Give My Regrets to Wall Street

by Mark L. Frigo and Joel Litman

Increased public scrutiny, decreased stock-option appeal, and the relentless expectations of Wall Street are taking their toll on a once high-flying consultancy. Is going private the way out?

Kenneth Charles and Matthew Phair sat on opposite sides of the conference room table, scratching away on their legal pads. As one voice after another leaked from the starfish-shaped phone, Matthew, the CFO of First Rangeway Consulting, took copious notes. Kenneth, the CEO, energetically doodled animals, as he often did when alone or with close associates. "During a conference call, no one can tell that you're drawing a dog," he liked to say, beaming approval on those who got the joke.

Doodling helped Ken focus, and his pen skittered across the paper as he listened to Victoria Michaels, a top-ranked sell-side analyst covering professional services stocks. Victoria was commending First Rangeway for its cost-control work and consequent increase in earnings. "But revenues are still flat quarter over quarter," she went on in a clipped voice that just missed being an English accent. "When and from where do you see revenue growth, and at what levels?"

"You know, Victoria, we've been holding client projects steady over the past year," Ken replied. "But proposal activity and engagement types point to an uptick next quarter, when corporate spending for our services should really kick in."

"We've already seen signs that we'll easily reach the targets we mentioned earlier," added Matt, jotting a number in the margin and drawing a box around it. "To reiterate, we stated a 10% quarter-over-quarter increase beginning next quarter."

The next question, from Kevin Danville of LRL Investments, was tougher. "Could you comment on how fruitful the business process outsourcing space might be over and above traditional consulting revenues?" Kevin asked, as

HBR's cases, which are fictional, present common managerial dilemmas and offer concrete solutions from experts.

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Going private is an attractive scenario for First Rangeway, assuming that it is able to raise the necessary cash. (Charlie Gremley, the investment banker, sounds optimistic on that score.) A number of factors support that judgment.

As Ken has clearly discovered, it is easier to manage important decisions when you are not under public scrutiny. Private companies worry about profits, of course, but the pressure surrounding quarterly reporting is obviously hurting First Rangeway's customers. It has also begun to take its toll on employees, who are working long hours and complaining about burnout. The analyst calls are creating stress for management and are proving a distraction from the company's core business.

In addition, the impact of new legislation and reporting requirements on a company of this size is enormous. I would estimate that it costs First Rangeway somewhere between $250,000 and $1 million a year to remain public.

The stock price for a relatively small technology consulting firm such as First Rangeway is also likely to be very volatile in the future, and that may cause major financial and business disruptions. It's not surprising that many of Ken's best people were lured to First Rangeway by stock options. Options, as we know, are great when employees think their value is going to rise. But if it doesn't, they are likely to become discouraged. In considering whether or not to stay public, Ken should worry not only about attracting the new talent he needs to drive the business but also about retaining the talent he already has.

Finally, the leadership team doesn't seem to be chomping at the bit over the prospect of mergers or acquisitions, so First Rangeway is under little pressure to use its stock as currency.

If First Rangeway does decide to privatize, however, it will need to feel secure about its profits as it goes forward. The company is going to have to raise a couple hundred million dollars in financing – presumably in debt financing – and that will have an interest cost. If the company's profits exceed that interest cost, then the difference will flow directly to First Rangeway's partners or private equity holders. But if there are no profits, or if cash flow is not sufficient to make the principal and the interest payments, it will put a tremendous burden on the company. Analysts can and do get angry over poor performance, and Ken is understandably concerned about that. But private debt holders can put you out of business.

The final deciding factor in this scenario is First Rangeway's board. I believe that the board will support a privatization strategy if such a strategy makes sense from both an economic and a business standpoint. Its members have a fiduciary responsibility to do what is in the best interests of the shareholders, and Ken can make a strong case that, because of the volatility of the market and the industry, it is in the shareholders' best interests to be bought out. If Ken is convincing on that point, even Nancy Westview, the board member who strongly advocates that First Rangeway remain public (and whose opinions may not be representative of those of the other members), will be unable to effectively object to the company pursuing a privatization strategy.

First Rangeway Consulting could undoubtedly continue to operate as a public company, and Ken and Matt still need to run some economic models and draw up their own list of pros and cons before making any critical decisions. But if I were in their shoes, I would soon begin the push toward going private.