Exit Early - Exit Often

New Strategies for
Angel Investors and Entrepreneurs

Keynote Speech at Capital Connects!
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My Background

- I am a nerd
- PhD in Electrical and Computer Engineering from the University of British Columbia
- Started my first company at grad school
- Nexus grew to be the world's 2^{nd} largest manufacturer of cable TV headends
- Sold in 1993 to Scientific Atlanta – now part of Cisco

My Tech Investment Funds

- When we sold Nexus, it was the first time I had money to invest
- Been an enthusiastic tech investor since
- Founded and managed a:
- Hedge fund – 1996 to 2000
- Venture Capital Seed fund – 2002 to 2006
- Angel fund – 2005 to present

How I Got Started on Early Exits

- I became fascinated by early exits in 2002
- When starting a Venture Capital seed fund
- Our local government provides a 30% tax credit to investors in qualified VC funds
- But under that legislation, the investors can get their money back in just five years
- Less than <u>half the time</u> for typical VC funds

Building a "5 Year" VC Fund

- As a fund manager, I knew I would need to focus on intently on exits
- To provide liquidity in just 5 years
- I managed the BC Tech Fund for 3 years
- During that period, I made 9 investments
- Had three exits – 2 acquisitions and an IPO
- #1 Canadian VC tech fund of that vintage

Outline of This Talk

- I believe this will be called a “golden era” for angels and entrepreneurs
- Exits are happening earlier than ever before
- The differences between angels and VCs
- What determines when you can sell?
- Why you need an exit strategy first
- Optimum strategy - Exit Early and Exit Often

Qualifiers on This Presentation

- I was a technology entrepreneur
- And now I am a technology investor
- My comments are from that perspective
- Some aspects of financing and exit strategies are different for life science and clean tech companies
- I am not including ‘public market’ strategies (until those markets recover)

Angel Investing is Still New

- Friends and Family investors have always been an important part of the economy
- But organized angel investing is still new
- The early angel groups started around 1997
- Angel investing today is where traditional Venture Capital investing was in the 1980s
- We are still discovering the best practices

Not The On-ramp to VC Funds

- Lots of what is written about angels describes us as a “freeway on-ramp” or “farm team” for traditional Venture Capital
- Some angel groups said that explicitly
- Some angel funds used that strategy
- That just hasn’t worked well (for the angels)

Successful Investing

- I've learned (expensively) that successful investing requires two things:
- Buying right – investing in the right opportunities using the right structures, and
- Exiting well – getting my money back at a good price and in a reasonable time frame
- Today, I am going to talk about exiting

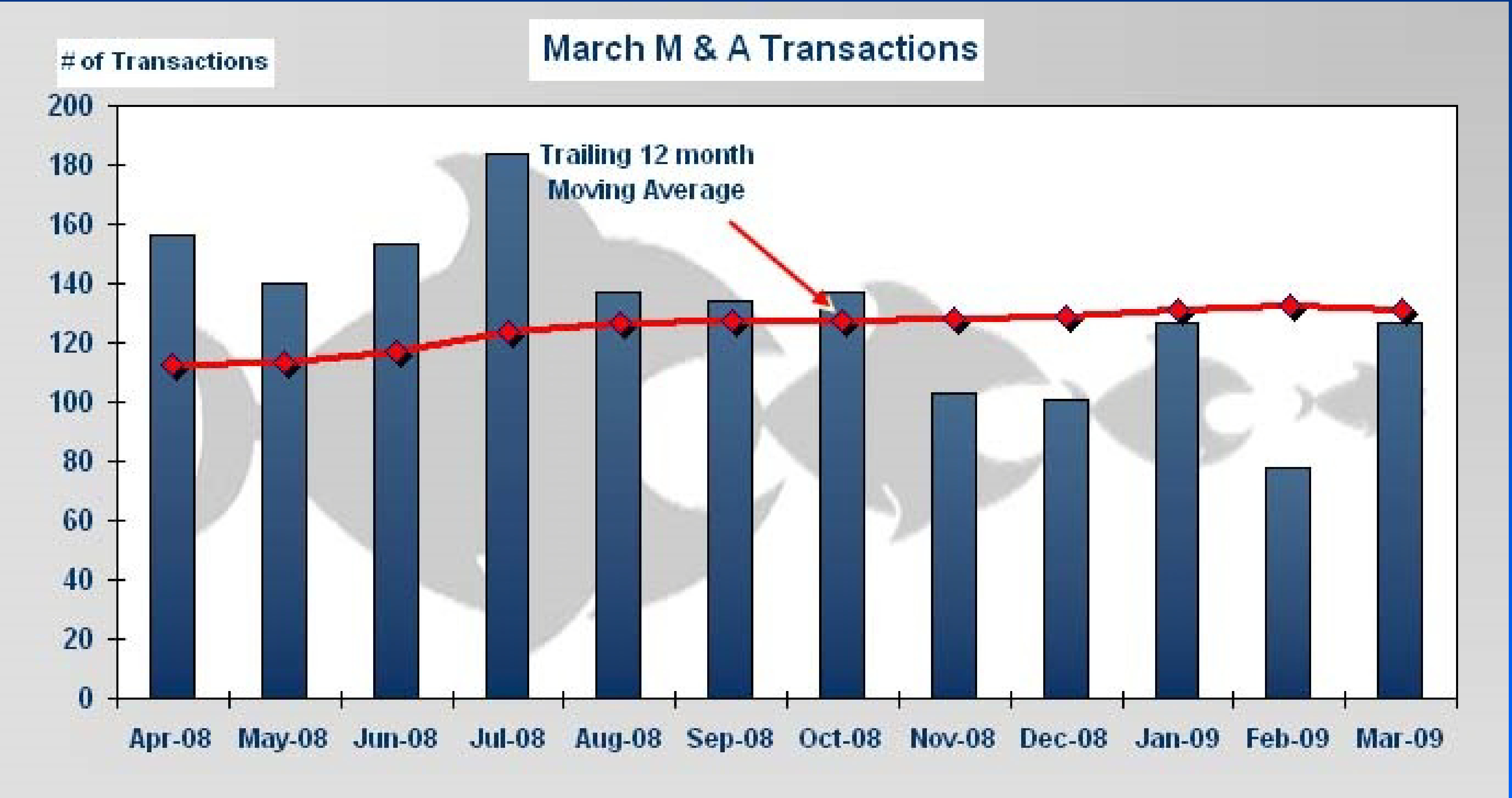
Lots of Doom and Gloom on Exits

- Lots written recently in the mainstream press about the bad news in exits
- IPOs have almost disappeared
- Total M&A transaction dollar volume has fallen by at least a third
- That's true, but it's only part of the story

We Always Hear About The Big Exits

- The media always reports the really big exits
- From my neighborhood, it’s exits like Club Penguin’s $350 million sale to Disney or Bioware’s $800 million sale to EA
- Those exits aren’t happening very often now
- The ‘new’ big story is the large number of smaller exits

Small M&A Transactions



From: Current Environment for Exits by Brent Holliday, Capital West Partners

Most Exits Are Under $20 Million

- Mergerstat database shows the median price of private company acquisitions is under $25 million, when price is disclosed
- But the price is not disclosed in most smaller transactions
- I estimate the median price to be well under $20 million
- And probably below $15 million

Examples of These Exits

- Google bought Adscape for $23 million (now Adsense)
- Google bought Blogger for $20 million (rumored)
- Google bought Picasa for $5 million
- Yahoo bought Oddpost for $20 million (rumored)
- Ask Jeeves bought LiveJournal for $25 million
- Yahoo bought Flickr for $30 million (rumored)
- AOL bought Weblogs Inc for $25 million (rumored)
- Yahoo bought del.icio.us for $30 – 35 million (rumored)
- Google bought Writely for $10 million
- Google bought MeasureMap for less than $5 million
- Yahoo bought WebJay for around $1 million (rumored)
- Yahoo bought Jumpcut for $15 million (rumored)

M&A Exits Are Happening Earlier

- Today it's not uncommon for companies to be acquired just a couple of years from startup
- Club Penguin, in Kelowna BC, is a game website for 6 to 14 year olds
- It was sold to Disney for $350 million cash just two years from startup
- YouTube was also 2 years old when it sold

Why This Is Happening Now

- 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 start-ups
  - We basically suck at building 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

Corporate Buyers vs. VCs

- This has created a new, very interesting environment where corporate buyers have become competitors to traditional VCs
- Companies have lots of cash
- And don’t see VCs as adding much value
- So they are buying promising companies at just about the time the VCs want to invest

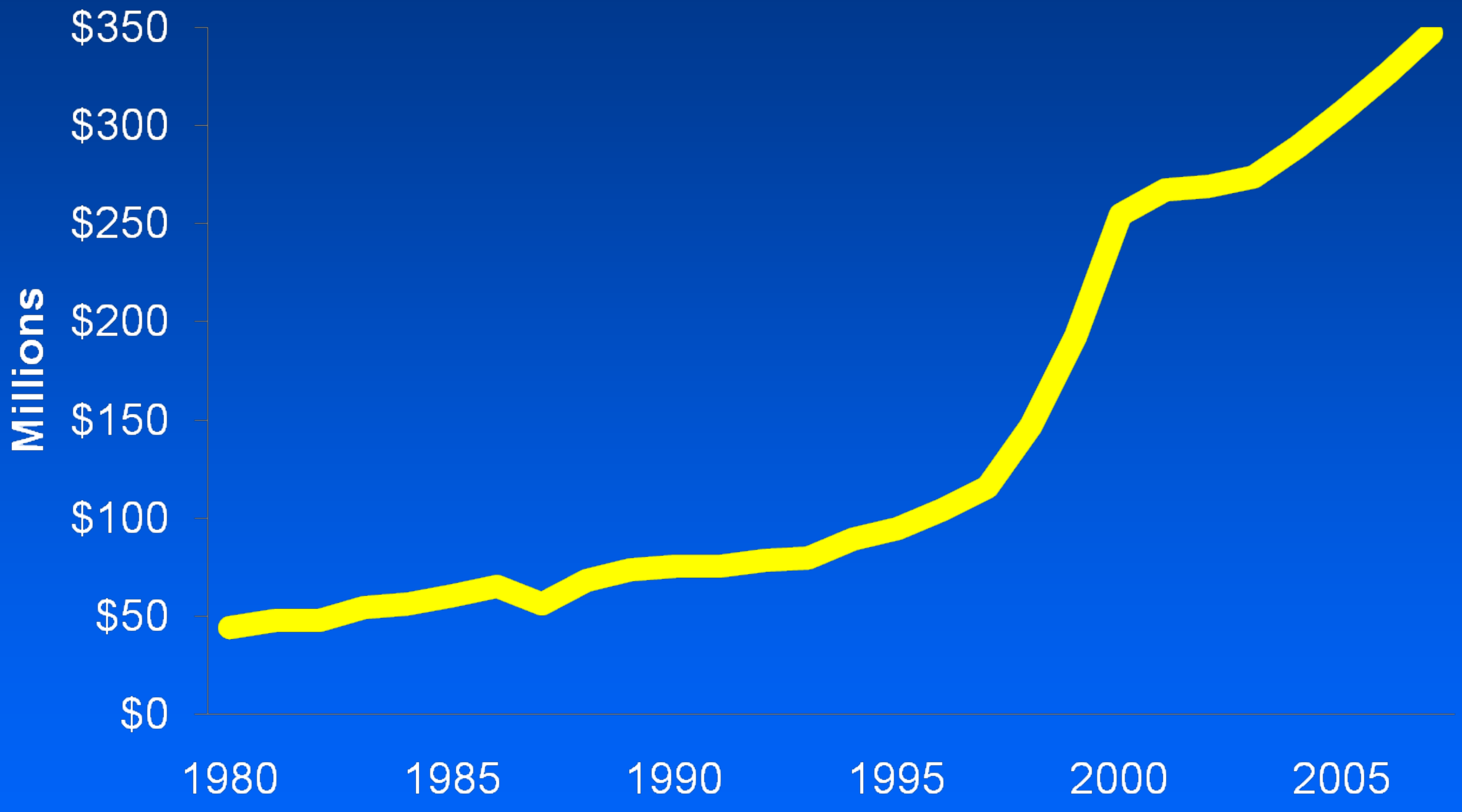
Venture Capital in Crisis

- The press is full of stories about traditional Venture Capital being in crisis
- Big VC funds clearly aren't working anymore
- Many believe the industry will shrink to less than half its current size – possibly a quarter
- I think this is just a healthy correction
- What does that mean for angels and entrepreneurs?

Angels and VCs - More Different

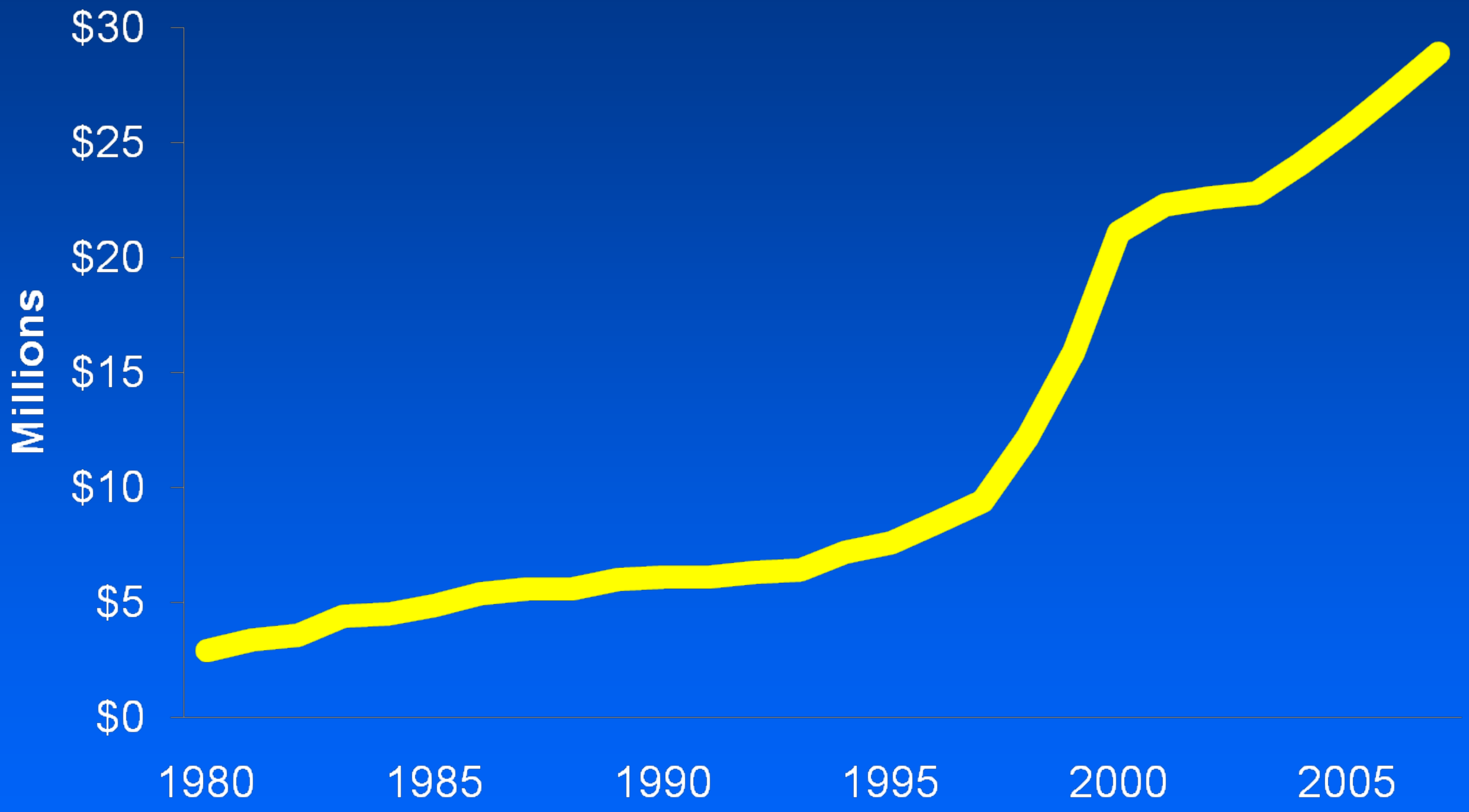
- This new environment is creating a much clearer understanding of how different angels and traditional VCs really are
- From an exit perspective, there are three important differences:
  1. Minimum investment size
  2. Minimum return required
  3. Acceptable time to exit

Size of Average VC Firms



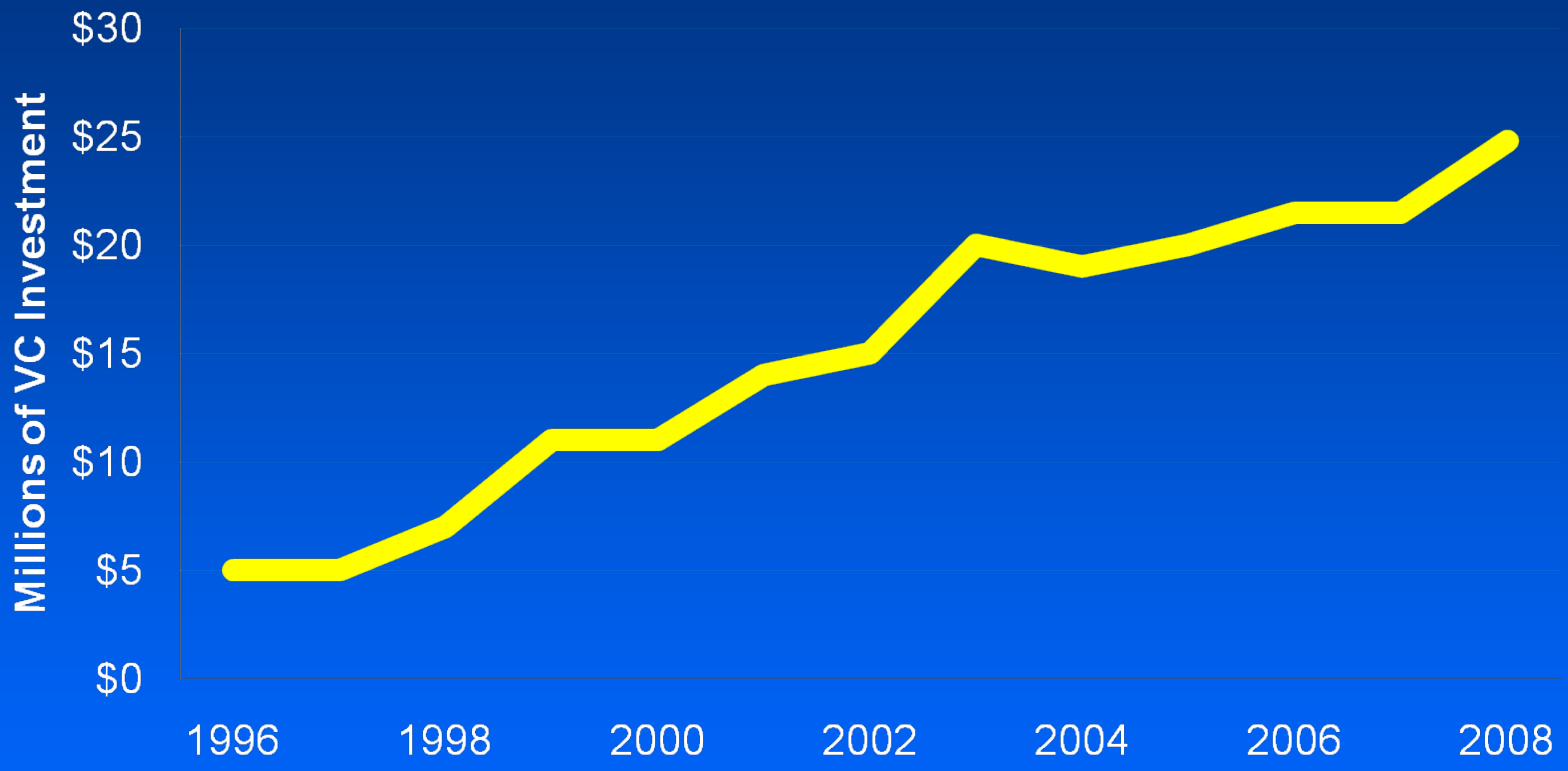
Source: US National Venture Capital Association, Thomson Financial

Average Capital per VC Principle



Source: US National Venture Capital Association, Thomson Financial

VC Investment Prior to M&A Exit



Amount of VC investment prior to M&A exit in millions. 2008 data for Q1
Source: Jeffries Broadview, Dow Jones VentureSource

VC Fund Math

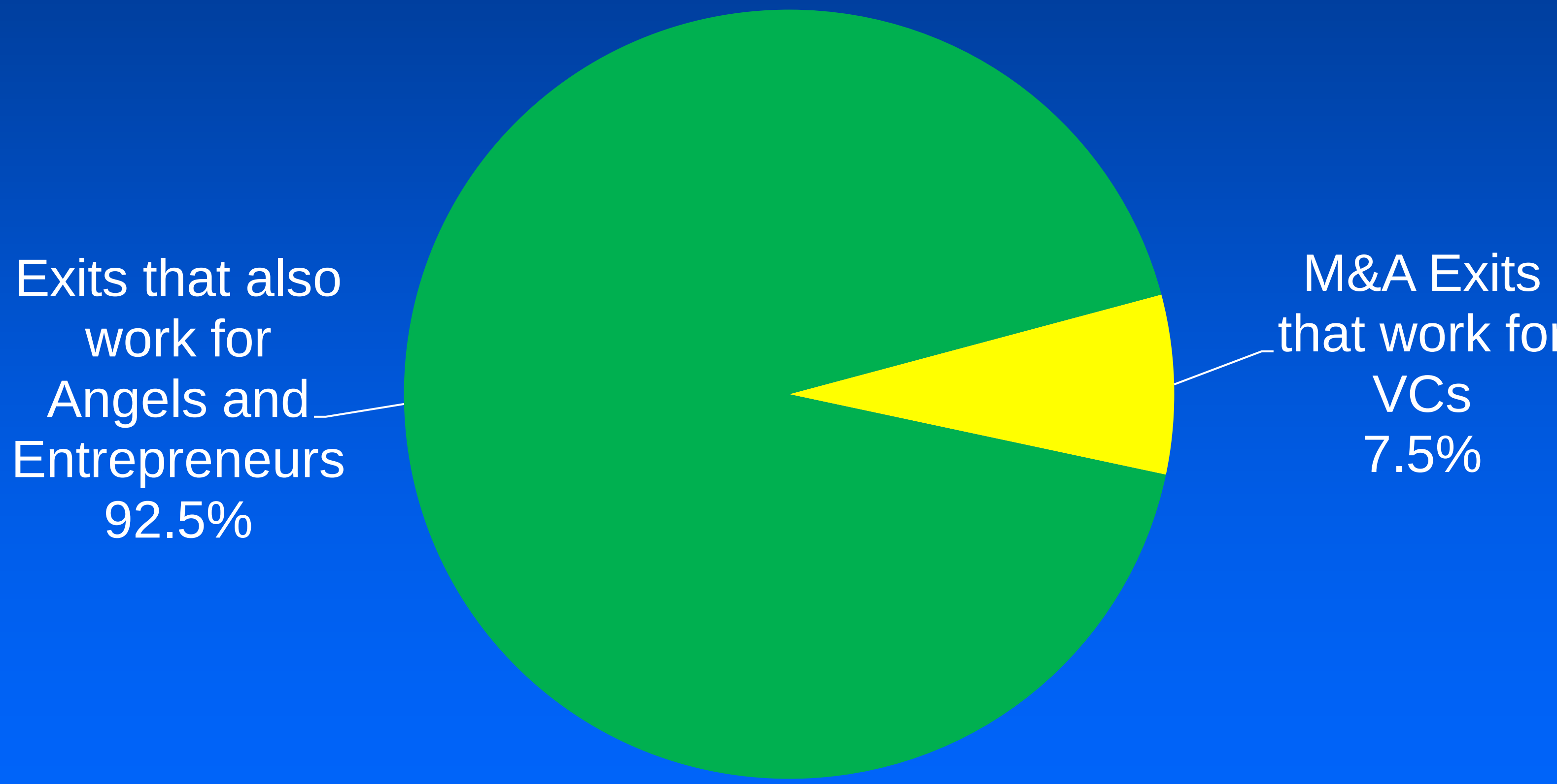
- VC funds have gotten larger and larger
- Struggle to write a check for under $5 million
- Traditional funds <u>only invest money once</u>
- All fund returns come from 20% of deals
- A VC fund needs a 20% annual return
- Simple math shows that VC's winners have to produce an <u>average 30x return</u>

What That Means for VCs

- This means VCs have to exit almost all of their successes for values over $100 million
- In the past, the majority of successful VC exits were big NASDAQ IPOs
- There've been very few VC backed IPOs for almost a decade
- And there probably won't be anytime soon
- So that leaves just M&A exits

92% of M&As Don't Work for VCs

VCs Need Exits over $100 million

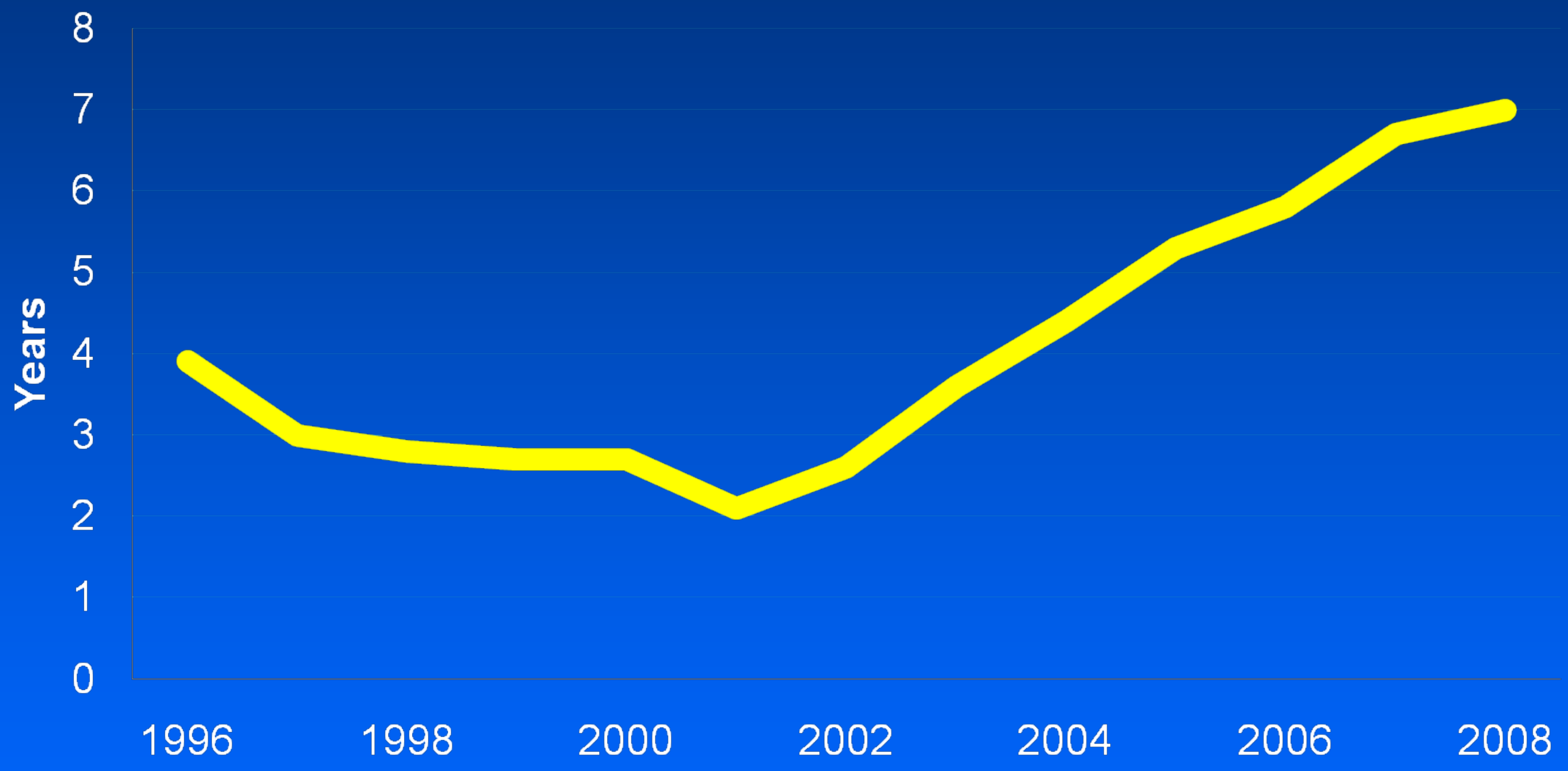


Data from Mergerstat

What About Angels and Entrepreneurs?

- Traditional, large VC funds need $100+ million exits to stay in business
- Those are good for angels and entrepreneurs too, but we don’t need them
- Angels and entrepreneurs can make great returns on M&A exits in the $10 to 30 million range
- With far less risk and much faster exits

Time from VC Financing to M&A Exit

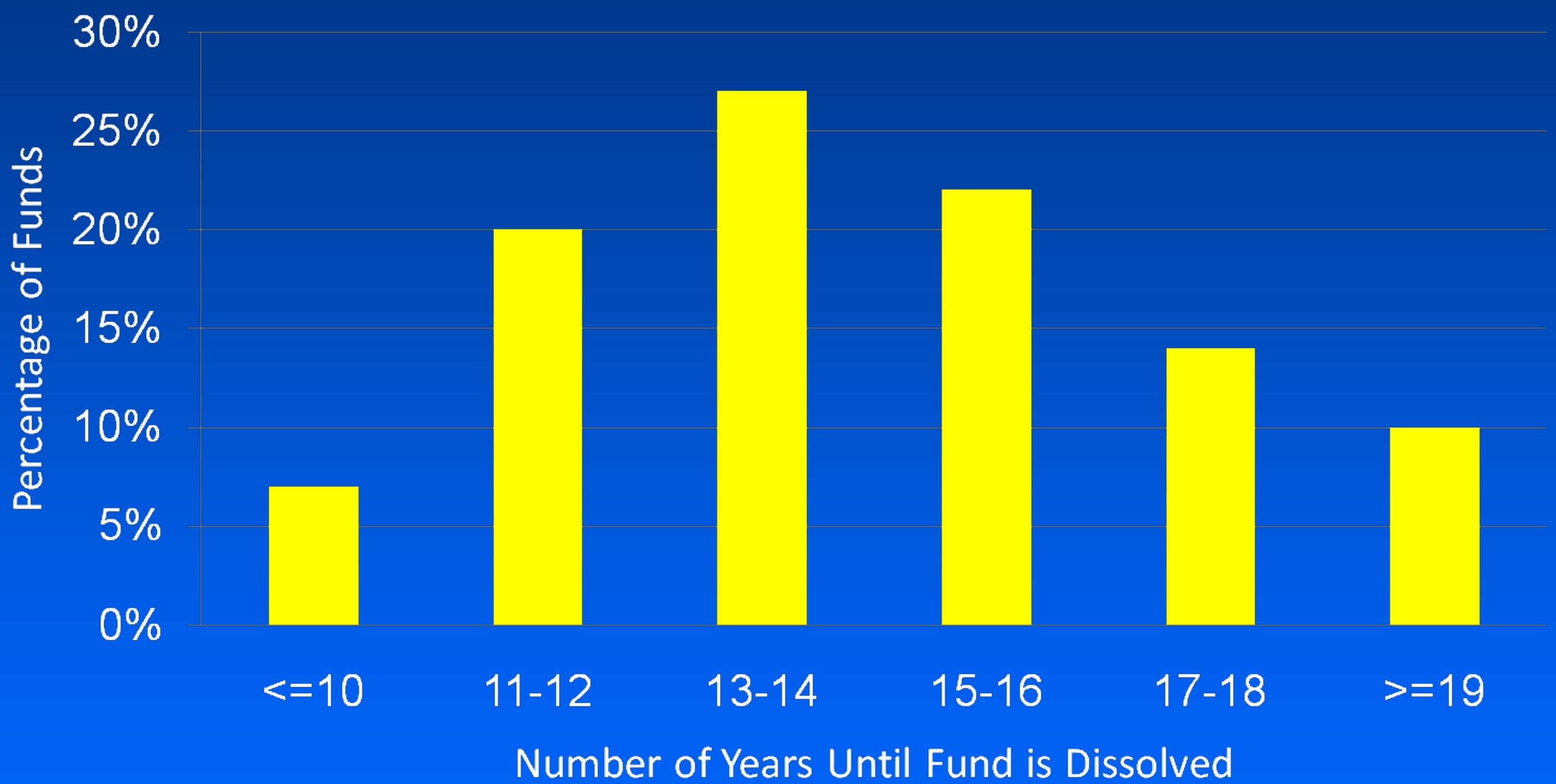


Median Time from initial VC financing to exit in years. 2008 data for Q1.
Source: Jeffries Broadview, Dow Jones VentureSource

It Actually Adds About a Decade

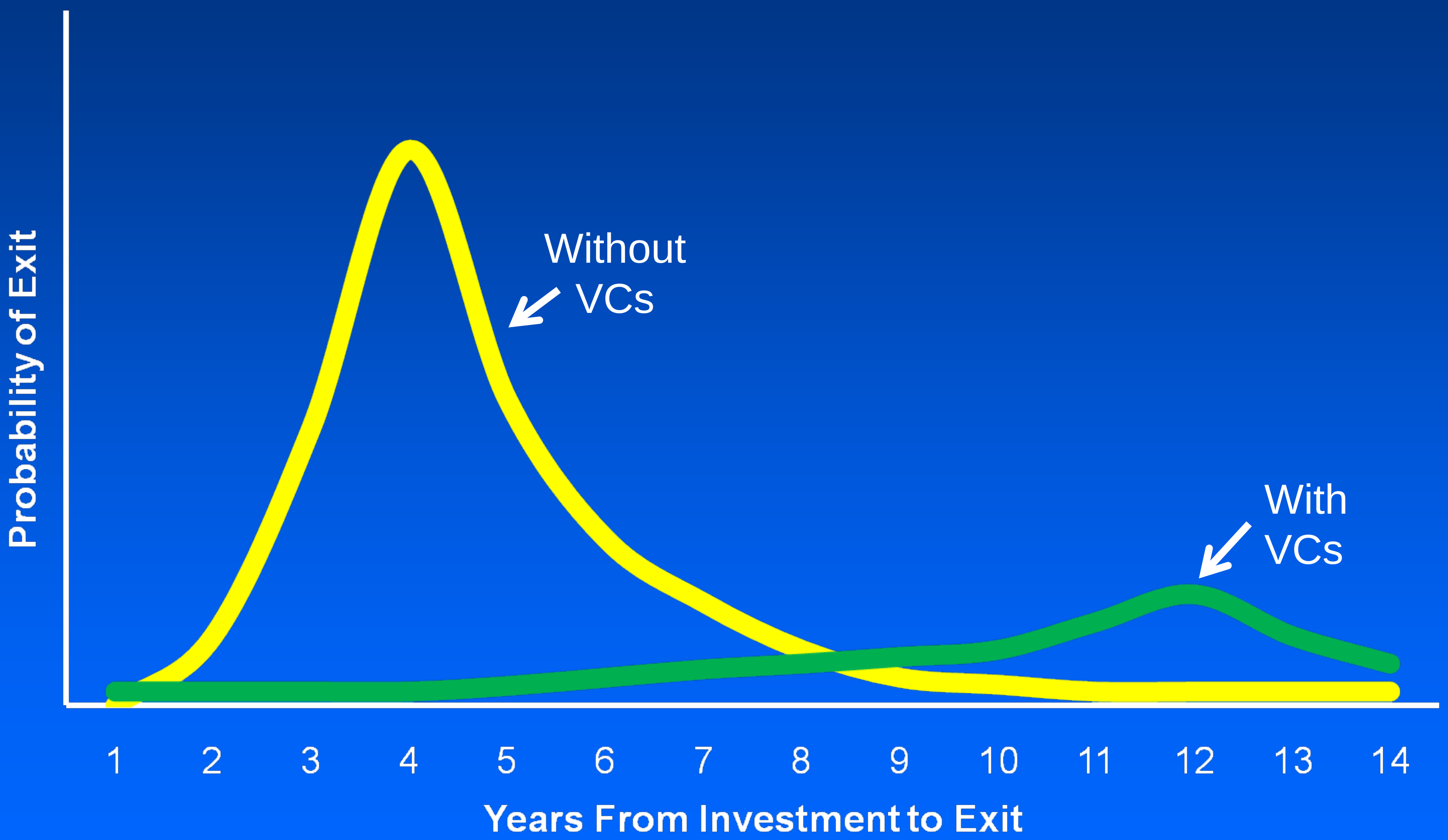
- A median of 7 years doesn’t sound so bad
- But the reality is quite a bit worse
- It’s 7 years across, A, B and C rounds
- A simple model shows that equates to about <u>10 years longer for the angels</u>
- At first glance that doesn’t seem possible
- Aren’t most VC funds 10 years?

Lifetime of IT VC Funds



Source: Adams Street Partners 2006 analysis of funds then dissolved.
The chart shows the year a 10 year fund was actually dissolved.

Exits Without and With VCs



What Happens When VCs Invest

New insights from Wiltbank Data

Source: Robert Wiltbank, PhD Willamette University with Funding from the Kauffman Foundation

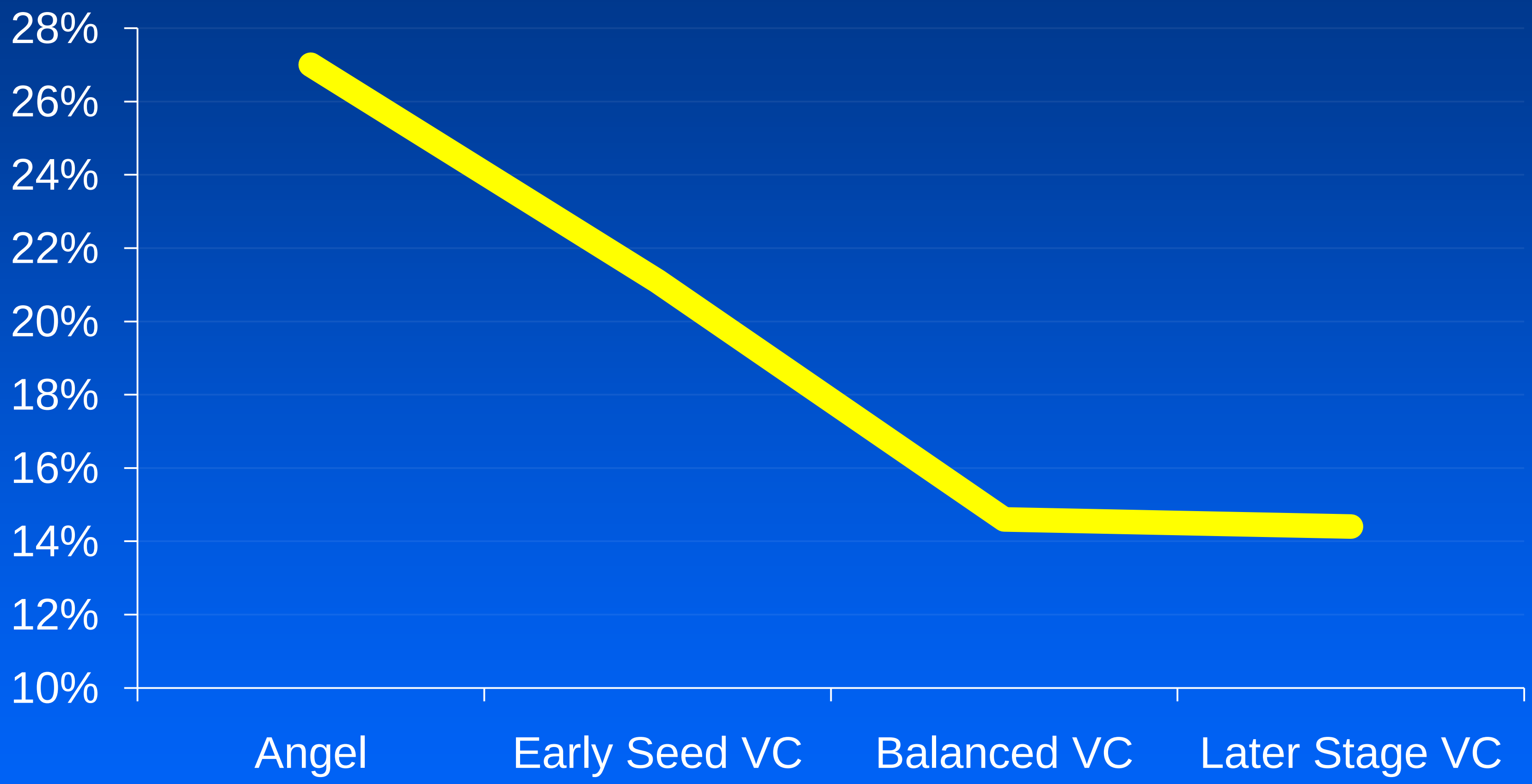
Angels or VCs But Not Both

- Fascinating new research May 2008
- Unique historical database of 182 Series A deals from the bankrupt Brobeck law firm
- “outcomes are inferior when angels and VCs co-invest relative to when VCs invest alone.”
- Angels alone “as likely as the VC-backed firms to have successful liquidity events”
- Optimum is ‘<u>Angels or VCs but not both</u>’

The Bottom Line

- When traditional Venture Capital funds follow on in angel investments, statistically:
- It takes about a decade longer to exit
- The risks increase substantially
- We don’t have data yet, but I believe today the extra time, higher risks and dilution mean <u>lower average returns for both the angels and entrepreneurs</u> when VCs invest

Highest Returns at Early Stages



Source: Wiltbank – Returns to Angel Investors in Groups,
Thomson Reuters' US Private Equity Performance Index

Are VCs Ever a Good Idea?

- Does that mean angels should never let VCs invest in their companies?
- Is it ever a good idea to invite VCs to invest?
- Please remember, these are statistics
- There are, of course, situations where the best decision is to have VCs follow on
- It all depends on the type of company

Angel or VC Checklist

	Angels	VCs
Amount of capital required to prove the business model	Under $5 million	Over $5 million
Years before being able to exit	2 to 5 years	Over 10 to 12 years
Most likely value of the company at the time of the optimum exit	Under $50 million	Over $100 million
Willingness to relinquish control of important financial decisions	Not always required	Almost always required

Angels Can Finance 95% of Deals

- I believe we are in a golden era for angels and entrepreneurs
- Never before has there been so many huge opportunities
- That were so easy to build companies on
- And were so easy to sell - so early
- That required so little capital

Why It Takes Less Capital Today

- When I was a young entrepreneur, it seemed like most companies needed tens of millions of capital
- Didn’t matter if it was a hardware company or a software company
- That created the enormous venture capital industry we still have today
- The fundamental economics have changed

The Internet and Open Source

- The internet, open source software and the huge, online global market means that
- Today, very valuable companies are being built on just tens of thousands of dollars
- Club Penguin, Plenty of Fish, MetroLyrics for example and thousands more
- Angel investors today can easily finance 95% of tech companies to an M&A exit

How Early Can You Sell?

- A common misunderstanding about M&A exits is that you have to grow the company to be profitable
- Or grow it to be larger than $X millions of revenue
- The real threshold is to ‘prove the business model’

What it Means to Prove the Model

- In a recurring revenue business, for example, you have a spreadsheet that clearly shows actual results for:
  1. Revenue per customer
  2. Gross margin per customer
  3. Customer lifetime (or churn)
  4. Cost of customer acquisition
- In other words, how much is a customer worth and what do they cost to acquire?

Proven Model and Value

- Some businesses have slightly different metrics to prove the model
- But when you prove the model you can build a credible projection that shows if:
  1. New owners added $X millions of capital,
  2. The business would have Y customers
  3. And be worth $Z millions
- Then you can successfully sell the business

It’s Often The Optimum Time

- As soon as you prove the model is often the <u>best time to sell</u>
- Always better to sell on an upward trend
- Sell on the promise not the reality
- Often when you can get the best price
- Very often ‘stuff happens’
- Most entrepreneurs ‘ride it over the top’

Building to Sell

- Entrepreneurs and angel investors would have better returns and more fun
- If we designed and built more companies for early exits
- Works particularly well in today's economy
- It starts with alignment on an exit strategy

First Exit Strategy, Then Finance

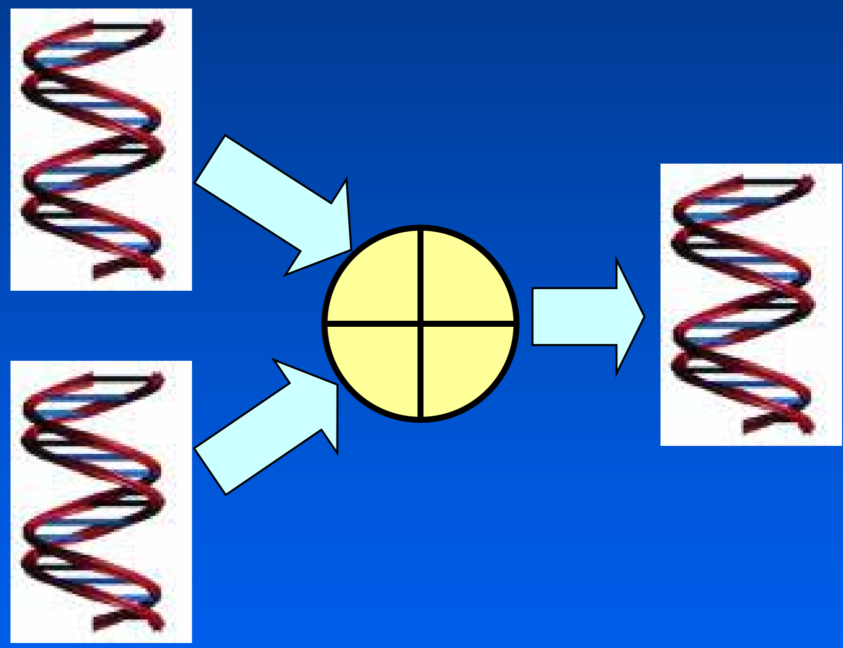
- This doesn't happen most of the time
- But the right way to build a company is
- Determine the type of business
- Build alignment on the exit strategy
- THEN develop the financing plan
- And then start to contact investors

Check Financial DNA Before

Entrepreneurial DNA

Combined with

Investors' DNA



Resulting Corporate DNA is a Hybrid of Entrepreneurs' and Investors' DNA

Check the compatibility first

The Exit Is Just Another Process

- Whether it’s a financing, product development, marketing or sales goal
- The chances of success increase dramatically if you have a good plan
- Your exit strategy is the plan for your business – the entire business
- Your plan should start at the end (the goal)

The Important Elements

- An Exit Strategy can be as simple as:
- “Our exit strategy is to [sell the company] in about __ years for around $ __ million.
- We plan to execute the exit by engaging a [mid market M&A advisor] by _[date]_.”
- The optimum exit strategy depends on the type of company
- Requires experience to do this early

Check The Alignment

- It’s surprising how often there is a serious mis-alignment between key stakeholders on the exit strategy
- The only way to check is to get a ‘signoff’ on a written exit strategy
- Usually takes at least one offsite planning retreat to build full alignment
- Even after, check alignment annually

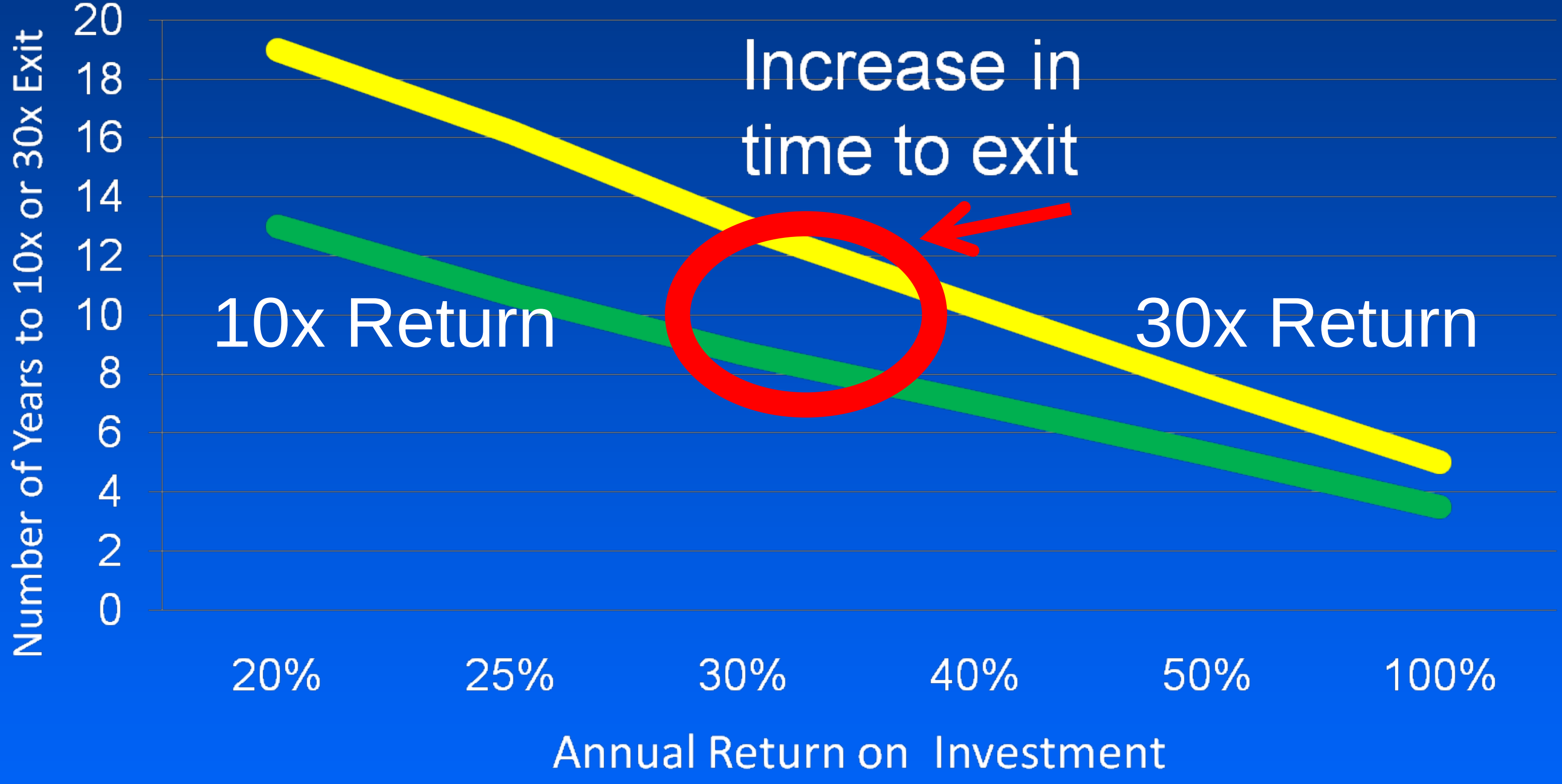
Summary – Exit Early and Often

- Determine the type of company
- The optimum exit strategy is probably an acquisition for under $30 million
- Build and maintain alignment
- Angels alone can finance 95% of companies
- After the sale, you have money to do it again
- Maximize returns - Exit Early and Exit Often

Resources

- www.Early-Exits.com – my book on exit strategies for angels and entrepreneurs
- www.AngelBlog.net – my blog for entrepreneurs and angel investors
- www.BasilPeters.com – for a video of this and some of my previous talks

Additional Years to VC Exit



To achieve a minimally acceptable VC fund return of 20% per year and assuming all of the returns are from 20% of investments