten years after the IPO. This is as opposed to "what's the price?" and "how much money are we going to make?"

BEM: Some people think of PE firms and VCs "get in, get out, get rich" kind of thinkers. Why would private equity holders take a different view?

KV: There are all kinds of reasons for PE firms to consider the long-term success of the company as a public entity. The first point is that they typically remain stakeholders. They don't get all their money with the IPO, and may in some cases get none. The second point is they are building track records over time. If you take out 3 or 4 clunkers, when you take the 5th one out you are going to get a discount. The third point is the counter argument. If you have a record of taking out winners, the market will pay a premium. For PE firms with successful post-IPO records, the price goes up because the risk goes down.

BEM: Let's discuss your three questions. Is the business ready to go public? Is the management ready to go public? And is the governance system ready to go public? How can you tell if the business is ready to go public?

HD: When a company is headed toward an IPO, you need to ask is it big enough? Is it developed enough? Is it successful enough in terms of the consistency of revenues and profitability? Is it robust enough or will it need a lot more investment in infrastructure to keep growing? There are a lot of factors that go into answering these questions. But the big question you are trying to answer is "Can this company perform well as a public company?"

KV: Realistically, when you're thinking about going public the question of business readiness is something any decent investment bank is going to get its arms around. Is this market large enough to support your growth requirements and your company being public? Is the management team able to scale the business?

BEM: That brings us to the second question. How can you tell if management is ready to go public?

KV: First off, there needs to be agreement between management of the company – who are going to be left holding the bag – and the equity investors about becoming a public company. There needs to be congruence about what to do with the company after going public. The worst possible situation for management is to be stuck running a company they did not want to take public in the first place. Is management going to be comfortable managing a public company? If not, it might be time to change leadership. But can you really do that just before and IPO?

HD: You are really asking "Is the management team that brought us to the IPO the right team to carry us forward?" This is a larger question that includes the whole management team, not just the CEO. Do you have the right management team in place to lead the company as a public company?

KV: From a managers' perspective being public is a pain. Why? You need to be mentally and emotional prepared to deal with a lot of new demands. You have to treat your new shareholders as partners. You have to flat out comply with regulations. You can no longer be dismissive of short- term results. Most people think of IPOs as a Roman holiday. But it's time consuming, expensive, and a real distraction to running the business.

BEM: Expand a bit more, if you would, on the idea of what it means for the management team to shift attention from getting to the IPO to delivering quarterly results.

HD: The key is whether management has demonstrated its ability to forecast and deliver operating results. And can they assess risk with any accuracy? Are they capable of continuing to provide the documents and filings once the IPO advisors leave? Now you're in charge of a real company. What do you do?

KV: Having been a CFO of a public company, I can tell you there is nothing worse than getting to the end of the quarter and realizing you are going to miss your numbers. The CEO and CFO are going to take the brunt of the questions from the Street. It's a lot more fun to get on the phone and say, "Oops, we exceeded our numbers." When you miss your numbers, you just feel physically ill because you know what's coming. If that happens once, you can earn back that credibility. If it happens multiple times, you are toast.

BEM: How do you then address the question of whether the governance system is ready to go public?

HD: A mature board has a skills matrix. Each board member fills a certain set of skill requirements that complement the needs of the business. A mature board represents a robust set of functional skills, industry skills, and specific skills unique to the business. Most pre-IPO companies don't have anything like this on their boards. So when they get ready to go public, they know they need to comply with the SEC requirement for a minimum of three independent directors. They know they need an audit committee chair or a compensation committee chair. And it's usually filled by "Who do we know?" It's the PE guy who says, "Oh I know somebody." How independent is that person likely to be? The temptation is to do only what's required to meet the minimum legal requirements.

BEM: You say that like it's a problem. Why?

HD: The company goes public, the board members divest their stock, and the CEO is sitting there exposed with all this new responsibility he or she has never had before and nobody around to help. The CEO then has to shift their attention from running the business to addressing these new demands. It can get overwhelming quickly.

KV: This is part of the reason why the profitability of the average post-IPO will drop significantly in the first two years after going public. That CEO is going to have to hire in a lot of expensive financial, legal, and other advisory talent to make up for what the board could have – and should have– provided.

BEM: Clearly there is a lot more to consider in moving a company toward its initial public offering than just "what's our takeout?" What summary advice would you give PE or VC investors who are considering an IPO?

KV: When you are thinking of going public, you have to ask: Is the market large enough to support your growth requirements?" Is the management team able to scale the business? Are they flexible enough to navigate through changing waters?

HD: And then look beyond the planned IPO to determine whether the company has the strategic vision, infrastructure and necessary human capital to survive its first five years as a public company. If not, take the time and make the investments to make sure it does before proceeding with an IPO. The message is this: spend the time and money to get ready before you take the company public.

ABOUT THE EXPERTS

HENRY DENERO has over 35 years of consulting, top management, and corporate Board experience. His work as a consultant includes 19 years at McKinsey & Company where he specialized in corporate strategy. Henry has held CFO and group executive positions at two Fortune 50 companies. He has served as Chairman and CEO of an Internet start up and on 9 public company Boards. Henry holds an MBA from Stanford Business School and a BA from Amherst College.

KEVIN VENTRUDO entered the investment banking field in New York in 1981 and his career spanned 20 years with Merrill Lynch, Sutro and Company, Salomon Smith Barney and SG Cowen Securities, primarily in the Los Angeles and Chicago markets. Kevin has led clients through virtually every type of corporate finance transaction, including IPOs, secondary equity offerings, private placements, high yield offerings and mergers & acquisitions. He also has consulting and executive management experience, having served as CFO of LA Gear (NYSE:LA) and as CEO of a business services firm in Northern Colorado. He currently serves as a Member of the Board of Directors at Sport Chalet, a publicly-traded sporting goods retailer with 55 stores, where he is Chair of the Nominating and Governance Committee and is a Member of the Audit Committee. Kevin holds an MBA from The Graduate School of Business at Stanford University and a BA in Economics cum laude from Yale College.

ABOUT THE AUTHOR

BENNETT MCCLELLAN has over 30 years of corporate and consulting experience. Most recently, he was a Managing Director in PricewaterhouseCoopers' Media & Entertainment practice. Bennett has also held management positions with leading entertainment companies, and has worked as a consultant for McKinsey & Company and Arthur D. Little, Inc. He also serves as a freelance journalist, and has had over 100 articles and editorials published. Bennett holds a PhD from Claremont Graduate University, an MBA from Harvard Business School and a BA from University of California-San Diego.