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Klesky, Klesky, quite contrary. How does your garden grow?

Challenges When Trying to Finance Growth

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Mentor-in-Residence

The Ted Rogers Leadership Centre

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Table of Contents

Introduction 1
The Evolution of Klesky Landscape Solutions (KLS) 1
Jager Advises 3
The Side Conversation 6
Preparing the Prospectus 7
77 East Capital Responds 8
The Negotiations 9
Breaking Point or Break Through? 11
Perspective for Responding to the Case and Questions to Answer 12

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Introduction

The year is 2011. The Klesky brothers, business-savvy, experienced entrepreneurs who have quadrupled the annual revenues of the family's commercial landscape business to almost $60 million over the last ten years, are meeting to wrestle with a key question: How do we finance more growth? Their firm, Klesky Landscape Solutions (KLS), headquartered in Oklahoma City, ranks 25th in the list of the top 100 companies in the landscape industry in the USA and is a regional leader in South Central USA. The brothers want to make a number of strategic acquisitions in the near term which will enhance both their geographic scope and their capacity to serve even larger customers. But to accomplish their dreams for the business, the brothers need to find alternate financing to fund not only their continued growth but also to provide liquidity to existing shareholders. Yet, the requirements of traditional investors like banks and private equity firms who want to mitigate their risk and assert majority voting rights are at odds with the brothers' desire to be a family-run firm, fully in control of their legacy.

The Evolution of Klesky Landscape Solutions (KLS)

KLS was founded by Arthur Klesky in 1969. Arthur, after being honourably discharged from the army following a tour in Vietnam, returns to Oklahoma City intent on making his mark as an independent business man. With his interest in landscape architecture, his abundant entrepreneurial spirit and his desire to ensure that his young family (which includes his three sons Michael, David and Daniel) is enabled by his success to fully participate in the "American Dream", Arthur establishes KLS. For the next 20 years, he significantly expands the range and reach of KLS' landscape design and installation services in the greater Oklahoma area. In 1994, he is bought out by and begins to work for Abba Construction, one of the largest regional commercial construction firms.

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In 1999, Arthur, taking advantage of the hard times that have befallen his parent firm, manages to repurchase KLS from Abba Construction. His actions are motivated by the fact that his three sons, who had been working for others since graduating from university, want to come back to run the family business.

At Arthur's retirement, Michael, the oldest of the three brothers, becomes the CEO of KLS. A graduate of Oklahoma State, Michael brings to KLS 20 years of business experience and the ability to open most doors in the region, on account of being a celebrated quarterback of the beloved Oklahoma State Cowboys football team and a decorated army veteran. David, armed with an MBA from the University of Southern California and several years in the finance industry, becomes the chief financial officer, and Daniel, who is a qualified landscape architect, assumes the post of vice president, operations.

Between 2000 and 2007, the brothers expand the business to include landscape maintenance. This is an important development as it allows KLS to keep clients on a continuous cycle from design to installation to maintenance. During this time, several branch offices are also opened in new markets.

In 2008, KLS recapitalises with what is now an unfunded private equity firm and two mezzanine funds, which own a total fully diluted ownership stake of 63% in 2011. With the help of this funding, KLS has successfully completed two acquisitions, has another acquisition under a Letter of Intent (LOI) and developed a list of potential acquisition targets. Experienced managers have also been hired, with succession planning put in place. While the majority of KLS' shares are now owned by others, the brothers together continue to have minority control over the key decisions impacting the operations and growth of the business.

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Under their leadership, KLS' track record has been impressive:

- As the number one commercial landscaper in the South Central region, KLS – with over 130 crews, 500 units of equipment, several branch locations, an experienced management team and approximately 600 dedicated employees – has the resources to take on large and complex projects and remain dominant in the marketplace.
- The brothers' focus on maintenance has fuelled profits: the 54% of the revenue now in maintenance work (with over 800 maintenance clients and a 95% retention rate) has provided 64% of the profit.
- The 10-year CAGR is 15%. For fiscal 2011, revenue is projected to be close to $60 million with an adjusted EBITDA of $10.1 million, equalling a 37% gross margin and 15% adjusted EBITDA margin.

The brothers know, however, that their current investors cannot (as in the case with the fund that is now de-funded) or will not (as in the case of the mezzanine investors) provide more financing. While they are not currently demanding to be paid out, the brothers anticipate that the investors will soon make some demands and thus a repurchase of their shares must result in a premium price.

"We have a good story to sell. Let's not get discouraged," says Michael to his brothers. "I have an old army buddy, John Carrier, who now heads an investment bank in town named Jager. I have discussed business many times over the years with John and have always found him helpful. His predecessor helped Dad when he bought out Abba Construction. If you agree, let's start with him to discuss our needs and the options."

Jager Advises

"Good morning, gentlemen," says John Carrier, president of Jager, as he greets the three brothers. "I appreciated receiving copies of your strategic plan and some background

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financials in preparation for our exploratory discussion today. Tell me what is on your mind."

"Thanks, John," says Michael. "Let me start us off. We feel strongly that KLS is at a critical juncture. If we can do the roll-up strategy we have outlined in our strategic plan, we are confident that KLS will achieve a new level. But we need funding. Ideally, we would like to maintain control and grow our ownership stake to establish our family legacy. We are here today, John, to understand our options. In 1999, Jager provided my father with the financing to liberate KLS from Abba Construction."

"Ah. So we did, but you are mixing apples and oranges. In your father's case, Abba Construction, which owned KLS outright then, was in dire straits, looking for cash, and KLS services were not critical for their survival. Your father also had a cash flow from KLS to pay a good part of the repurchase fee," says John. "Your current situation is quite different. When you took on investors to accelerate your growth in 2008, you already chose a different path. You now have a fiduciary obligation to those who have provided you with funds. As that obligation is for a majority share of KLS, no bank will wholly lend you the money to pay out your current investors. The level of debt it would put on your balance sheets would be considered too much of a risk. And, I don't think I am wrong in saying that the family doesn't currently have the funds to meet KLS' obligations and fund growth. I get that you are conflicted between wanting to do it on your own versus being beholden to others in your decision-making, but you need to be realistic. Perhaps it is an option, and I stress 'perhaps', for you to make arrangements with your current investors to repurchase their shares over time and accept that your growth will become less accelerated. This would be a different strategy from the one you presented."

"But we want to execute our strategy," exclaims Michael. "So, what are our options?"

"Well," replies John, "you are a mature business so it is not likely that angel investors or most venture capitalists will now be very interested. Banks, like ours, will lend some

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money through a private equity arrangement; our risk exposure is more limited in this kind of situation. We will also help you find and negotiate the best deal with a suitable private equity partner."

"A private equity investor is going to want majority control on our decisions, though. Correct?" asks Michael.

"Yes. Generally, they will want control over budgeting, capital expenditures, borrowing, acquisitions including targets, valuations, strategy and risk analysis and executive hiring. Private equity firms are all about managing and limiting their downside risks and elevating returns. While there may be some wiggle room on some of the details, they will want a majority stake, majority decision-making rights, to hold you to high performance standards with a tailored incentive scheme and to ensure they get their investment back if things go south, all while taking an annual service fee, usually about 2%, along the way. That's the downside. On the upside, they will really want you to succeed because it is a payday for them and their investors, too. With the right private equity partner, they can provide you not only with the funding you need but also with some expertise and guidance to ensure effective implementation of your strategy. They also can be good at developing exit strategies, be it an IPO, buy-out or other refinancing. But they won't touch you if they don't have confidence in you and don't believe they can work with you. So, with good partners, not having minority decision-making rights should not be as difficult as you envision. There is no significant business focused on accelerated growth that operates without being obligated to its shareholders. You know your business. You're good at it. But you need to accept that investors will demand you to be accountable to them, whoever they are!"

"Nonetheless, we will want issues of control and level of ownership to be part of the negotiations," emphasizes Michael.

"Again, one can and should negotiate the details, but your desire for minority decision-making rights will be tough to achieve and I suggest we tread carefully in any negotiation

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about this and not make it the first thing you demand," cautions John. "With that in mind, do you want us to work with you to find a private equity partner?"

With the stated agreement of his brothers, Michael replies, "Yes. As you have presented it, it seems to be the most viable option given our desired path for the business."

"In that case," responds John, "we will help you develop a prospectus that tells the story of KLS which we, on your behalf, will circulate to potential investors. When a promising partner is found, we will oversee the negotiation process with you to ensure your interests are protected and the process proceeds in a way that allows you to have confidence that this will be the partner you can work with. Please be aware that there will be a great deal of due diligence undertaken by various parties. You need to be prepared to be transparent and as available as possible."

The Side Conversation

After their meeting with John, the brothers huddle at a nearby coffee shop to debrief. They agree on three points:

- First, they will see what potential investors have to say, thinking that even if they don't actually conclude a deal they might, at least, get good insight about KLS' valuation.
- Second, wanting the highest price possible in order to buy out current investors as well as provide themselves with significant reinvestment funds, they will take the next few weeks to figure out the projection assumptions they need to use to maximize the purchase price for KLS.
- Third (and very important), they will leave their demands for a higher share amount and minority decision-making rights to the final moment of any negotiations.

The brothers also agree that they will not confide in John or others at Jager about their decided-upon approach to the negotiations.

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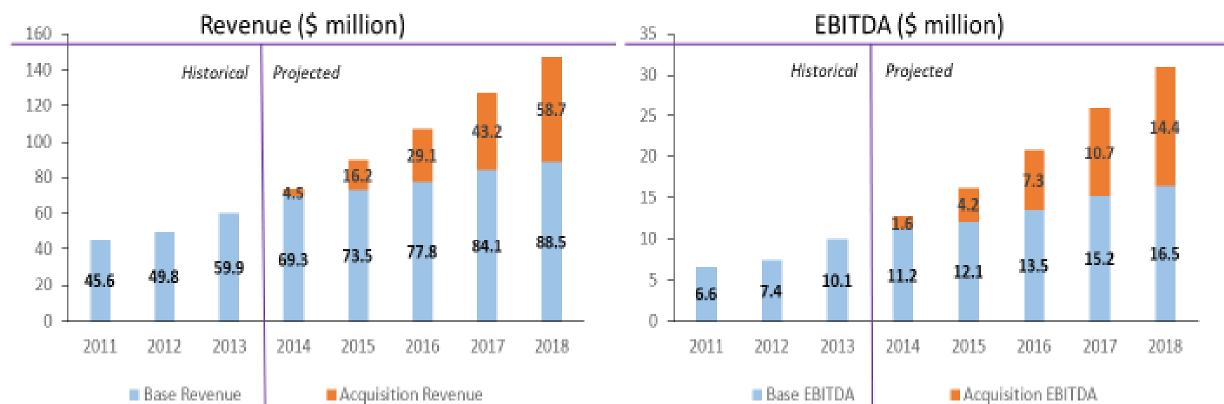
Preparing the Prospectus

To show the best-case growth prospectus, the brothers prepare the chart shown below. Underpinning this chart are four key assumptions about how the business will unfold:

- There will be aggressive growth of the maintenance business.
- Growth of the installation business will continue, although it will be outpaced by that for maintenance work.
- KLS' dominant market share will continue to result in high barriers to entry, minimizing competition.
- With additional capital, there will be a fast-paced roll-up of several acquisitions.

KLS Projections Included in the Jager-Circulated Prospectus



REVENUE DISTRIBUTION	2011	2012	2013	2014	2015	2016	2017	2018
Installation	44.1%	37.0%	45.6%	47.0%	39.8%	35.0%	31.4%	28.3%
Maintenance	55.9%	63.0%	54.4%	53.0%	60.2%	65.0%	68.6%	71.7%

	2011	2012	2013	2014	2015	2016	2017	2018
Base EBITDA Margin			14.8%	16.7%	16.0%	16.4%	17.4%	18.0%
Acquisition EBITDA Margin				36.4%	26.3%	25.1%	24.7%	24.4%
TOTAL EBITDA MARGIN				17.2%	18.1%	19.5%	20.3%	21.0%

REVENUE GROWTH	2011	2012	2013	2014	2015	2016	2017	2018
Base Rev Growth		9.1%	20.2%	15.7%	6.1%	5.9%	7.9%	5.4%
Installation		-8.6%	48.3%	25.2%	-0.3%	1.1%	3.4%	0.4%
Maintenance		23.2%	3.7%	7.7%	12.3%	10.1%	11.5%	9.1%
TOTAL GROWTH				23.2%	21.6%	19.2%	19.0%	15.8%
Installation				26.8%	3.1%	4.6%	6.9%	4.2%
Maintenance				20.1%	37.9%	28.9%	25.5%	21.1%

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To calculate these projections, the brothers amplify the momentum established by KLS' historical data by downplaying possible threats or timing delays. For example, with some uneasiness, the brothers have been recently monitoring the extent to which smaller competitors, who can charge lower prices, might cannibalize KLS' growing market share in the maintenance business. In the last year, three albeit relatively small KLS contracts have been lost to much smaller competitors. As KLS relies less on converting their existing installation customers to maintenance work and goes head-to-head with others for this work, the competitive threat could possibly be greater, which will mean that KLS will have to lower prices and therefore profit margins if the company is to compete.

Additionally, the conversion rate of existing installation customers to maintenance contracts could be slower than the brothers' projections suggest: turnover of a commercial property from installation to maintenance can be significantly delayed as the developed property transfers to a new corporate identity.

Finally, the brothers have accelerated the rate at which they integrate the roll-up acquisitions into their operations. They assume that potential private equity investors will focus on their successful track record, the competence of the management team, their market share, their enormous infrastructure (all of which gives KLS a big competitive advantage) and will likely not have a detailed enough understanding of the regional competitive environment to question these assumptions.

77 East Capital Responds

A month after the KLS prospectus is circulated, Jager gets a call of interest from Max Wellington and Mark Layton, managing directors of the mid-market private equity firm, 77 East Capital (77C), located in Toronto, Canada. KLS hits all of 77C's criteria given KLS' strong management team and growth platform, its compelling value proposition and what seems to be the high barriers to entry for potential competitors in the South Central regional market. 77C has an established track record for significantly enhancing their

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companies' returns through a combination of organic growth, expanding margins and a focus on acquisitions.

Indeed, the private equity firm's demonstrated capabilities in executing a consolidation strategy in partnership with management differentiates 77C from others. Quickly building a relationship with the brothers, 77C is chosen as the firm to go forward in negotiations.

The Negotiations

In December 2011, based on the projections provided by the prospectus, 77C and KLS sign a LOI agreeing to a transaction whereby 77C will purchase KSL for $78 million based on $10,100,000 of adjusted 12/31/2011 LTM EBITDA (a multiple of 7.71 times adjusted EBITDA) and provide management with an option pool equal to 10% of the fully diluted equity with half of the options having a time-vesting component and half having a vesting schedule tied to performance of the underlying equity. To be eligible to participate in the option pool, KLS management agree to roll 90%+ of their proceeds into financing the deal, a sign to Max and Mark that KLS is committed to finalizing an agreement with 77C.

Based on the execution of the December LOI, 77C engages with numerous service providers (Legal, Tax, Accounting, Insurance) to provide due diligence and documentation services.

Upon the completion of financial due diligence, on February 13, 2012, 77C provides a revised purchase price of $69.4 million, using the same 7.71 agreed on multiple, reflecting the fact that: 1) the acquisition that was intended to be completed prior to close and represents $1,100,000 of the KLS' $10,100,000 in EBITDA is taking longer than projected in the prospectus; and 2) that adjusted EBITDA for the trailing twelve month period is lower than the forecast (as initially provided by the prospectus) which formed the basis of the bid presented within the LOI signed in December. 77C's financial due diligence to date was able to therefore catch some, if not all, of the overly optimistic assumptions that the brothers had baked into their prospectus forecast.

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Through Jager, KLS initially responds on February 14, 2012 with their refusal to adjust the original purchase price and as a result 77C informs all of its service providers doing due diligence on their behalf to immediately stop work.

Following several emails and discussions, a conference call is held on February 18, 2012 with all parties (which includes all key management and current investors), where value expectations are discussed and debated. Jager and the brothers continue to convey that 77C is the right group to partner with and that the brothers are excited to move forward – and the extended management roll helps to support this position.

The parties come to an agreement on February 22, 2012 to revise the purchase price to $73 million. No other economic/value terms in the LOI are re-negotiated or highlighted as sources of concern other than the need to set a working capital target. In particular, no issues with the option plan, which remains at 10%, or requirements for minority governance rights are raised.

Then 77C re-engages with its service providers to continue due diligence and documentation. On February 26, 2012, 77C provides KLS with the Agreement of Limited Partnership which defines, among other things, the parameters for the management of KLS business, and the Management Agreement which provides for the authorization and grant of Class B Partnership Interests to members of senior management. Together with the employment agreements that have been previously provided on February 12, 2012 and the 77C LP operating agreement provided on March 5, 2012, the brothers have all the documents required to understand their specific rights as employees and shareholders going forward.

What seems to be the last material economic point to discuss, the working capital target, is debated among the parties over a period of several days. On the one hand, the sellers (as represented by the Board, which includes the current shareholders of KLS) suggests a working capital target of $3.4 million, compared to 77C's position that the appropriate

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target is $5.1 million. Following several discussions, the parties agree on March 8, 2012 to settle on a working capital target of $4.25 million.

With full knowledge of the terms outlined within the draft of the Management Agreement (providing for a 10% option pool consistent with the terms of the LOI) and all other documents, management executes an amendment to the LOI on March 9, 2012 extending exclusivity until March 23. In this amendment, there is no mention of any material changes required to the governance structure or the quantum mechanics of the management option pool. In negotiation of this extension, Jager suggests that two weeks will be sufficient to close the deal, leading 77C to believe that no material deal points remain.

Breaking Point or Break Through?

Nonetheless, on March 16, 77C receives the brothers' mark-up of the management agreements. They include a demand for a minority investor negative control rights over every material strategic and operational decision, liquidity rights not afforded to other investors and an un-dilutable option pool of 25%.

Max and Mark are stunned by this communication. Had any one of these requirements been forwarded to 77C at any point in the process, it would have caused them to terminate further negotiation and thus mitigate their expense exposure, which now stands at around $600,000. They call John at Jager to express their dissatisfaction with the latest demands and their anger at having spent so much on due diligence and negotiations when the main actors, to their surprise, seem to be acting in bad faith with both 77C and KLS' current investors.

What Max and Mark do not know is that the brothers' last communication has been sent to 77C over John's objections. John now picks up the phone to stress to Michael that the ball is in their court: "How you choose to handle this will decide not only the path forward for KLS but also your options for financing in the future."

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Perspective for Responding to the Case and Questions to Answer

IMPORTANT NOTE TO THE TEAM ON HOW YOU SHOULD FRAME YOUR RESPONSE:
In your presentation in response to the questions below, please respond as the senior management team of KLS which includes the brothers (Michael Klesky, chief executive officer, David Klesky, chief financial officer, and Daniel Klesky, vice president, operations.) In your analysis of the case, in addition to whatever else you may want to say, please be sure your presentation, in an order of your choosing, includes your perspective on the questions asked below.

Questions

1. What are the relevant facts of this case? Left as it is, what action do you think 77C will likely take now?
2. Based on the facts in this case, what are the challenges faced by a company like KLS when trying to finance growth?
3. What are the issues in this case? To what extent are any of the issues an ethical issue? A legal issue? Or, in your opinion, an issue that has developed because it is a consequence of a negotiation or industry standard?
4. When you, as the brothers, are considering your next steps, what other individuals and groups have an important stake in the outcome of the negotiations? Do some have a greater stake because they have a special need or there are special obligations to them?
5. What options have you, as the brothers, considered to solve the issues you have raised?
    - Which option(s) will be most consistent from an industry perspective?
    - Which option(s) will produce the most good and do the least harm?
    - Which option(s) is/are fair to all stakeholders?
6. Considering all the perspectives, which of the option(s) is/are the right or best thing to do? Why?

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