Private Parts

Equity firms stamp their marks

by Rich Ehisen

Growing a company takes capital, and the bigger the growth potential, the more capital is needed to make it happen. For local entrepreneurs, that has meant bank financing. But thanks to a big push in recent years from California's major government pension funds, a growing number of private equity players from across the nation are now looking long and hard at the Capital Region for solid investment opportunities. And while the subprime mortgage crisis has made bank financing harder to come by, many of the region's equity players say there is more private money now than ever before.

"There's an enormous amount of equity capital available in the country right now," says Neil Paschall, managing director for the Granite Bay office of The McLean Group, a Washington, D.C.-based investment bank. "There's no shortage of capital. There's only a shortage of good ideas."

According to Private Equity International, a London-based financial media group that tracks equity markets around the globe, the top 50 equity funds worldwide have raised more than a trillion dollars for investments in the past five years. That is an outrageous sum by anyone's standards, but PEI notes that it only accounts for 65 percent of the total private equity funding for that period.

That's good news for the local business community. Bank debt can be a fairly inexpensive way to fund growth, but it also comes with a host of covenants that might not be a good fit for emerging-growth companies without the kind of collateral that bank lending requires. But even presuming a bank will lend that kind of money — and the company is able to handle the monthly cash flow to make debt payments — many entrepreneurs are not comfortable being leveraged to the hilt. That can make private equity capital a much more attractive option.

Private equity deals can be very complex, but the basic premise is simple. Companies that use private equity are essentially selling off a portion of the company to investors as a way to fund its growth, which in theory increases the company's value for shareholders. This could come very early in the company's life cycle, such as with angel investors that provide seed money, or venture capital firms that help a young company through early stages of growth. It could also come much further down the line with a mid- or late-stage equity group that will eventually sell the company or take it public — usually in three to seven years — so investors can see their return on investment.

The growth in private equity capital nationwide has been building exponentially for years now. But according to Curt Rocca, a partner in DCA Capital Partners LP in Roseville, good ideas or not, the Capital Region has rarely been the beneficiary of that boom. "The vast majority of both venture and later-stage private equity funding has historically gone to a relatively small subsection of the state, primarily San Francisco, Silicon Valley, Los Angeles

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and San Diego," says Rocca, whose firm specializes in funding later-stage companies.

But many observers believe that situation is starting to change, with the credit going primarily to equity investments from state pension funds like the California State Teachers' Retirement System and the California Public Employees' Retirement System. In 2001, CalPERS created the California Initiative Program to seek out investment opportunities in traditionally underserved markets across the state.

There are substantially more of those markets than one might think. Between 2001 and 2007, 92 percent of all the private equity dollars committed to California went to companies headquartered in 153 of the state's 1,700 zip codes, according to Thomson Financial Private Equity, which tracks private equity transactions. Rocca says the narrow investment perspective has prevented companies in places like Sacramento from achieving their full potential.

"We always hear about the lack of headquarters in this area. Part of the reason for that is, historically, companies have gotten to a certain point and said, 'I need the capital, but I don't have it, so I'd better sell.' Companies wind up selling at a much earlier stage in their development," Rocca says.

CalPERS hopes to change that. Starting with an initial capital commitment of $475 million across 10 equity funds, the California Initiative has since added another $550 million under the supervision of investment manager Hamilton Lane. Of those commitments, the initiative has now allocated more than $400 million to new investments in 202 California-based companies, with an aggregate ROI of approximately 18 percent. And while the overall equity funding bias toward the usual markets has continued since 2001 — 25 percent of all the California-based companies receiving equity funding were outside

continued on page 38

of the traditionally funded zip codes — fully 50 percent of CalPERS' allocations have gone to companies outside of those areas.

Joncarlo Mark, a senior portfolio manager with the CalPERS Alternative Investment Management Program that oversees the California Initiative, says the initiative also gave the beginnings to the area's first two institutionally backed venture capital funds, DFJ Frontier in West Sacramento and American River Ventures in Roseville, both of which focus on early-stage funding for technology companies. "There were no institutionally based [venture capital] funds before the California Initiative, and now DFJ is working on a second fund," Mark says.

The market value of CalPERS' private equity fund tops $23.9 billion, so $1 billion isn't a huge dent in its portfolio. But it's more than enough to help kick-start growth that might otherwise go unfunded, particularly in areas that venture and mid-stage funding often ignore. And CalPERS isn't laying its money down to drive a purely altruistic agenda. Quite the contrary, Mark says. Although the initiative wants to have a positive economic impact on diverse and underserved markets, the main objective for seeking out new opportunities in California is to earn great returns for the pension fund.

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"We ask a lot of our fund managers. We want to see 20 to 25 percent returns, so you have to be sure you are not limiting your partners from finding interesting opportunities. You can't be so myopic that you only invest in certain zip codes," he says.

Perhaps just as important as the actual dollars put to work, the thrust of efforts like the California Initiative are helping to reformulate the mindset of the Capital Region, says Scot Lenet, managing director for DFJ Frontier. "I think the opportunities have been here in the past, but not the capital to fund them," he says. "That takes a certain risk culture that was never here before the California Initiative."

The initiative has so far paid off in a big way for a few local companies, including Bustos Media LLC, a Sacramento-based Spanish-language media company with

continued on page 40

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Is private equity right for my company?

There are pros and cons for any equity arrangement, so determining whether that route is the right fit for you takes due diligence. Every situation is different, but there are some rules of thumb that could make the process easier for everyone involved.

According to private equity veterans, like Wildlands Inc. CEO Steve Morgan, the No. 1 consideration should be the professional relationship with the equity provider. Wildlands, a Rocklin-based habitat development and land management company, regularly uses private equity to fund its projects. While equity investors will often take on a role in their investments — usually with a seat on the board or in some other advisory position — Morgan doesn't go that route.

"There is no management participation whatsoever. We would not have an equity fund that required a say in management. We have a hard enough time figuring out what we do without having to explain it to anyone else," he says. Morgan instead relies on developing relationships with investors who agree to let him run the show.

Morgan's way of doing things is not necessarily unique, but it isn't the norm either. Rarely does an equity group hand over a significant chunk of change without expecting at least some say in how the money is spent in adding value to the company. That said, his way clearly works for his company because, as he notes, "We did not solicit any of these deals. They solicited us."

There is also the problem of the investor wanting a return on investment within a set time, usually three to seven years. That means the current management team needs to be prepared to sell or recapitalize the company within that time.

Recapitalization could come from an initial public offering or another equity deal, which may or may not fit into ownership's long-term plan.

It certainly didn't fit into what Sacramento environmental firm Jones & Stokes Associates Inc. had in mind when it was working on its long-range growth plan last year. President and CEO John Cowdery says they went in believing they had two simultaneous challenges: acquiring growth capital while retiring a long-standing employee-owned stock option program. After considering a bevy of private equity offers, Cowdery realized they had a third challenge: finding an investor that had respect for its corporate culture, specifically in regard to how the firm values its employees.

"We had discussions with about 35 potential investors, most of which were private equity groups. Some were pretty good, but many of them were too focused on returns and not on the work environment. We are all about our employees, so that did not work for us." Neither did the likelihood that, because of the ESOP obligations they faced, the company would be back at ground zero again in around five years. After a six-month process, the company ultimately decided on a buyout rather than an equity fund. Virginia-based ICF International, a strategic buyer already in the environmental field, purchased Jones & Stokes earlier this year for a total acquisition price of about $50 million.

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operations in several states across the West and Midwest. In 2004, the company drew significant funding from Opportunity Capital Partners, a Fremont-based firm that is one of the nine California Initiative funds.

Opportunity Capital, along with other CalPERS and CalSTRS investors outside of the California Initiative, helped Bustos raise more than $100 million in equity funding, which the company subsequently leveraged to acquire another $100 million in bank loans. That funding allowed Bustos Media to quickly build a network of radio and television stations across eight states, with a significant portion of its original equity capital still available.

The California Initiative also played a major role in the meteoric rise of MaxPreps Inc., a Web-based company that compiles scores, statistics, scouting reports and other information on high school sports and teams from around the country. The company, based in Cameron Park, launched in 2003 with only local coverage. The next few years, board members funded minor expansions. That was fine in the interim, says CEO Andy Beal, but the company wasn't going to reach its potential without a major influx of capital. "We were really at a wall," he says. "We wanted to go beyond California, but we needed the money to do it."

In 2005, DFJ Frontier helped MaxPreps acquire $3.2 million in capital, which Beal says allowed him to expand nationwide. With interest in high school sports skyrocketing, the company went through a second round of funding in 2006 — with DFJ Frontier and two East Coast funds — that produced another $7 million in equity capital. Beal hadn't even worked through that capital before media giant CBS Corp. bought the company for an undisclosed amount in March 2007. Beal credits the original funding round for making the deal happen, saying that "getting professional investors on our board of directors was critical" to putting MaxPreps on the national radar. "By the B round, equity groups were calling us. That would have not have happened had we

continued on page 42

not had the first round of local funding through DFJ."

Although the California Initiative doesn't fund DCA Partners, Rocca says its influence has been a catalyst for what's to come. "I think from the standpoint of availability of capital, the Sacramento Region has done more to evolve over the past three to four years than ever before. With us, you have the region's first-ever mid-stage private equity fund, and then with the Central Valley Fund you have the first significant mezzanine debt lender, also focused in the Sacramento Region. So for the first time, this region has access locally to the full spectrum of the financing food chain," he says.

Even with this new wave of homegrown equity funding, nobody is ready to say the region has reached par with California's traditional business hubs. As Paschall is quick to point out, "Of the top 100 venture capital firms in the United States, about 30 of them are located in Mountain View.

"The reality is that there is an enormous amount of equity capital out there, and it doesn't have to come from a local equity group. Everybody is looking for a good idea everywhere," he adds.

But venture capitalist Lenet, who also teaches in the UC Davis MBA program, says having legitimate equity players in the Capital Region contributes to the education of the next generation of entrepreneurs. "Every year the entries we see in our annual business plan competition at UC Davis are getting better," he says. "They are growing from small retail-based ideas to those using underlying technologies that are VC fundable. More and more of our students are looking around and saying, 'How do I do something bigger?' I'm seeing a new push of real company creation."

The trick now, says CalPERS' Mark, is to build on that head of steam. "I think our program has truly catalyzed the region's entrepreneurial ecosystem," he says. "This is becoming a great place to invest, but it will only stay that way if people continue to evolve this ecosystem."

It's critical for people to see the region as a place to develop a great idea without having to take it somewhere else for funding, Mark says. "If there are entrepreneurs out there with good ideas, which need capital, they don't have to drive to Palo Alto anymore to get it," he says.

Lenet says the day could still come when someone starts the company that gives Sacramento an identity makeover. "Sacramento needs a company like Dell or Microsoft that provides thousands of jobs," he says. "It only takes one of those companies to completely change the landscape."

Adds Rocca: "I really believe success breeds success, and we need to have more successes. We've had some, and we just need to have more." ©