THE GLOBE AND MAIL

Private investor takes cosmetics company to next level

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Deals with Canadian firms are being closed by large and sophisticated investors that, at first glance, seem to fall well below the revenue threshold usually required for a chat over lunch – never mind an acquisition.

Private equity and strategic buyers are dipping their nets into shallower waters and scooping up small companies. U.S. investors, in particular, are not waiting for businesses to grow organically because they recognize there's a risk they might attract the eye of a Canadian equivalent. Once a business has signed with a tier-one private equity firm or a strategic partner, there won't likely be room for another investor, unless it's at a significantly higher price.

Sophisticated investors have the experience, and the research and consumer data, to identify what might be tomorrow's stars, given some additional capital and oversight. The trick is to spot small businesses that already have a product with market leadership potential. The company must be able to replicate its efforts in multiple markets and address a highly specific customer need.

The founders and shareholders need to demonstrate they have the operational competence to take capital and use it to roll-out an expansion strategy. Lee Graff, founder and partner of Cover FX, a foundation cosmetics company, landed her investment partners through serendipity.

Ms. Graff was invited to lunch, under the impression she was meeting with the owner of a U.S. retail chain who was interested in carrying her cosmetics. She went over the Cover FX story for two hours. First, she talked about the specific customer need the company addressed – Ms. Graff had worked with a dermatologist for many years, mixing colour and textures onto patients' faces.

They each presented a unique and complex skin-coverage situation, such as port-stain birth marks, scarring, diseases, burns and redness. From these hours of looking at different skin tones under sunlight, dabbing on a variety of foundations, and getting frustrated by the process, Ms. Graff began to mix the Cover FX palate in her own kitchen with a chemist. Years of pleasing patients enabled her to develop a deep, customer-oriented culture where foundation needed to be better than "good enough."

Working with hundreds of men and women to match their foundation coverage needs helped her build enough expertise to please a dermatologist. Cover FX was on trend with customers wanting natural, high-quality cosmetics that are good for their skin.

First box checked: highly specific customer need.

Ms. Graff then brought on board one of the founders of MAC Cosmetics who delivered initial capital, chemical know-how and executive experience. To an outside investor, such a seasoned entrepreneur presented enormous market credibility.

Second box checked: Ms. Graff demonstrated that she knew how to work with a powerful and opinionated market leader.

Then she described how Cover-FX had grown with Shoppers Drug Mart, scaling up to supply a sophisticated chain store. Ms. Graff shifted Cover FX from being available only through an appointment with a dermatologist to being a product on a shelf in a retail chain. Cover FX had to shift its customer strategy so it hired a social media expert to build its online brand and used other guerilla marketing techniques, such as flash mobs, to build attention.

Ms. Graff explained to her lunch guest how Cover FX was operating in the Land of the Giants, going up against the likes of L'Oreal and its marketing budget, and surviving because people were loyal to their foundation provider.

Third box checked: Operational competence to scale up and operate across different markets.

By the time lunch ended, Ms. Graff's lunch partner revealed himself as a partner in a New York private equity firm. She was shocked but says: "I am glad I did not realize he was private equity as I would have been guarded."

The private equity firm made Ms. Graff an offer. She knew that for Cover FX to continue to grow, she needed to move beyond her bank and her original investors, who had fatigue from covering payroll and unexpected expenses. Private equity was willing to take the risks and put up the money for packaging and a website redesign.

Ms. Graff says the private equity firm wants her to build the business and it brings a range of skills her firm did not have. It introduced analytics to the culture and funded the systems updates and upgrades required. It was time to go to the next level and that required a great deal more financing than her partners were willing to put forward.

Ms. Graff says the hardest part for owners is to admit that someone else can run their business as well, if not better, than they can. "The brand went beyond me," Ms. Graff says. "I had to put my ego aside, and although I did not always like the decisions, it is okay.

"Cover FX is in Harrods and Harvey Nichols. Who knows how far it will go?"

The company is now selling in several countries, including through its website.

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