

Fall 2004

## KLINE HAWKES TEAM:

Frank Kline	Managing Partner
Jay Ferguson	Partner
Nick Memmo	Partner
Klaus Koch	Partner
Alain Rothstein	Principal
Ron Saxena	Associate
Peter Ivory	Special Venture Partner
Leslie Shaw	Chief Financial Officer
Kim Magnin	Director of Finance
Cameron Wood	Director of Operations

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## Kline Hawkes Opens a New Chapter

Firm goes to market with Kline Hawkes III

Welcome to our special tenth anniversary edition of the Kline Hawkes newsletter. Frank R. Kline received his first commitment from our largest institutional investor, the California Public Employees' Retirement System (CalPERS) in November 1994 at which time Kline Hawkes & Co. was born. As this newsletter will attest we have learned much and put in many long hours since those early days and have profited greatly from our experience and hard work. In this issue of our newsletter are articles that cover just about every facet of private equity investing including the story of our recent investment in O2 Science, the growth story of one of our fast paced portfolio companies - CaseStack, the sale of a company in an article about UFO, and the story on Sensor Systems which profiles a recent liquidity event. As Kline Hawkes Pacific approaches the end of its investment cycle with over 70% of its capital invested or committed, the Partners are on the road, beginning in September, with the fund raising effort for Kline Hawkes III, L.P. More details on our latest fund and other developments can be found in this issue of the Kline Hawkes newsletter.

## Kline Hawkes III

Latest fund seeks to raise \$300 million

September will mark the beginning of a new fund raising initiative for Kline Hawkes III, L.P., the firm's third private equity investment partnership to date. The Fund is being established to lead late-stage venture, expansion stage private equity, and small company change of control opportunities. The Partnership will invest in established companies with enterprise values ranging from \$10 million to \$75 million. The Partnership is seeking \$300 million in capital commitments from qualified investors to pursue superior investment returns in excess of 30%. The general partner of the Partnership will be Kline Hawkes III Advisors, LLC, a Delaware limited liability company.

Kline Hawkes III's targeted investment strategy is based on a combination of (i) its partners' proven track record over multiple funds focusing on growth equity and small change of control opportunities, (ii) the untapped pool of small companies with limited access to traditional equity and debt markets seeking expansion growth capital, (iii) an increase in opportunities to recapitalize businesses to fund inter-generational transfers, and (iv) attractive valuations relative to middle market and large companies. Kline Hawkes continues to believe that the outlook for late-stage venture, expansion stage equity and small company change of control situations is extremely favorable. The Partnership will use the same investment strategy as in previous funds and will attempt to control significant equity ownership positions.

The principal owners and members of the General Partner are Frank R. Kline, Joseph E. Ferguson, Nicholas C. Memmo and Klaus E. Koch ("the Managing Members") and will be supported by its Board of Directors, which will include Stephen D. Weinroth and Thomas S. Volpe. The Partnership will be managed by Kline Hawkes' seven investment professionals. The Firm's Managing Members and investment professionals are a cohesive and experienced team that has worked together for many years. The Managing Members, each with over ten years of experience in investment banking and private equity, have successfully managed multiple funds dating back to 1981. Through these multiple funds, a total of

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**CaseStack, Inc.**  
Stacking up the customers

Santa Monica based CaseStack, Inc. initially caught Kline Hawkes' attention because of its solid management team and its potential to rapidly scale in the growing \$77 billion outsourced logistics services market. Twelve months into the deal, that potential is being realized across the board as CaseStack continues to amass new clients and forges key alliances with some of the biggest names in the industry.

Founded in August of 1999, this business process outsourcing company provides logistics services to mid-sized companies; delivering its proprietary supply chain management software via an Application Server Provider ("ASP") based platform. Led by Dan Sanker, the management team brings extensive industry experience from Procter & Gamble, Zebra Technologies, Nabisco, Consolidated Freightways, Dole Foods, and Lucent Technologies. The Company's advanced transportation and warehousing system provides end-to-end fulfillment services that enable clients to reap the benefits and economies of a sophisticated, global logistics system - without all the infrastructure investment.

In the consumer packaged goods (CPG) industry, a company's competitive edge is increasingly determined by its supply chain strategy. As CPG businesses grow, logistics functions become increasingly complex, draining companies of capital and manpower. CaseStack's solution enables clients to use one source for all their global logistics services and consolidate shipments with those of other manufacturers.

Mid-sized clients like Lea & Perrins, Sunsweet Growers, Hain Celestial Seasons, Marie Callender's and about 500 others have embraced the CaseStack Solution as a more efficient and effective way to get their products to their customers (i.e. retailers, wholesalers, and distributors). Worcester'shire sauce manufacturer, Lea & Perrins is one of those mid-sized clients that lacks the critical mass to run its own logistics operations. Mark Graham, the company's supply chain manager described their experiences prior to CaseStack, "We were working with five independent distribution centers and they were all working independently. To do anything we had to make five separate phone calls and arrangements. Moving to the CaseStack system was a wise move on our part." Graham also states that CaseStack's consolidation programs can save them money by enabling them to "ship at full truckload rates," instead of costly less-than-truckload rates. In addition, since Lea & Perrins' SAP system is integrated into the CaseStack ASP platform, Lea & Perrins' management is making real-time decisions about inventory, production, and customer service.

Sunsweet Growers wanted to improve visibility into its supply chain and shave expenses as its products moved from manufacturing plant to warehouses to supermarkets. According to Sunsweet's customer service manager, Daniel Fisher, they considered an SAP tool that would have cost "hundreds of thousands of dollars." Instead, it turned to CaseStack. CaseStack has nationwide relationships with warehouses and freight haulers, and it schedules warehousing and shipping services for Sunsweet via its software platform.

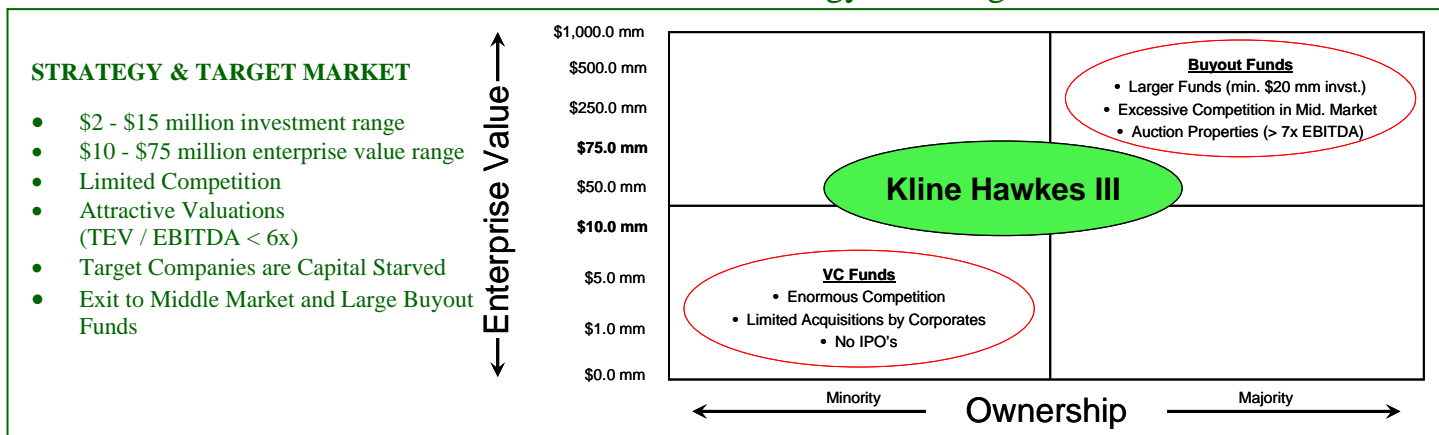
Success like this is driving growth; since Kline Hawkes invested in July 2003, CaseStack has built up its clientele by over 78% - to 495 companies. Year over year revenues have increased approximately 72% while CaseStack's margins have continued to improve as it gains critical mass. In fact, Dun & Bradstreet ranked CaseStack the 30<sup>th</sup> fastest growing new company in America, as reported in the June 2004 issue of Entrepreneur Magazine. In addition, CaseStack's growth has recently been recognized by Inc Magazine, LA Business Journal, and the Deloitte Technology Fast 50.

If those numbers aren't proof enough of CaseStack's impact on the outsourced logistics industry, Wal-Mart provided further evidence of CaseStack's growing presence when the two companies formed an alliance last year. Today, CaseStack consolidates product out of its warehouses from multiple mid-sized manufacturers and utilizes its technology to determine the best way to get that product mix on full truck-loads to Wal-Mart's distribution centers. CaseStack already ships over two million pounds of products into Wal-Mart per month, and the program is growing by about 40% per month by offering industry-leading cost-savings for shipments for Wal-Mart vendors.

"The Management Team has built a highly scalable business that brings a new level of efficiency and cost savings to a traditionally manual and inefficient industry", remarked Kline Hawkes Principal and CaseStack board member, Alain Rothstein. "While the logistics function is pivotal to all CPG manufacturers, most mid-sized companies don't have the necessary resources to accurately and cost effectively manage the process. The bottom line is that CaseStack enables its customers to better compete with their larger competitors."

"Kline Hawkes has worked closely with us as we plot and continue to execute our growth strategy", noted Dan Sanker, CaseStack's CEO. "They've provided us with ongoing strategic guidance and made some high-level introductions to exciting prospects we soon hope to convert into clients."

## Kline Hawkes III Investment Strategy and Target Market





### Cogent Acquires UFO

Sale marks 4<sup>th</sup> acquisition for the year



On August 12, 2004 Cogent Communications (Amex: COI), a multinational Tier One, optical Internet service provider, announced the acquisition of Kline Hawkes portfolio company, Unlimited Fiber Optics (UFO) in an all stock transaction. The transaction marked the successful conclusion to an initiative that was begun in November, 2003 when Broadmark Capital was engaged to review various strategic alternatives.

Broadmark was able to draw interest from four strategic buyers, one of whom came close to inking a deal that fell apart at the eleventh hour. Fortunately for Unlimited Fiber Optics, Cogent has been highly acquisitive of late and took no time to negotiate terms for an acquisition, successfully closing the transaction within three weeks. The purchase was the fourth in 2004 for the Washington D.C. based high speed Internet provider and its 10<sup>th</sup> acquisition overall, including the assets of PSINet, Inc.

According to Jay Ferguson, Kline Hawkes Partner and UFO board member, the sale of UFO was necessitated by the size of the fledgling company and intense consolidation within the industry. Jay noted that, "In terms of Unlimited Fiber Optics' customer base and their penetration in their initial markets of San Francisco and Los Angeles, the company had performed remarkably well to date. Some of their key customers include such household names as British Telecom, Cisco Systems, E! Entertainment, Electronic Arts, Kodak and Sony among others. However, in order to step up to the next level and generate \$20 to \$30 million in business, UFO needed access to more capital to broaden its market platform. The obvious solution was a sale to a strategic, such as Cogent."

Cogent plans to use the acquisition to further augment its Point-to-Point Layer 2 Transport services announced earlier this year in cities including: Chicago, Dallas, New York, Washington, D.C. and San Francisco.

### Kline Hawkes III *continued from page 1*

\$182.5 million has been invested in 60 companies yielding an average IRR of 40%. Over the past 20 years, including the recent economic downturn, venture capital investments have yielded an average of 15.7% return per year, according to Thomson Venture Economics.

As with the Managing Partners' prior funds, the Partnership will invest across a range of industry verticals including, but not limited to business services, manufacturing, information technology, and healthcare services. While the Partnership's investment strategy is opportunistic in nature, it will avoid specific industries that can be overly susceptible to unpredictable trends or do not match with the Partnership's investment experience, such as real estate, fashion, media, oil-gas, and entertainment.

For more information on Kline Hawkes III, L.P., please contact one of the Managing Members - Frank R. Kline, Joseph E. Ferguson, Nicholas C. Memmo or Klaus E. Koch.

## Kline Hawkes Investment Profile

*Kline Hawkes is a Los Angeles based private equity firm investing in growth capital transactions, as well as traditional buyouts, including MBOs, corporate divestitures and inter-generational transfers.*

#### Industry Focus:

Information Tech.	Business Services	Manufacturing
<ul style="list-style-type: none"> <li>• Telecommunications</li> <li>• Hardware/Infrastructure</li> <li>• Enterprise Software</li> </ul>	<ul style="list-style-type: none"> <li>• Business Process Outsourcing (billing, logistics, staffing, etc.)</li> <li>• Environmental</li> <li>• Healthcare Services</li> </ul>	<ul style="list-style-type: none"> <li>• Electronic Equipment</li> <li>• Aerospace/Defense Spin-offs</li> <li>• Industrial Products</li> </ul>

#### Geography:

Domestic focus with emphasis on western U.S.

#### Investment Parameters:

\$2 to \$15 million in equity  
Lead or co-lead  
Enterprise value range \$10 to \$75 million

#### Company Characteristics:

Private company or public company spin-off  
Revenues greater than \$5 million  
Management team with extensive industry expertise  
Profitable or trending towards profitability



## Sensor Systems, Inc. The crafting of a liquidity event

Sensor Systems is a software company that provides imagery analysis technology for satellite surveillance and medical diagnostics. In late 2001, as the United States began to prosecute the global war on terror, the company experienced an unprecedented demand for its imaging software. As sales escalated and margins improved, Kline Hawkes believed conditions were ripe for an exit from the Sterling, Virginia based company. CIBC was hired by the board to find a suitable buyer, but the only interested parties were large financial institutions that wanted to load onerous amounts of debt on Sensor Systems' balance sheet. Consequently, an alternative exit had to be devised that would satisfy both Sensor's management and investors alike.

Founded in 1993 by Steve Huff, Sensor Systems was first introduced to the firm by long time Kline Hawkes advisor and Sensor System investor James I. Valentine in October 1997. At the time, the company was testing a new medical imaging product called MEDx at the UCLA medical clinic, which it released shortly thereafter. This latest software development from Sensor introduced revolutionary medical advances, bringing functional MRI (fMRI) capabilities to the clinical environment for the first time. MEDx has since gone on to become the world's leading product for the visualization and analysis of advanced medical imaging applications and is in-stalled in over 400 of the world's leading medical re-search facilities and hospital centers.

By 1999 Sensor Systems was breaking new ground once again with the implementation of its RemoteView software. RemoteView is used to process imagery from new state of the art high resolution satellites such as IKONOS and provides an extensive range of features and capabilities that merge the technologies of raster based images and vector based geographic information systems. These new high resolution satellites produce images of the earth's surface at a ground resolution of one meter with unparalleled positional accuracy. Once again Sensor Systems' software solution came to dominate its target market. Initially, Sensor worked almost exclusively with the big defense contractors such as Lockheed Martin and Northrop Grumman. But Sensor's rapid growth can be largely attributed to the growing demand from federal agencies such as the Department of Defense, the U.S. Army and Marine Corps, the Defense Intelligence Agency and the Central Intelligence Agency.

### Sensor Systems' RemoteView displays one-meter resolution image of Washington D.C.



Since Sensor Systems satellite imagery technology comprises the core of Sensor's business, (making up 80% of the company's revenues), it was hoped that one of the defense companies could be a potential buyer. Judging by Sensor's recent performance and their successful penetration of the government market a sale was more than a possibility.

*“The manner in which Kline Hawkes negotiated the deal was indicative of investors who understand the big picture... I wouldn't hesitate to work with them again.”*  
Kirk Brown

Unfortunately, no defense contractor stepped forward to acquire the company. There was intense interest on behalf of five or six financial institutions, but none of their offers were palatable for Sensor's management. It was disappointing for all involved but not a surprising result as far as Kline Hawkes Managing Partner, Frank R. Kline was concerned. “The outcome of the Sensor Systems sale was typical in many ways for a company projecting to do around \$40 million in revenues in 2004. Sensor Systems certainly had an attractive growth story and significant profit-ability, but unless a business can be accretive to a large publicly traded company's earnings, it's hard for the likes of a Boeing or a Lockheed Martin to get interested. And that certainly proved to be the case. We still wanted to exit the company and so we had to come up with an alternative strategy, which was selling our piece back to management.”

As Kirk Brown, Sensor's COO explains the transaction, “We could appreciate Kline Hawkes' desire for a liquidity event given the fact that they'd been in the company for close to six years and the market conditions were so favorable. I believe that the deal we eventually struck was beneficial for everyone concerned. Upon closing, when all was said and done, Kline Hawkes looked to make a 39% return on their investment, while negotiating a warrant to protect their upside in case a large corporation did snap us up. For Sensor Systems' part, we were able to retain control of our own destiny and grow the company as we thought best, without drowning in debt. I truly can say the manner in which Kline Hawkes negotiated the deal was indicative of investors who understand the big picture. Frank and his team knew what they wanted but they weren't about to burn their bridges in order to achieve it. I wouldn't hesitate to work with them again.”

## O2 Science

After lengthy negotiations respiratory business can breathe easier



As a mid-sized private equity firm Kline Hawkes prides itself on its ability to create its own deals. Tempe Arizona based O2 Science is a prime example of a complex management buyout that required equal parts inspiration and perspiration - and considering it took seven months to close - a good dose of patience.

Formerly a subsidiary of DVI, Inc., O2 Science was first introduced to the firm by Kline Hawkes board member, Stephen Weinroth. O2 Science is a regional provider of respiratory services and home healthcare products, which includes the provisioning of oxygen equipment, sleep related equipment and respiratory mail order medications. The typical O2 Science customer is a former hospital patient with chronic lung disease, emphysema or a similar respiratory ailment. Upon being discharged from hospital, the patient is sent home on oxygen and will most likely remain on oxygen for the rest of their lives. At this point the patient's respiratory therapist or doctor will contact O2 Science and have them go into the patient's home to set them up with the appropriate oxygen products and services. At roughly 55% of their product mix O2 Science's home oxygen equipment and services offering comprises the largest portion of their business. Their fastest growing segment however is continuous positive airway pressure (CPAP) products and services for patients suffering from obstructive sleep apnea. The company's mail order medications deliver safe, convenient and accurate unit dose medications directly to patients in a timely manner, making up the last of O2 Sciences three main revenue streams.

Under the tutelage of CEO Mark Hanley - a 20 year industry veteran - O2 Science's revenues increased over 600% between 2000 and 2003 as the company expanded from four locations to sixteen; an exceptional performance for a company addressing a \$5 billion industry that is growing at approximately 12%. The prospects for O2 Science appeared bright until their parent company, DVI, Inc. filed for Chapter 11 bankruptcy protection. DVI, Inc. is an independent specialty finance company for healthcare providers worldwide. The Jamison Pennsylvania based firm extends loans and leases to finance the purchase of medical equipment throughout the world and offers lines of credit for working capital backed healthcare receivables in the United States. As soon as Mark Hanley learned of DVI's predicament he immediately set about raising capital to buy O2 Science out from the troubled parent.

### O2 Science's "RT" Cruisers



As Mark Hanley explains, "I didn't realize it at the time, but O2 Science was a particularly sought after investment. We must have talked to at least twenty private equity firms before finally settling on Kline Hawkes. I was impressed by Kline Hawkes' no nonsense straight forward approach and the manner in which they took a complicated and drawn out deal and kept it as simple as possible. We were also on the same page in respects to growing the company, once we took control. I'm glad I backed my instincts because, in hindsight, I don't think the deal would have closed without them."

Commenting on the deal Klaus Koch, Kline Hawkes Partner and O2 Science board member noted, "As soon as we were introduced to the opportunity we realized that Mark Hanley - who owned the O2 Science name and knew the business inside out - was the key to getting a deal done. Once Mark and O2 Science's senior management agreed to team with Kline Hawkes we knew that it would be just a matter of time before DVI would have to negotiate with us." Consequently, a deal was struck with Mark Hanley in November 2003 in which Kline Hawkes would sponsor a management buyout.

*“We must have talked to at least twenty private equity firms before finally settling on Kline Hawkes.... I'm glad I backed my instincts because, in hindsight, I don't think the deal would have closed without them.”*

Mark Hanley

It took some time but eventually the strategy paid off. Initially DVI hired an investment banker to sell the division on their behalf, but it soon became apparent that because of Mark Hanley's unique relationship with O2 Science, and due to his intimate knowledge of the service driven business, a deal could not get done without him at the table. The Kline Hawkes/O2 Science team first approached the parent company in December of 2003, and then reengaged DVI three months later with an offer to purchase the entire assets of the company minus its debts. By this stage DVI realized it was the best outcome they could hope for, given their perilous situation. All that was required was approval from the Bankruptcy judge overseeing the DVI reorganization which was given on May 11<sup>th</sup> 2004.

Looking forward, O2 Science is hoping to continue the rapid expansion it has achieved in the past three years with an eye to a sale to one of the large publicly traded companies. Two of the largest companies in the industry, Apria and Lincare, spent a combined \$243 million on respiratory businesses in 2003 alone. As he has done in the past, Mark Hanley has the utmost confidence he can successfully exit the business again. For its part, Kline Hawkes will do everything in its powers to make sure that deal also gets done.



AboveNet Communications, Inc.  
San Jose, CA  
Collocation facilities and services  
[www.abovenet.com](http://www.abovenet.com)  
*Acquired by Metromedia Fiber Network.*



Alta Healthcare System, LLC  
Santa Monica, CA  
Operator of acute care hospital chain  
*Sold September 2001*



Ascendent Telecommunications, Inc.  
Encino, CA  
Telecom equipment manufacturer  
[www.ascendenttelecom.com](http://www.ascendenttelecom.com)



CaseStack, Inc.  
Los Angeles, CA  
Outsourced transportation and warehousing logistics services  
[www.casestack.com](http://www.casestack.com)



Cogent Communications  
Washington, D.C.  
IP Networking Services  
[www.cogentco.com](http://www.cogentco.com)  
*Acquired UFO Communications*



Evant, Inc.  
San Francisco, CA  
Demand chain forecasting and replenishment solutions  
[www.evant.com](http://www.evant.com)



IP MobileNet, Inc.  
Irvine, CA  
Wireless data communications hardware and software  
[www.ipmobilenetinc.com](http://www.ipmobilenetinc.com)



LivHOME  
Los Angeles, CA  
Private-pay at-home healthcare services  
[www.livhome.com](http://www.livhome.com)



Micronet Technology, Inc.  
Irvine, CA  
Data storage technology  
[www.micronet.com](http://www.micronet.com)  
*Acquired by Ampex Corporation (ASE:AXC)*



National Water & Power  
Santa Ana, CA  
Utility billing software & services  
[www.nwpc.com](http://www.nwpc.com)



O2 Science  
Tempe, AZ  
Provider of respiratory services and home healthcare products  
[www.o2science.com](http://www.o2science.com)



Overture Services, Inc.  
(Formerly GoTo.com)  
Pasadena, CA  
Internet search  
[www.goto.com](http://www.goto.com)  
*(NASDAQ: OVER)*



PaeTec Communications, Inc.  
Fairport, NY  
Telecommunications service provider  
[www.paetec.com](http://www.paetec.com)  
*Acquired CampusLink*



Rent.com  
Santa Monica, CA  
Online apartment leasing services  
[www.rent.com](http://www.rent.com)



Sensor Systems, Inc.  
Sterling, VA  
Visual analysis software  
[www.sensor.com](http://www.sensor.com)



Transoft Networks, Inc.  
Santa Barbara, CA  
Fiber channel software  
[www.transoft.net](http://www.transoft.net)  
*Acquired by Hewlett Packard (NYSE: HPQ)*