



## EDITORIAL

# FIGHTING THE LAST WAR?

HISTORY FREQUENTLY DERIDES GENERALS for "re-fighting the last war"; in other words, being so committed to strategies that worked in the past that they are blindsided by a new technology, a new approach, or some other unforeseen event. With the turmoil that's currently rocking Wall Street, there are a few music industry "generals" who may be in danger of clinging to a financial strategy that seems to have outlasted its usefulness.

To sum up, this strategy involves two basic steps. Step one involves either borrowing large sums to buy a business or prevailing on venture capitalists for chunks of "no strings attached" money to fund an ambitious expansion plan. Then in step two, when financial results start looking halfway decent, the company sells shares to the public. Everyone wins: The venture capitalists or lenders get their initial investment back—plus some equity in a going concern, managers of the business are enriched with a significant ownership stake, and the business itself ends up on solid financial footings with a decent balance sheet.

This strategy has been well executed in the music products industry on numerous occasions. In the early '80s, Dr. Sidney Harman borrowed heavily to buy JBL Sound and a host of other audio companies from the conglomerate Beatrice Foods. A few years later he took Harman International public, used stock proceeds to bring debt levels down to a reasonable level, and laid the foundation for a successful company. More recently, investment bankers Dana Messina and Kyle Kirkland used the same approach in buying The Selmer Company and Steinway & Sons. In possibly the most talked-about deal of the last decade, Guitar Center management borrowed \$115 million to buy out majority shareholder Ray Scherr. A year later management successfully sold stock to the public, retired much of the debt, and stepped up expansion plans.

All across the country retailers are intently watching the roller-coaster gyrations of the Dow Jones index, wondering whether it will crimp consumer confidence and have an impact at the cash register. In the music industry, however, the stock market's biggest impact may not occur at the consumer level. William

Dunkelberg of the National Federation of Independent Business summed up, "With the investment portfolios of people who back startups plummeting in value, these so-called 'angels' don't feel as angelic."

For over a century, music products retailers have relied on three basic sources to finance their expansion: retained earnings, bank credit, and whatever terms they could wrest from their suppliers. There's nothing inherently wrong with this type of financing, but it does put a limit on how fast a business can expand. Last year MARS Music, a company with substantial losses and a promising retail concept, rewrote history when it secured \$20-plus million in venture capital. This "no strings attached" capital infusion allowed MARS to open stores at an unprecedented pace without having to worry about niggling issues like net worth covenants or personal guarantees to a bank.

Now that investors have apparently had their fill of new stock offerings, a number of important questions arise. Will companies like MARS be able to execute the "two-step" strategy anytime soon? In the absence of a clearly defined exit strategy, will "angels" continue to generously dole out capital? Secondly, if venture capital dries up and these companies have to rely on financing through banks, retained earnings, and supplier credit, will they be able to expand as rapidly?

We don't presume to have the answers to these questions; however, the prevailing opinion on Wall Street suggests that ambitious entrepreneurs are going to have to find new ways to finance growth. As reported elsewhere in this issue, an investment banker from Morgan Stanley recently declared in the *Wall Street Journal* that "The IPO (initial public offering) market is dead!" Put another way, the "two step," which worked so well in the past, may be a grand battle plan left over from the last war.

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