

An adviser's view of esmertec AG's fund-raising

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Last month, esmertec AG raised E23m which marks the largest private equity fund-raising in European software in the last 18 months. The Swiss java mobile software company was advised by Go4Venture, a London-based equity private placement specialist. Jean-Michel Deligny gives Go4Venture's perspective on the challenges of the project.

When esmertec started their fund-raising efforts at the end of 2002 with a view to raising E15-18m, management and shareholders had plenty of reasons to think they would easily achieve success. esmertec had:

- *A unique technology:* with its intellectual property, developed over the last 15 years, esmertec is the only company in the world able to install Java on any phone, including mass market phones with small processors and little memory.
- *A "ripe" target market:* all market studies point to a robust mobile phone market, driven by the exploding demand in developing countries. Furthermore, all analysts agree that Java is becoming a "must" in the mobile industry as it allows operators to provision sophisticated applications regardless of the underlying hardware platform.
- *Strong and growing revenues:* esmertec had revenues of c. E5m in 2003 and is expecting E22-23m in 2004 on the basis of a backlog of 120mn phones to be shipped in the coming months.

Leveraging existing relationships of its Board members, the company started approaching investors at the end of 2002. However, by March 2003, the Board realised that the project was not progressing as planned: although investors contacted were showing a clear interest, nobody was rushing into offering a termsheet. This reflected the hesitant mood of investors at the time, and the challenges of agreeing the value of a company ramping up its revenues exponentially.

As a result the Board decided to bring in advisers. Multiple candidates were considered from large investment banks (eyeing the IPO business) to one-man bands, who could bring in the extra nudge required. In the end, esmertec chose Go4Venture on the basis of our mix of

investment banking skills, specialist equity private placement skills, sector expertise, and the attention that a boutique would bring to the project.

As we got to work the challenges became quite clear:

- *Pool of target VCs too narrow:* Existing investors had been helpful in providing introductions, however their selection of VCs had not been methodical. Many of the VCs who should have been considered had not been contacted. We ensured that all the relevant names, not only from Europe, but also from the US and Asia, were considered: a total pool of over 80 investors.
- *Revenues not sufficiently substantiated:* Revenue projections were outstanding, but the documentation to substantiate them was lacking, making it difficult for investors to assess their risk/reward. Tremendous effort went into building detailed and credible bottom-up projections with esmertec, led by our financial modelling specialist, Ian McLoughlin (PhD, mathematical modelling).
- *Insufficient defence for target valuation:* We put considerable effort into documenting the valuation of the company, resulting in what one investor described as "the best documentation [he] had ever seen in a placing document".
- *Demanding existing investors:* Management and existing shareholders had a clear idea of the objectives for the fund-raising, however some of these objectives were obviously contradictory (eg maximising valuation whilst keeping a "clean", incumbent investor friendly, termsheet). We put in place a process which created comfort among existing shareholders that they would get to understand the trade-offs between the terms and valuation that the market at large was prepared to offer. That information was essential in bringing the round to a close.

Helped by the detailed business plan, financial projections and valuation document, solicited investors were able to decide quickly whether this was the sort of risk/reward profile that they were prepared to underwrite.

A pattern started to emerge with investment funds trying to force esmertec into a deal at a low valuation in what they clearly saw as a buyers' market. During the course of the Summer we therefore advised the company to change tack and turn the table on the VCs. Armed with the fact that existing investors had stated their willingness to support the company all the way (ie they could put the money in for the full targeted amount), we decided to issue a termsheet with a pre-money valuation increasing over time, with offers invited on a first committed, first served basis. Part of the credibility of the approach was based on the market information gained during the multiple discussions we had had during the process, which allowed us to set what was seen by all to be a "fair market price".

This is obviously a highly unusual but quite innovative structure. The result was spectacular with the round largely oversubscribed and, in the end, esmertec raising E23m, instead of the E15-18m initially envisaged, with five new investors joining the original VCs.

What are the lessons to be drawn from the esmertec case? Apart from the value of a systematic price discovery process there are three other points worth mentioning for future fund-raising:

Fund-raising is obviously heavily dependent on the point in the cycle you are in. As the market picks up over the next 12 months, we expect valuations to gyrate (upwards) quite substantially. Keeping a finger on the pulse of the market is key in getting the right value for your business, so knowing about recent deals is essential.

Even the best companies are typically not great at documenting their achievements in a fashion credible to investors. This is partly because management does not have the time or the expertise to know exactly what investors want to see. Make sure you have people on your team who can dedicate the resources and who have experience of what investors require to make their decisions.

Orchestrating last minute competition among investors is key in getting to the right deal. We always advise our clients that price is actually not the game (if you have taken the time and effort of a proper price discovery exercise, you know by then what the market is prepared to pay for your company), the goal is mainly to get all the various other terms right. Assemble a large enough team to have various echelons in decision-making to play the negotiation game, with one party in charge of coordinating positions across various options. Having an adviser usually makes the whole process vastly more credible and therefore efficient.

All this work assumes a great working relationship between management, shareholders and advisers. In the case of esmertec, it was not a difficult task as we were working with a great management team and a united set of shareholders. That's obviously what lies at the core of a great company such as esmertec.

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