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THE STONEWOOD PERSPECTIVE

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StoneWood Interview Series

The Plight of the Canadian Small Cap
An Interview with Stephen Sorocky, CEO of Virtek Vision

In January, Stephen Sorocky was appointed CEO of Waterloo, Ontario-based Virtek Vision. Fresh from a successful turnaround of a small VC-backed Toronto-based instrument company, Stephen brought a breadth of experience developed at firms such as EDS and Spar Aerospace where he rose to run one of the firm's most successful divisions.

Virtek Vision is a $53mm per year technology spinout founded years earlier by two University of Waterloo professors. Publicly traded on the TSX, the firm's performance had been uneven and its stock had steadily declined from a high of $7.00 per share several years earlier to a low of under $0.40 when Stephen joined the firm. The Board of Directors gave Stephen a strong mandate to quickly identify the firm's underlying challenges, recommend sweeping changes, and drive the firm to consistent revenue and earnings growth.

Events of the ensuing six months however caught everyone by surprise and took the firm down an altogether different path of hostile takeover attempt, restructuring and eventual sale to NYSE - listed Gerber Scientific of Connecticut.

StoneWood Group's Bob Hebert sat down with Stephen Sorocky to discuss the lessons which Virtek Vision holds for all small-cap publicly traded companies.

What were the circumstances around you being hired as CEO?

I was hired by the board to make some hard decisions in a firm that was struggling to find its way.

The company had two businesses. The first was a laser imaging and templating business which was profitable but considered low growth. The other was a laser marking and engraving business. This was initially an investment made in a German-based entity which was subsequently bought outright. The business was considered high potential though it continued to lose money.

Virtek lacked a strategy. Virtek had a history of inconsistent profitability. It also had a tendency of moving in and out of businesses. Some of these, such as a biotech venture they pursued several years ago, were considered initially as exciting and high growth, only to subsequently falter and be sold. The stock price had mirrored these ups and downs, having been as high as $7.00 per share during the biotech euphoria and languishing at around $0.40 per share when I arrived. To make matters worse, the firm had raised additional funds the year before at $0.85 per share and a lot of shareholders were not happy.

What did you find on arriving at the firm?

I arrived in January of this year and in short order observed two major themes.

First, the company had no discernible marketing or market strategy. It seemed that they would get in and out of businesses without spending a lot of time to really understand the business or the amount of money it was going to take to develop them or the markets they were addressing. It was opportunistic and haphazard.

Second, the company had a culture based on top-line revenue growth. To the best that I could figure it out, this started when they got into the biotech business. This was a period of some frenzy and euphoria. The stock shot up to $7.00 per share and everyone had big expectations of growth. To reward those expectations, there was a focus on top line revenue growth. People were compensated and even incented on sales and all the systems lined up behind. Even the CFO had his bonus when originally hired, if you can believe it, tied to top line growth.

The effect of this of course was that sales pursued contracts at any margins and solutions to every sales problem were framed in terms of pricing. Functions like engineering were driven by the opportunity de jour or short term win considerations. Managers did not have a set of metrics by which to justify long term investments and thus few were undertaken.

When I asked people to show me what reports they were using to manage the business there were very few used relating to G&A, or cost of goods. It was all about revenues. This is why profits were so inconsistent. Some years they did well while other years they got killed. It was guaranteed to always be a surprise.

This sales driven culture was not hard to identify and within six weeks I implemented a wholesale change to the compensation system of the whole management team. I introduced new financial metrics, and made sure the systems and incentives drove the appropriate behavior to move the company towards consistent profitability.

How did you deal with the marketing issue?

The marking and engraving business unit always loved to speak of their $3 billion addressable market. But there was no data or breakdown of segmentation by which to guide our growth. No one really understood where we fit into the overall marketplace and thus it was impossible to challenge assertions of how we were doing.

I engaged an outside firm to quickly segment the market for us. We articulated six profitable segments in which we had a presence and which had a 15% or greater growth rate. The $3 billion market became a $230mm market that was truly addressable by us today. We then aligned our sales force, our collateral, our product management to these markets where we could speak of clear competitive advantages. We were also then in a position to look longer term at adjacencies and growth opportunities.

The imaging and templating division was also operated on a set of assumptions. It was considered a division with limited growth potential and as a result being milked. But to me these assumptions were untested. The firm was primarily operating in the US market and many of its aerospace customers had or were in the process of shifting manufacturing offshore where we were simply not effectively pursuing business. It seemed to me that there was potentially a whole world of market opportunities that may have been untapped and so we started to look into how we might expand our market footprint through new sales initiatives and channels.

What happened next?

Between January and April we had done lot of the work to understand the business and set the stage for the turnaround. There was a board meeting scheduled for July and we were well underway to having developing a very attractive, very predictable growth plan for the company.

It should also be noted that we had also given some thought to the broader positioning of the company as a publicly traded entity. Small publicly traded companies like ours are often orphaned in the markets. We only had one analyst covering us and our trading volume averaged 20,000 shares per day. We were very illiquid. We needed to regain credibility by adding consistency to the business. Earnings quality was going to have to be established brick by brick and I knew we had the plan.

I was very excited. We were a company trading at $0.41 per share with $0.25 per share in cash alone and two pretty interesting businesses with a lot of potential. Some of the early changes we made would immediately stabilize the business and our plans going forward were reasonable and achievable.

But then things suddenly changed. Can you explain?

Did they ever! One of our investors happened to be at a conference and struck up a casual conversation with one of the speakers, the CEO of a company called StockerYale Inc. This was a US-based, publicly traded laser company which on the surface appeared to share similar challenges to our own company. The discussion was benign.

Shortly afterwards however, I received a visit from the CEO of that organization wanting to explore the possibilities of a friendly takeover. He spoke of the benefits of two small cap companies merging, the reduced costs of only having one public listing, the $100mm in revenues of the combined companies and the greater attention the firms would attract in the public markets.

As I began to think about this proposition and looked into the other firm I grew increasingly concerned. The firms were in unrelated segments of the laser businesses and there were few synergies that I could see. Plus, their firm was losing $5mm per quarter and it wasn't clear to me at all how they would even finance such a transaction. Finally, certain past legal proceedings against principals of the firm also gave me grave concern about the fit with our organization and people. The only thing that I knew for certain was that the $7mm we had in cash was tantalizing to this other company.

What happened next was also concerning. Someone began buying stock in the firm in volumes that were unusual. The stock began to move up and triggered attention. Though we could not tell or prove who was doing it, it seemed designed to force our hand in disclosing the casual expression of interest by StockerYale. That effectively put us into play.

What did the Board do?

The board announced the expression of interest and took the position that with $0.25 in cash, that Stocker's offer of $0.65 per share was a non-starter. Stocker Yale responded by initiating a hostile takeover bid for Virtek.

We now had 60 days to respond. We formed a special committee to consider the offer. We engaged an investment banker. Though it sounds unfair, one of my lessons from this whole process is that once advisors and investment bankers get involved it is hard to go down any other path than the sale of the business.

In any event, we began to look at our options. Perhaps we could dividend the cash, or buy-back shares or maybe sell the imaging and templating division. As we thought about it, this last option started to make a lot of sense. This was a profitable business which alone was likely more valuable than the offer that was made for the whole business. We could sell the business, use the money to buy-back stock through a substantial issuer bid, in the process bettering the StockerYale bid. It would also leave us with a pure play in the laser marking and engraving business which would focus our business on a high growth market and was encouraged by a number of our investors. Everyone would benefit.

Our investment bankers found two potential buyers. The first was MiTek which was a customer of ours and a subsidiary of Berkshire Hathaway. The other was Gerber Scientific. In the final analysis MiTek won with a bid of $25mm. We were quite excited for in a short period of time we had gone from a $14mm market cap to $32mm in cash plus a pure play business to go forth. This was about $0.94 per share. We also reached agreement with Royal Capital to invest a further $3mm in support of the growth of the M&E business.

But before we had the required meeting with Shareholders to approve the deal, Gerber called back and said that since they had lost the bidding for the one division, they would now like to buy the whole company at $1.05 per share. MiTek declined their option to match the bid when they learned that it was Gerber and not a competitor of theirs. They could still have access to our products as they had up until now with our current relationship. Ultimately over 93% of Virtek's shareholders tendered their shares in November to the Board supported offer by Gerber.

What are the lessons you take away from this?

First, it is important to communicate, no let me say over-communicate with your shareholders. We had a company worth a lot more than it was valued. But past management had lost the shareholders confidence and thus they were willing to respond favorably to the short term liquidity opportunity and value increase from an offer that they might otherwise have summarily dismissed.

I was a new CEO and though I could see the possibilities four months was not sufficient time to show the results of my plan and earn shareholder confidence and we paid for that in the final analysis.

What else?

Well, I realize now that our situation was somewhat predictable and that we should have anticipated it. I do not mean that the ultimate outcome was predictable but rather that an illiquid company trading at $0.41 that had $0.25 in cash was vulnerable. We should have talked about the various scenarios that might come to pass. We should have had advanced defensive plans in place, a team ready in the wings, and a set of contingencies in the event that things went offside and we faced the short timelines and constraints of a publicly traded company. Once an offer is tabled, a whole range of options is taken off the table as you have to respond as per the regulatory rules.

I would even say this applies to a VC-backed company which is what I managed before joining Virtek. These are unusual times in that community and if I were running a startup with $8 or $10mm sitting in the bank from previous rounds, I would be very careful. The rules of engagement could all come crashing down as investors scramble to deal with a bunch of issues such as the need for liquidity and the limited opportunities to realize upon their investments in today's economic environment.

Another observation pertains to the Board of Directors. We had an effective board with a good chairman who facilitated the whole process and a number of Board members who had experience in takeovers. I would advise companies to make sure that they have someone on their board with experience in M&A situations and who can bring a steady hand to the proceedings.

Finally, I would suggest that companies select their advisors very carefully. Be careful what you write down as the objectives for an investment banker. Ensure that they are incented and paid in line with objectives of the Board and shareholders appropriate to opportunities present and constraints in a given situation. If it is transactions that they are paid most generously for then you can reasonably predict that you are going to see a transaction of some sort.

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