

## **The Globe and Mail Report on Small Business Magazine**

### **Jason & Jonathan go public**

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From the February 1 2007 Issue of the Globe and Mail  
Report on Small Business Magazine

### **To compete in the online playground against bruisers like Disney and Nickelodeon, kids' web portal Kaboose had to bulk up fast Here's how it got \$50 million bigger in a hurry**

On the morning of May 3, 2005, Jason DeZwirek and Jonathan Pollack take their places at the head of the boardroom table in the office of GMP Securities, a Bay Street investment bank. DeZwirek is the co-founder and CEO of Kaboose Inc., a Toronto new media company that runs a parents-and-kids portal packed with games, recipes, online scrapbooks and parenting resources. Pollack, the CFO, is his numbers man, and together they've hired GMP to provide advice on how to raise money.

DeZwirek managed to keep his seven-year-old business alive through the tech meltdown of 2000, but he knows that if he's going to have any shot at gaining the room's trust, and staying afloat, he has to project supreme confidence at the same time as he's impressing upon them the urgency of Kaboose's situation. DeZwirek hates this kind of public speaking.

There are about 50 GMP sales reps either present or on the speakerphone from the firm's Calgary and Montreal offices. DeZwirek explains that Kaboose is one of the top 10 family sites in North America, with 12,000 pages of content and six million unique visitors every month. It competes with U.S. behemoths like Walt Disney and Nickelodeon, generating revenue by selling advertising to companies such as Heinz and Sony. In late 2004 and early 2005, Kaboose acquired two well-known family websites—[Birthdayinabox.com](http://Birthdayinabox.com) and [CampSearch.com](http://CampSearch.com)—but DeZwirek is convinced that his 100-employee company's only chance of survival in the long term lies in taking over even more kids' and parenting sites. And that means assembling a hefty war chest.

The problem is that the amount of money Kaboose is worth, and the amount DeZwirek needs to go on a shopping spree, is a moving target. The market for online media space has been red hot ever since Google pulled off a \$1.7-billion (U.S.) public offering in 2004. Unfortunately, DeZwirek is also unable to point to another Canadian company that does what Kaboose does. But even if he could, it probably wouldn't help, because most of these brokers don't understand how new media companies make money. There's yet another problem: Investment bankers don't like to back small fish—particularly ones that are battling vastly bigger U.S. companies.

After the presentation, GMP's vice-chair, Paul Pew, gives DeZwirek and Pollack some sage advice: Institutional investors like firms with a game plan, a good “use of proceeds” story and “a path to profitability.” In short, they want a long-term capital appreciation or the possibility of cashing out quick. Pew insists it will be easier to raise the millions they need if DeZwirek and Pollack commit to taking Kaboose public within a year. The two agree in principle.

In doing so, they've committed to spending the next 12 months crisscrossing North America, negotiating non-stop, in search of capital, companies to buy and the best road forward. The first step, right off the bat, is a week-long North American road show, with stops in New York, San Francisco and Calgary. DeZwirek, Pollack and GMP director Lorne Sugarman soldier through a brutal schedule of up to a dozen meetings a day, delivering their pitch wherever they can get in the door. Often, they are so disoriented they find themselves in meetings forgetting which points they've made, and to whom.

In turn, they're met by prospective backers who are variously bored, engaged, provocative. A few lord their financial clout over DeZwirek, letting him know they control the cash that can make or break his firm. He learns to bite his tongue and stick to the script.

For DeZwirek, the road show is a high-speed education in the mysterious ways of the equity markets. While Pollack, 35, is the fast-talking number cruncher with the London School of Economics degree and Wall Street experience, the 36-year-old DeZwirek has spent his entire career working in digital media, first developing educational CD-ROMs, then producing educational material and games for clients such as Corus and Teletoon, before starting Kaboose in 1999.

The road show wraps up in Toronto. The last meeting is in the mahogany-appointed boardroom of a venerable Bay Street brokerage, where they face a handful of traders in their 60s. When DeZwirek, Pollack and Sugarman walk in, they are offered tumblers of Scotch; it's 11 a.m. DeZwirek thinks, “These guys are never going to get it.” But he finds his skepticism is misplaced when the firm buys a “significant chunk” of Kaboose warrants (options that can be converted into shares when the company goes public).

By the end of May, DeZwirek and Pollack have raised \$4.6 million privately from institutional investors—not bad for three weeks' work—but they know that isn't enough. They'll have to look beyond these kinds of deals in order to raise the money they need to grow Kaboose. The question is, where do they go next?

As the advisers at GMP lay it out for them, the company has three options: a traditional initial public offering, a reverse takeover or a merger with a capital pool company. The first choice holds little appeal for them because IPOs are expensive, laborious and time-consuming. In a reverse takeover, Kaboose would acquire the shares of a bankrupt public company, but this approach seems more suited to resource exploration firms looking for tax writeoffs than to a new media company needing capital. DeZwirek and Pollack decide their best hope is to merge with a publicly traded shell that's empty save for cash put up by professional investors. Capital pool companies (CPCs) go public solely on the strength of the directors' resumé's, with shares often selling in the 10- to 12-cent range. Usually, a CPC that

has gone public must merge with a private firm within a year. The merger turns the private company public, thus allowing the CPC directors to cash out immediately. In June, TSX officials provide DeZwirek with a list of CPCs looking for partners. He and Pollack interview the directors of five of them, to find out whether there is a fit and what the terms of a potential deal might look like. They especially want to know how much Kaboose stock the CPC directors will demand and how quickly they intend to exit the business.

Their search leads them to Murray Sinclair, the managing director of Vancouver merchant bank Quest Capital Corp. and an investor in numerous resource companies. Earlier in the year, Sinclair had set up Iron Springs Capital Corp. as a CPC. The company went public on the TSX Venture Exchange in July, 2005, selling enough 25-cent shares to raise \$300,000 on the strength of Sinclair's track record for finding private firms with great prospects.

Through the dying days of the summer and into the start of fall, DeZwirek, Pollack and Kaboose president Jonathan Graff hammer out an agreement with Sinclair that will allow Iron Springs to merge with Kaboose by November. It's an all-consuming job, with Pollack spending 80% of his time sorting through the minutiae. Because this is not a traditional IPO, Kaboose doesn't have to file a preliminary prospectus with the Ontario Securities Commission, but it does have to prepare a 232-page information circular for shareholders of Iron Springs and Kaboose. The process involves multiple drafts, revisions and extensive scrutiny from both lawyers and accountants. "It is the marketing document for the company," explains Paul Pew. "You have to spend a lot of time on it."

While they're preparing the disclosure documents, Pollack starts readying Kaboose's finance and accounting department for the rigours of the public reporting process. Since the deal is taking place in the post-Enron era, the money side of Kaboose's operations will come under intense scrutiny, and its tax reporting policies and internal control systems must be in perfect order. Pollack will also have to gear up to generate quarterly financial statements, which means he needs to increase the size of his finance department, from one accountant to seven.

At the same time, DeZwirek, Pollack and Graff begin briefing the employees about the stringent regulatory environment they are about to enter. They run training sessions explaining unfamiliar practices, such as confidentiality about new developments at the company and rules governing insider trading. Including the legal and accounting fees, the process will cost almost \$300,000.

Late in the fall, DeZwirek and Pollack head out for their second North American road show of the year. Now that Kaboose is prepping for its public debut, the stakes are much higher.

GMP is also expecting more than just an elaborate sales pitch from DeZwirek and Pollack. The investment bankers need to get a read on how big the demand for Kaboose's stock will be, and the price investors will be willing to pay. In Pew's experience, most issuers—and especially upstart firms still run by their founders—think their company is worth far more than the markets do. But much depends on the initial pricing as well as the timing of the deal. "You can have all the elements, but if the timing isn't right, then it's not going to fly, no matter what qualitative and quantitative advantages a company has."

Still, DeZwirek and his team are very bullish about Kaboose, and they have good reason to feel upbeat, given the upsurge in investor interest in online media plays. They remind prospective investors that News Corp. CEO Rupert Murdoch recently paid \$580 million (U.S.) for the online firm that owned social networking site MySpace. Their message: They need lots of cash on hand so they can move quickly if a target firm comes up for sale.

D-Day is November 25, the moment when Kaboose's shares finally go on sale to the public through the TSX Venture Exchange. The Kaboose/GMP team has spent the preceding month lining up a syndicate of brokers that has agreed to sell \$10 million worth of Kaboose shares at a dollar apiece. The windfall transforms the company's balance sheet. Compared with 2004, Kaboose's working capital has increased sixfold, to \$12 million. For several weeks after the stock offering, the shares hover in the \$1 range—and then, much to everyone's delight, they start to climb.

But the Kaboose team can't relax for long. As planned, Murray Sinclair and one other Iron Springs director resign from Kaboose's five-member board, opening up two pivotal positions that will need to be filled.

Governance is a very big deal now, and small firms that go public often find themselves needing to fill empty spaces on their board. There's no off-the-shelf formula for finding good directors. Securities lawyers, outside auditors and investment bankers can propose candidates from various backgrounds, but these days, everyone's looking for number crunchers who can read a financial statement and won't snooze through audit committee sessions.

DeZwirek approaches a CA named Bernard Kraft to serve as the audit chair. His family has known Kraft through other business ventures, and he fits the bill: A director with a gold mining firm and a Toronto real estate company, Kraft has a track record not just with accounting but also forensics and commercial valuation—perfect for a company like Kaboose that will be looking to spend its new-found capital on acquisitions.

As DeZwirek expected, it doesn't take long for acquisition opportunities to present themselves. In December, he locks on to a big fish—a U.S.-based portal called BabyZone, North America's second-largest site for parents with newborns. Through online ad sales, it generated \$4.27 million (U.S.) in revenue in 2005, almost 70% more than in the previous year. What's more, BabyZone is actually turning a profit.

Unfortunately, though, BabyZone is selling for much more money than Kaboose has on hand, so DeZwirek and Pollack decide they need yet another infusion of capital. Behind the scenes, they begin working with TSX officials to have their stock “graduate” from the Venture Exchange—which is dominated by penny stocks, oil and gas exploration plays and R&D start-ups—to trade on the Big Board, alongside more established companies whose shares tend to be valued in dollars rather than in cents. The move becomes official in February, 2006, giving Kaboose the distinction of having made one of the fastest transitions of any newly traded company.

Thus repositioned to attract more committed investors, DeZwirek proposes a second public offering to his board. In June, 2006, the company issues a fresh batch of Kaboose shares, this time at \$1.40 apiece. The net proceeds—\$37.2 million—are

more than sufficient for Kaboose to snap up BabyZone for \$22 million (U.S.) and still have millions left over for future deals.

In May, 2006, only a year after that first meeting in GMP's boardroom, Kaboose has seen its revenue triple, to \$6.5 million, and its stock is hovering in the \$1.30-to-\$1.40 range. Despite the acquisitions and revenue growth, however, the company is still in the red, posting a \$1.5-million loss for the second quarter of 2006.

Kaboose has emerged from this complex campaign better positioned to survive on a playing field dominated by giants like Disney. As of late 2006, the company's market capitalization is \$140 million—almost four times higher than its worth when Kaboose and Iron Springs merged. But for DeZwirek, the journey wasn't just about leverage and money. He has learned that running a public company means, above all, answering to shareholders and the investment community. There's nowhere to hide. He also knows that the key to surviving in this glass house is to always under-promise and over-deliver. These days, he has the air of a battle-tested veteran, displaying the thick-skinned worldliness that goes with the job of running a company whose once-private business dealings are now available for all to see. "Don't assume that everyone is going to love your business," he counsels, "and don't be offended by it."

Accompanying Sidebar Article

## **DO YOU REALLY WANT TO GO PUBLIC?**

Going public isn't for everyone. It's certainly not a solution for entrepreneurs looking to cash out quickly. While the rules vary depending on the size of the issuer, company principals must put their shares in escrow for anywhere from 18 months to three years after going public on the TSX. If the goal is to sell your business, you're better off approaching a merchant bank or a private equity firm that can connect you with buyers.

But if you're looking for access to capital or an increase in your company's value, Justin Beber, a corporate securities lawyer at Goodmans LLP in Toronto, says going public is often the best route. Other benefits include enhanced liquidity for existing shareholders; the option of using stock in future acquisitions; and employee incentives that go beyond a salary.

On the downside, Beber warns that a public company has to contend with a loss of confidentiality due to disclosure rules; constant pressure to focus on quarterly results and the share price; a loss of control due to the dilution of shares; the challenges of recruiting experienced corporate directors who aren't connected to the company's principals; the risk of hostile takeover; and the ongoing administrative cost of complying with securities rules.

If so, get ready to pay

Going public can bring in truckloads of money, but getting there will take a hefty bite out of the corporate treasury. Jeffrey Dyke, a Calgary-based securities lawyer with Gowlings, says small deals—for instance, a \$2-million merger with a publicly traded shell company—usually trigger a 10% commission for the investment dealer. With initial public offerings that exceed \$10 million, the rate drops to 6% to 7%.

Then there's the hype budget. A typical two- to three-week road show can cost up to \$500,000, depending on the complexity of the deal. “For a little company, it seems like a lot at first,” says Trish Moran, a Toronto-based investor relations consultant. “But you've got to do it right. You've got only one chance to go public, and you don't want to blow it.”

As for the legal fees (which vary widely across Canada, but can hit \$300 an hour), a standard reverse takeover or CPC deal will eat up roughly 200 billable hours. For IPOs, due diligence by securities regulators will ensure the legal team clocks at least 300 hours of work. That's \$60,000 to \$90,000 right there. In the case of reverse takeovers and CPCs, both the shell company and the target firm require lawyers, resulting in an additional \$50,000 to \$75,000 on each side of the deal.

It all adds up to a pretty hefty outlay—not just for the professional fees, but for the time the company's management spends working through the fine print. But as Kaboose chief executive Jason DeZwirek says, there's no point in skimping. “A lot of people get focused on the dollars and cents, and they don't realize that these are investments in the company.”

## The art of the pitch

When you're trying to get your ideas in front of investors, a great personal reference always beats a good business plan. Once you're in the door, however, you need to know your plan inside and out, and be able to sell it convincingly. Ron Dizy, a partner at Celtic House, an Ottawa-based firm that specializes in funding early-stage investments in high-tech companies, advises entrepreneurs to be clear on the details before even thinking of asking for money:

1. What is the niche in the market that you're going to fill? It's surprising how often people can't clearly define why they started their company.
2. Why does this niche exist, and is there a reason someone else hasn't already filled it? This gives you the chance to demonstrate your understanding of the competitive dynamics in your industry—a.k.a. “the food chain.”
3. Why will your team succeed? You need to demonstrate how and why you can build sustainable barriers to entry. And, by the way, it is almost always a team that will get investors' attention, rather than an individual, because founding teams tend to outperform individuals.
4. Know these three things: How much money will you need? When will you begin to generate revenue? And when will you be in the black? You should be aggressive in your assumptions, but not ludicrously so. And you must not only know the numbers cold but also be clear on the assumptions that underlie them. On what have you based your cost estimates? Why the increase in R&D in year three? Investors will assume that your business plan is wrong (and it probably will be). But your job is to demonstrate that you have a realistic understanding of what it takes to grow a business.