Section 3

Don’t Ride It Over the Top

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Exiting in Internet Time

- The internet has accelerated everything
- It allows entrepreneurs to market and sell to hundreds of millions of prospects in just days
- The internet has also accelerated almost every other aspect of the startup lifecycle
- Entrepreneurs now have “Weekenders” where they build entire companies in a weekend

Weekender Sold in 10 Days

- In 2009 when I wrote “Early Exits”
- I speculated that one day: “They’ll probably define an early exit as selling the company before the end of the weekender”
- That almost happened in November 2009
- A team of entrepreneurs in London built a business in one day and sold it online in ten days: www.24hour-startup.com <– great video
- Not an isolated example, see www.Flippa.com

More Exits In Just 2 – 3 Years

- Flickr sold for $30 million at 1.5 years old
- Delicious sold for $30+million 2 years from startup
- Club Penguin for $350 million at 2 years old
- YouTube sold for $1.6 billion at 2 years old
- Playfish sold for $275 million at 2 years old
- Mint sold for $170 million at 3 years old
- AdMob sold for $750 million at 3.5 years old

A B.C. Really Early Exit

- This Vancouver company asked me to keep their details confidential – for now
- They wanted to test the idea for their first product, so called on a medium-sized US corp
- The prospect soon asked to buy the company
- The CEO called me for help
- Three months later the money was in the bank
- Company was less than 12 months from startup and still hadn’t launched the first product

A New <u>Really Early</u> Exit

- Anyone heard of the company PumkinHead?
- How about their product - About.me?
- About.me was acquired by AOL
- Just four days after its public launch
- That may be a new record
- Better way to measure is from startup (= 1 year)
- This illustrates what experienced entrepreneurs and investors can accomplish in this market

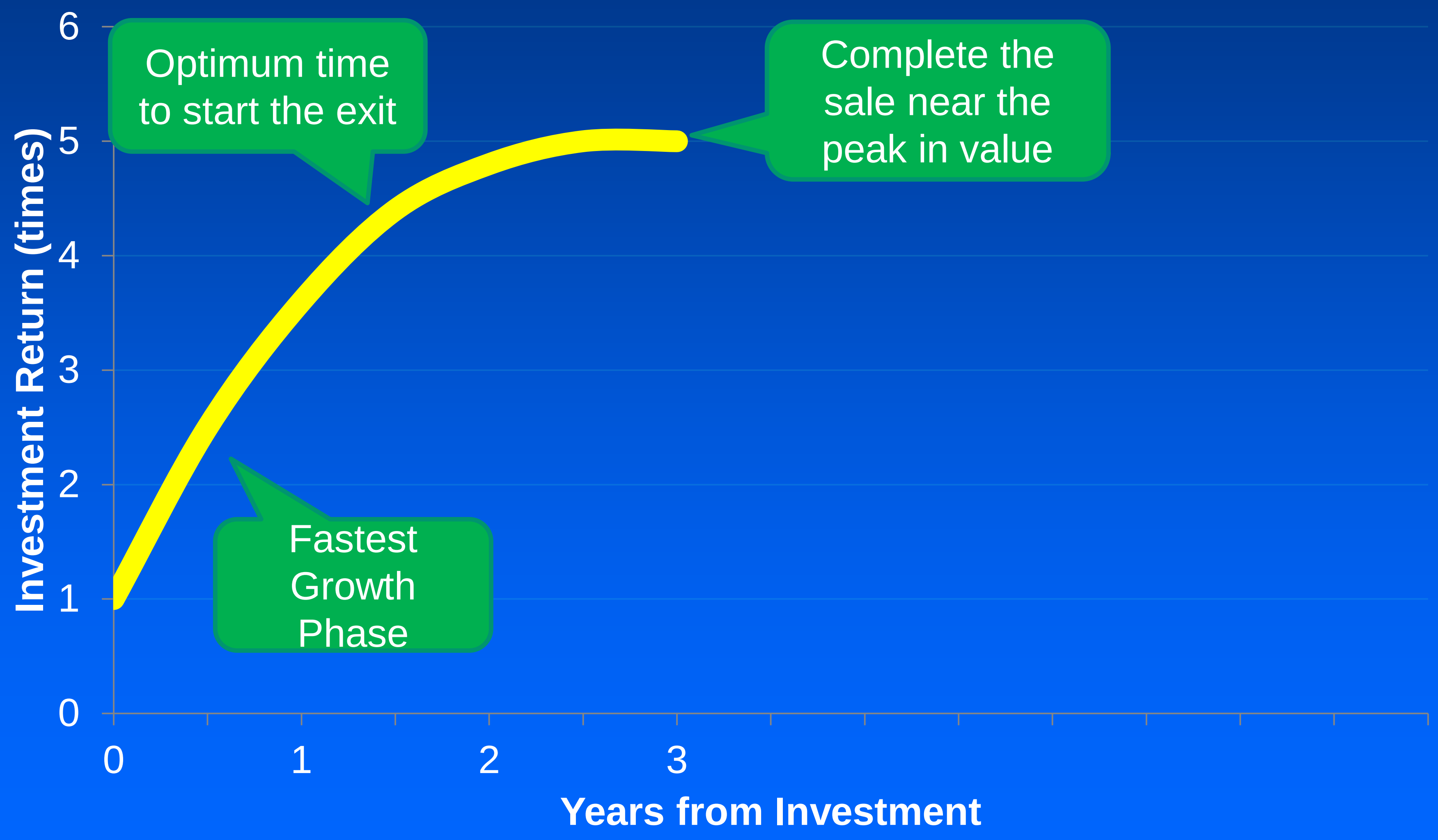
How Long It Takes to Exit

- The short answer is usually 6 to 18 months
- From the time you engage the M&A professionals
- Until the cash is in the bank
- But it can often take longer if the company isn’t ready, or if the structure needs to be cleaned up, or if the financials need improvement

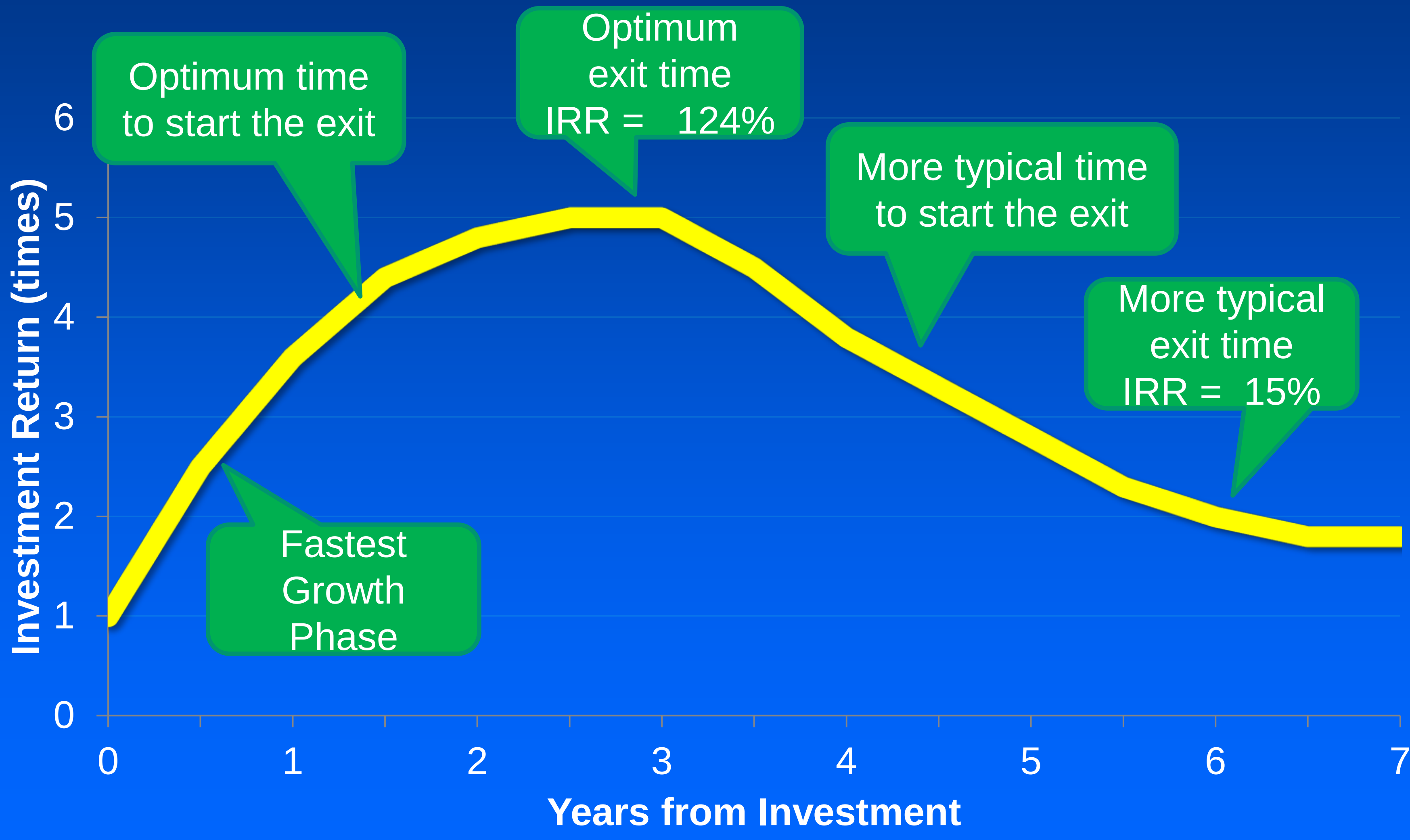
Ideal Exit Timing

- In an ideal situation, the company board would incorporate this 6 to 18 month delay
- Into the company strategic and operating plans
- Look forward in time and then start the exit
- 12 to 18 months before the peak in the company’s exit value

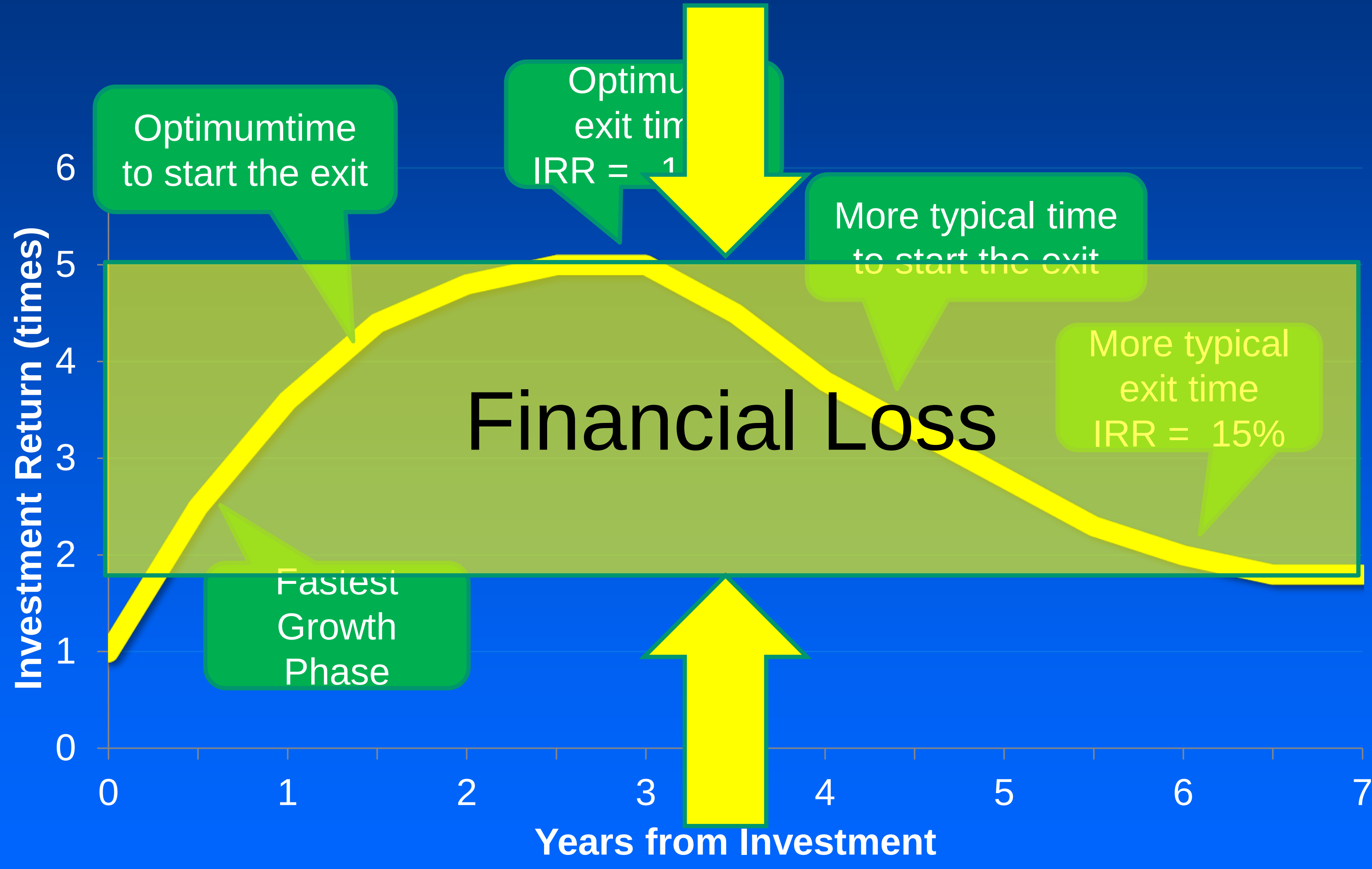
Ideal Exit Timing



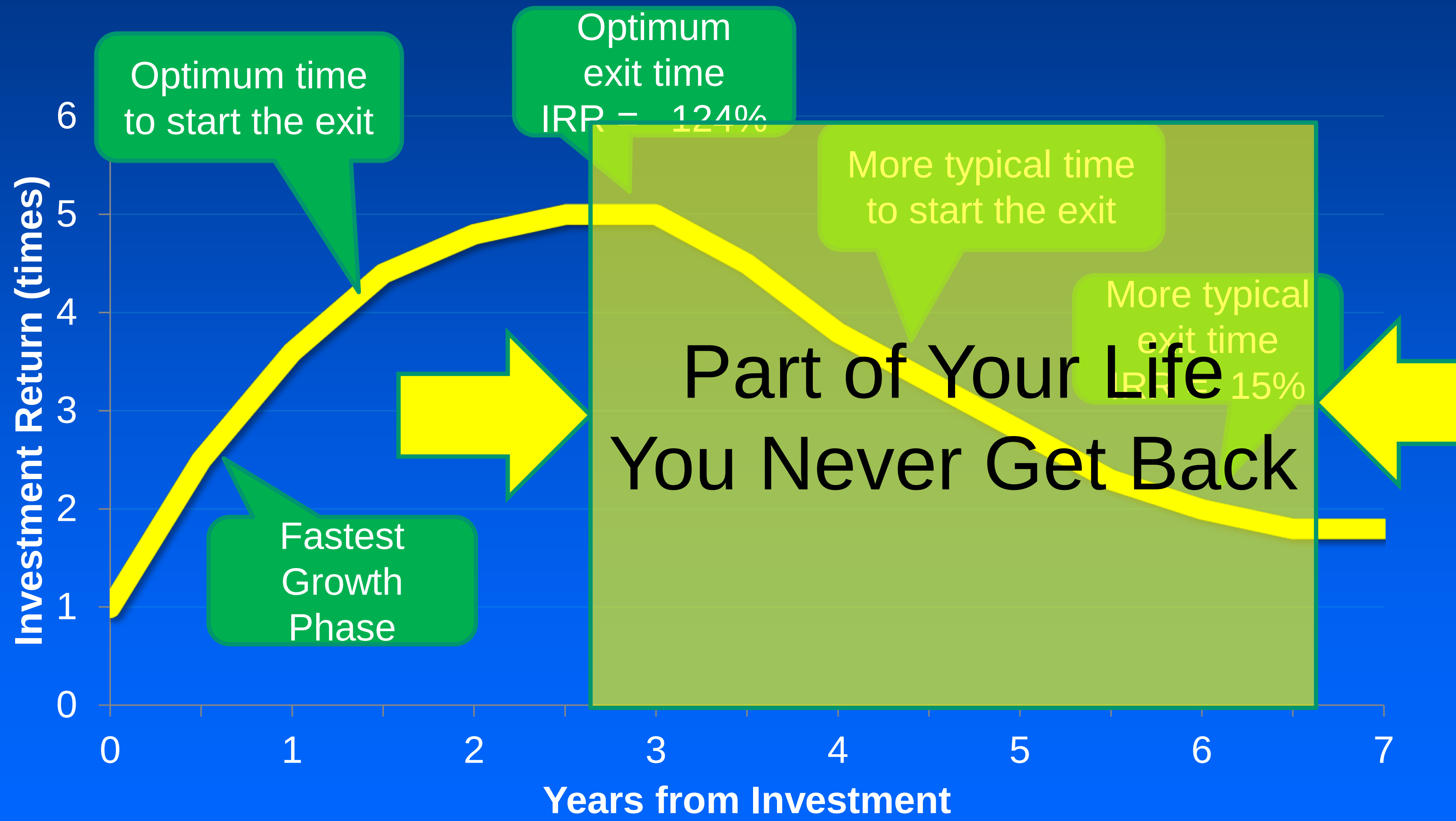
“Riding It Over the Top”



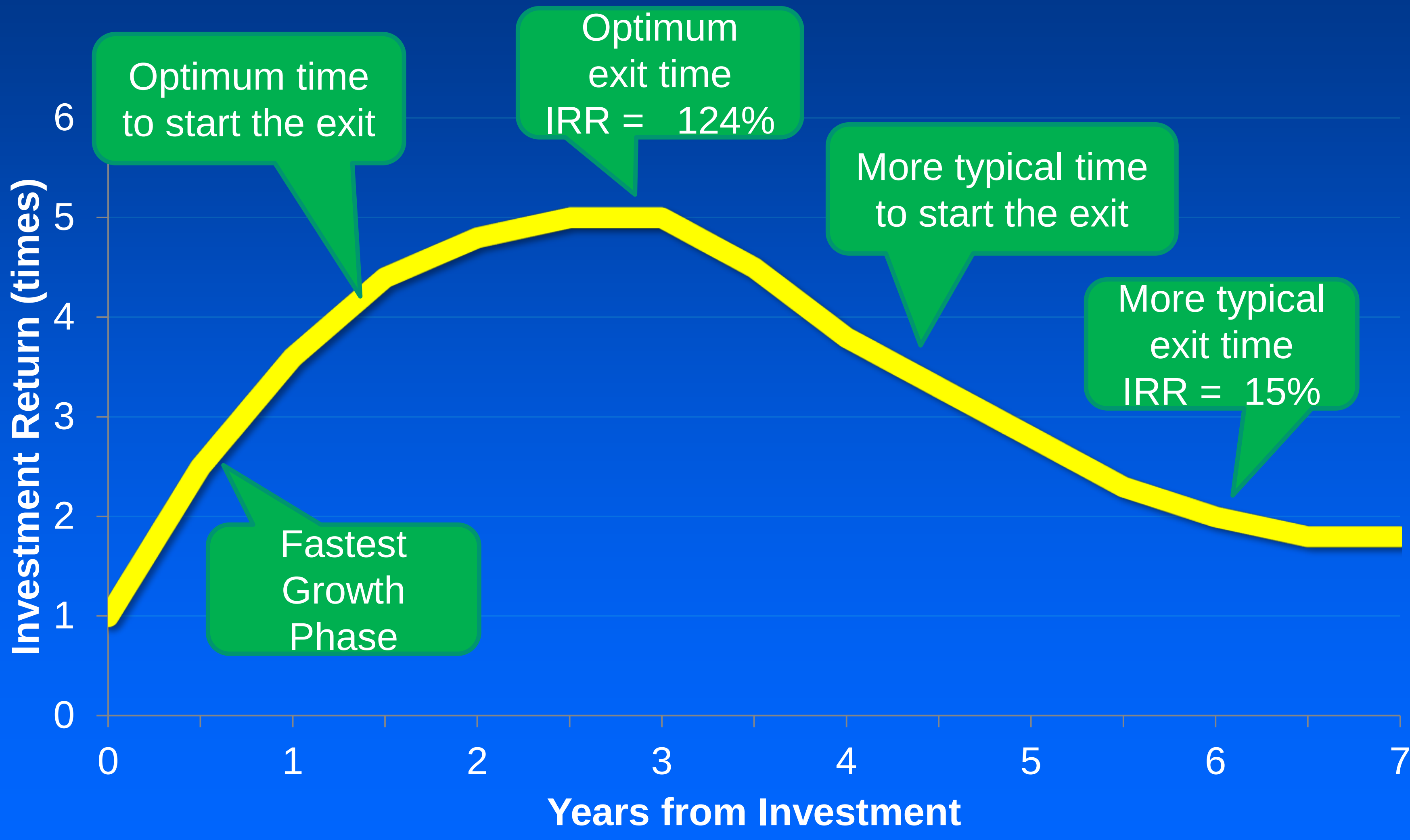
The Financial Loss



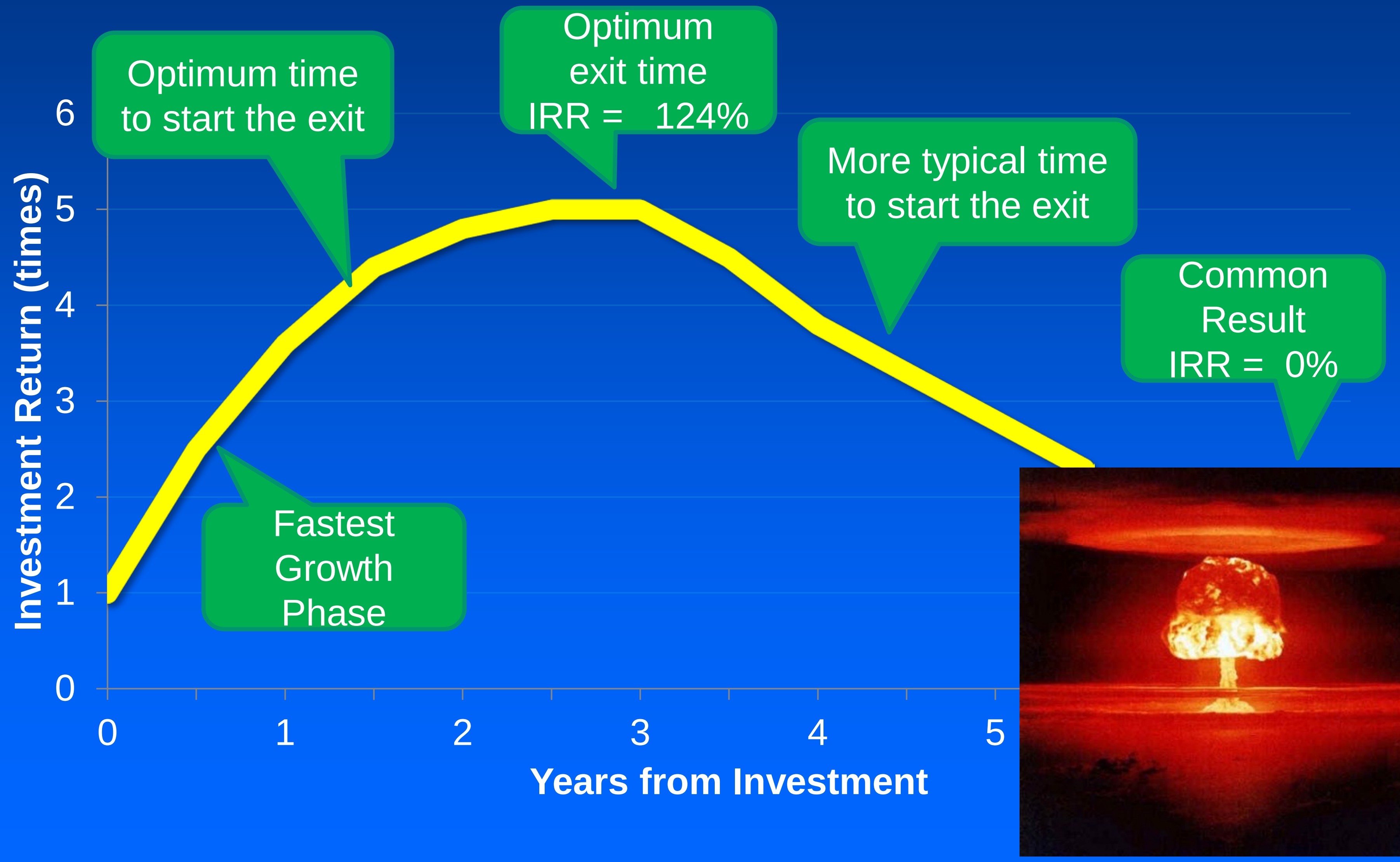
Part of Your Life You Never Get Back



This is Actually Optimistic



What Often Happens



Why ?

- After seeing this happen over and over again
- I started to recognize a few patterns
- And realized there were logical reasons
- Why, if a company misses the ideal time to exit
- There’s a significant probability it won’t just exit for less,
- But will <u>never exit at all</u>

Reasons This Happens

1. Over-investment by VCs
2. Competition
3. Negative momentum
4. Waves of Consolidation

Over Investment

- When a sector becomes “hot” many Venture Capital funds will invest simultaneously
- All hoping to fund on of the few winners capitalizing on the new technology or trend
- Most VCs have much more money than they can deploy well
- When they find a new opportunity, they typically invest very aggressively - $10s millions
- Often driving early innovators out of business

Competition

- Competition is a surprisingly common reason promising companies end up never exiting
- Startups often succeed early because they apply a new technology,
- Or recognize a trend or new market opportunity
- Often their own success generates awareness and attracts new entrants into the market
- Just as the market is maturing and becoming more expensive to operate in

Negative Momentum

- It’s not easy to see the stock price graph in a private company
- But after a while, the team gets a sense that value has peaked and is decreasing
- The fun and excitement are gone
- The best and brightest leave first
- Followed by the other most valuable people
- Ultimately causing the company to lose even more momentum

Waves of Consolidation

- A more devastating reason that companies that miss the ideal time often end up never exiting is
- “Waves of Consolidation”
- This is a relatively new phenomena driven by early exits and internet acceleration
- Unlike the earlier threats, missing this effect is
- Virtually impossible to fix after the fact, and
- Almost always fatal – even if it takes years

The Beginnings of a Wave

- Today, we are all connected by
- The internet and especially social media
- Lets us see what’s happening in the world and our businesses better and faster than ever
- In business today, most competitors have immediate access to the same information
- And make similar decisions at almost the same times

Large Company Growth

- Medium and large companies grow primarily through acquisition
- Many have more cash than they can deploy
- And are under pressure to acquire companies
- Partly to grow but also to keep new innovations from being acquired by their competitors
- And because the buyers are all connected
- They often make decisions at the same time

Hypothetical Example

- For simplicity, let’s imagine an industry where there are three large competitors
- All run by smart executives
- And all with lots of cash
- When technology or markets create a new opportunity to grow their businesses
- They usually all see it at about the same time
- Sometimes triggered by an external event

They All Decide to Acquire

- Often they all decide <u>at the same time</u>
- to acquire a company in a specific space
- In many situations, the impetus is external
- For example, created by an M&A advisor
- Who shows a specific company to all of the potential acquirers in the world
- And describes the strategic opportunity

They All Get Interested

- The buyers all work in the same global market
- If an acquisition makes sense for one of them
- It usually does for others too
- And what M&A advisors all hope for is that several buyers will get interested
- And a competitive bidding situation will develop
- Which is good from the seller’s perspective

But From the Buyers' Side

- Buyers are smart too
- Regardless of whether they got the idea from an M&A advisor, or some other way
- Once they decide they want to acquire a business in a certain area, they
- Look at most of the companies in the field
- Let M&A advisors know they are looking
- And make direct, unsolicited offers to acquire

Why The Buyers Do This

- Buyers have several motivations:
- To determine which company is most attractive for them to acquire – i.e. price
- To give them more choices and therefore more negotiating leverage
- To ensure that if they don’t win the auction on their first choice,
- They have a backup acquisition opportunity

And People Start to Notice

- This starts a cascade of events
- The big company’s competitors hear they are interested in acquiring a certain type of company
- They don’t want to be late, so they also start
- And get their corporate development teams and M&A advisors looking
- Soon every company in the industry has received some unsolicited interest

The Wave

- Which creates the beginning of the wave
- Buyer interest brings in more buyers
- And more M&A advisors
- Which flushes out more companies that could be acquired
- Starting them on their own exit process
- All building to a flurry of acquisitions in the niche or sector

It’s Too Late When You See It

- From the outside, it looks like this happened very quickly
- Often just within a quarter or two
- But it had actually been going on for much longer
- But because public companies, and NDAs, are involved it’s not easy to see from the outside
- Once a company sees the wave it’s often too late to react

What Happens After the Wave

- The wave results in most companies who want to buy finding a company to acquire
- Almost overnight the buyer interest stops
- If a company did not get acquired during the wave, it is virtually impossible after
- And that’s not the worst news

The Market After the Wave

- After the buying crescendo
- Each of the successful buying companies have just paid a lot to enter this new sector
- Usually $10 – 20 million
- Most of the buyers will plan to invest a similar amount in growing their new acquisition
- And competing for market share against their traditional competitors

Killing the Small Companies

- The companies that were not acquired are now in a very difficult situation
- Their market has become much more competitive
- Instead of fighting with other small, underfunded companies, they are up against giants
- With enormous investment capability and highly effective brands

Killing the Small Companies

- The small companies cannot afford to compete
- Or to operate in an industry where everyone is willing to lose money – possibly for years
- Often small businesses that were very profitable become unprofitable almost overnight
- And at the same time, their ability to raise capital disappears because the investors saw the wave
- And don’t want to fund a fight with the big guys
- And know a future exit is very unlikely

Missing the Wave

- Missing the Wave of Consolidation is a particularly heartbreaking error
- Many of the companies that missed were very valuable and often extremely profitable
- The wave destroys both
- For CEOs that <u>have built</u> valuable businesses,
- <u>Not missing the wave might be their most important job</u>

The Right Side of the Wave

- Most CEOs are so busy operating the business it’s almost impossible to watch closely enough
- And the early signs are not easy to see even if you are looking
- The best way to get an early indication is to watch the trends that start the wave process
- The other is to speak to a lot of M&A advisors
- Almost all CEOs need help with this

An Unsolicited Offer

- One of the saddest parts of my job is to explain this to CEOs
- They often contact me all excited about a big company talking about an unsolicited offer
- I start by saying that’s rarely good news for the shareholders
- But after learning more, see the signs of a wave of consolidation
- At that point they are dangerously late

Summary on Exit Timing

- Like many parts of life, and business, “timing is everything” with exits
- Timing our exits better can significantly improve angel investor portfolio returns
- And for entrepreneurs can literally change their lives
- Recommendations:
- Have someone watching the M&A market
- Drive your exit process – don’t wait for an offer

Section 4

Buyers Today and Why They Have So Much Money

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Financial Markets are Changing

- As we recover from the ‘mortgage crisis’
- And worry about the European debt problem
- All investors are all trying to adapt to:
  1. Poor equity returns for over a decade now
  2. The lowest interest rates of our lifetimes
  3. Concern about the future value of money
- The result is an enormous amount of capital looking for better returns and reasonable safety

Types of M&A Buyers

- Active M&A buyers today include:
  1. Big Companies
  2. Medium Sized Companies
  3. Private Equity Funds
  4. Boomers (individuals, or small groups)
  5. Family offices
  6. VCs operating like P-E Funds – very new
  7. International Buyers – small but growing

Big Companies

- Very visible but not the most likely acquirers for most of your companies
- Spending more on M&A than R&D
- Best way for them to increase shareholder value
- Have teams of people dedicated entirely to buying companies
- Compensation plans are designed to motivate executives to acquire companies

Big Company Thinking Today

- Many have so much cash it's a problem
- And more pressure than ever to deliver a better return to their shareholders
- Noticing increased competition for acquisitions in their 'sweet spot'
- Generally feel this is a good time to buy
- And that prices and competition will increase

How Big Companies Think

- One of my friends from a Fortune 500 company explained it this way:
  - We (big companies) know we aren’t good at new ideas or startups
  - We basically suck at building a business from zero to $20 million in value
  - But we think of ourselves as really good at growing values from $20 million to $200 million or more

“Under $20 Million Is Easy”

  - A company priced at $100 million is already out of our sweet spot to buy
  - $100 million also requires board approval
  - But at $20 million, it’s really easy for me to get it approved just inside my division
- Many big companies are spending more on M&A than internal R&D
- Today, it’s the best way for them to grow

Google Wants Even Earlier Exits

- I was surprised recently to learn just how early Google wants to do acquisitions
- Charles Rim one of the top Google M&A guys:
- "90% plus of our transactions are small transactions. … less than 20 people, less than $20 million and that is truly the sweet spot"
- "we do prefer companies that are pre-revenue"
- http://www.exits.com/blog/google-wants-even-earlier-exits-than-in-early-exits

Medium Sized Companies

- For every Fortune 500 company that might acquire a company,
- In the $10 to $30 million range
- There are probably ten times as many medium-sized companies
- That might be interested and can afford to buy
- Selling CEOs are surprised to see how many companies they hadn’t thought of, or even heard of, end up bidding to buy their company

P-E Funds are Back

- P-E funds are like VCs but want to own 100%
- They use a combination of equity and debt
- Before the mortgage crisis, almost 40% of M&A volume was related to P-E funds
- Two years ago it was only 13%
- Today’s fiscal stimulus has pushed the cost of debt lower than it has been in our lifetimes
- In the past year, the P-E funds are back

Boomer Buyers

- A relatively new category of buyers that I call the Boomer buyers – much like Angels
- This group is showing up more and more often
- Haven’t been getting good returns on either their debt or equity portfolios
- Worried about the future value of their cash
- Like many of us, have been eating well and working out for decades now
- Many thought they had retired

Boomer Buyer Thinking

- After a few years of retirement, they realized they could only play so much golf and drive so many expensive sports cars
- They were bored and realized all that clean living could mean they could be active for several more decades
- These boomers have capital and have friends with more (money is not usually a problem)
- Many remember how much fun they had operating companies

Boomers are Dark Horses

- The fascinating thing about the boomer buyers is that they can be the most aggressive and fastest moving of all
- Most of these buyers made their money successfully running companies
- They are often the ‘smartest guys in the room’
- They usually operate locally and are most interested in transactions under $20 million

Family Offices

- Common in Europe, but until recently, was not a term we heard much in the North America
- Refers to very wealthy families, or groups of families, that hire captive investment teams
- Some ‘high power Wall Street’ people are moving to family offices
- Build diversified classes of investment portfolios
- Allocating more assets to acquiring companies
- Just like P-E funds

Family Office Thinking

- Like everyone else, feeling pressure to deliver returns and worried about the value of money
- Traditional debt and equity looking less and less attractive
- Operating businesses look like an asset class
- That should be more resilient to macro economic changes like inflation and deflation
- Only challenge is finding enough to buy

VCs Operating Like P-E Funds

- New, very interesting and happening quietly
- VC funds that ‘appear’ to be investing
- Are actually acquiring all - or close to all
- Mostly anecdotal reports so far
- A few described in detail under confidentiality
- Cashing founders and angels completely out
- And not requiring the founders to come to work
- Clearly betting on the horse…not the jockey

Speculation on VC Thinking

- Working hard to stay in stealth mode
- Not sure if their investors will approve
- Can only speculate on what they are thinking
- Likely the old VC model is permanently broken
- Have more cash than they can invest
- Corps and P-E funds increasingly competitive
- If we can’t fight them, maybe we should join them

International Buyers

- Still a small, but growing group of buyers
- Very strategic
- Do not usually move quickly
- Balance of payments has created huge dollar surpluses in most of Asia
- Europeans would like to move money to the US
- Dollar holders are increasingly nervous
- So are moving to buying active businesses

Big Corps Have So Much Cash

- Many big companies have so much cash that it’s a problem – shareholders complain
- Google has $20 billion
- eBay has $5 billion
- Amazon has $3 billion
- Microsoft has $35 billion
- Cisco has $43 million
- Apple has $97 billion ← cash and investments

Cash for Acquisitions

	Cash	Available for M&A
US Companies	$ 2 Trillion	Most
Global Companies	$ 8 Trillion	Most
P-E Funds	$0.4 Trillion	All
Boomers (US only)	$ 8 Trillion	Small but Growing
Family Offices (US)	$ 1 Trillion	Small but Growing

How Many is $1 Trillion?

- It’s difficult to put $1 trillion in perspective
- Most acquirers consider their ‘sweet spot’
- As somewhere around $20 million
- The median price is closer to $15 million
- Just one of these $1 trillion buys
- 50,000 acquisitions (at $20 million each)
- There are many times more buyers than sellers

Buyers Practically Unlimited

- For many exits under $50 million
- The number of buyers is, for practical purposes, almost unlimited
- Often see three or four types of buyers
- Simultaneously bidding to buy the company
- Each type of buyer thinks and acts differently
- They all have lots of cash
- And there can only be one successful bidder

A Sellers' Market

- The number of buyers and amount of cash available makes the current M&A environment:

1. A sellers' market
2. Fast moving and diverse
3. Talk is that prices are up 20% in a year

A Golden Era for Entrepreneurs

- I believe history will call this a golden era for technology entrepreneurs.
- Never before has it been so easy to
- Create such valuable companies
- On so little capital
- And sell them so early for so much money