Exit Strategies for Angel Investors

Bellingham Angel Education

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by Basil Peters

Outline

- My background
- Exits are the most fun
- Current trend toward early exits
- Why you don’t want a VC to invest
- How selling can increase values by 50+%
- Case studies of some of my exits
- Workshop on exit valuations

My Background

- Geek, nerd, techie
- PhD in Electrical and Computer Engineering from the University of British Columbia
- Started first company while at grad school
- Nexus became the 2nd largest manufacturer of cable TV headends in the world

My Funds

- Sold Nexus in 1993-4.
- First time I had money to invest
- Have been an active investor ever since
- Hedge fund – 1996 to 2000
- Venture Capital fund – 2002 to 2006
- Angel fund – 2005 to present

Me not working

- Angel investing is the most fun I am allowed to have
- Speaking at universities to encourage more young entrepreneurs
- Also enjoy fishing
- Run because its so efficient
- Collect really old money
- Work hard to avoid airplanes

Exits Are The Most Fun

- I discovered that exits are the most fun part of being an entrepreneur or investor
- I was an embarrassingly slow learner
- For the first decade, I couldn’t conceive of selling one of our companies
- But once we sold one, the light went on
- Enjoy exits even more as an angel investor

Why Exits are The Most Fun

- Interesting people
- Fascinating value creation and negotiations
- And really big $$$
- There's always a good party
- Everyone always feels great after
- Companies and people graduate to bigger futures

Exits Are Changing

- Exits are also the least well understood part of being an angel or entrepreneur
- In earlier times, exits were driven by venture capitalists because they had the control
- Things have changed a lot
- Today, more exits strategies are determined by angels and entrepreneurs

Exits Today

- Exits are happening earlier than ever before
- Often only two or three years from startup
- Most exits valuations are under $30 million
- The M&A market in 2007-8 was excellent
- In Q2 2008, for the first time in history, there were zero venture backed IPOs in America
- Great times for angels - terrible for VCs

It's a Good Time to be Acquired

- Big companies growing by acquisition
- Big co's "Stink at innovation and know it" Vivek Mehra, Silicon Valley VC.
- Spending more on acquisitions than R&D
- "2007 will be hailed as the biggest year for acquisitions of venture-backed technology since the dot.com days." Tom Stein, *Mergers and Acquisitions*, May 2008.

Most Exits Are Under $30 Million

- Average selling price around $12 million according to Om Malik in *Business 2.0*.
- Most significant trend in tech for investors
- Happening because big companies believe $10 to 30 million is their sweet spot
- Their skill set is growing from tens of millions to hundreds of millions
- Big Cos are prolific buyers under $30 million

Examples Under $30 Million

- 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)

Angels and VCs more different

- This new exit environment is creating a clearer understanding of how different angels and VCs really are
- In three important ways:
  - Minimum investment size
  - Minimum return required
  - Acceptable time to exit
- Each part of the "unwritten agreement"

VC Fund Math

- VC funds are larger and larger
- Can’t write a cheque for under $5 million
- Most funds can only invest the money once
- All fund returns come from 20% of deals
- A VC fund needs a 20% annual return
- Simple math shows that the winners have to produce an <u>average 30x return.</u>

Unwritten Contracts with Investors

- Bloggers have helped entrepreneurs, angels and VCs understand each other better
- Entrepreneurs used to think it was simple
- Just increase the value of the shares
- But now realize that investors also want to realize on their gains
- Achieving an exit is part of the contract

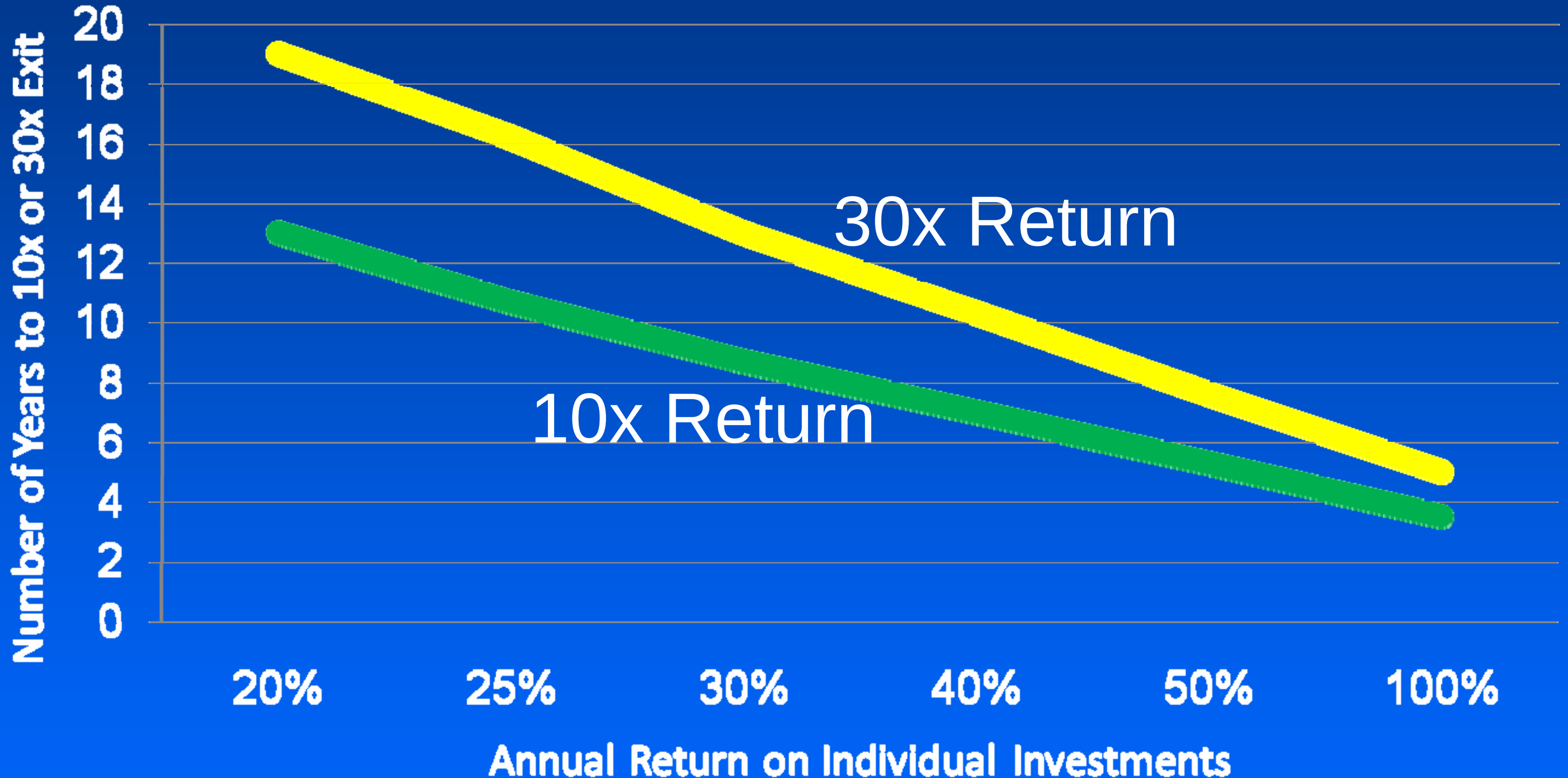
Unwritten Contracts with VCs

- ‘Unintentional Moonshot’ by Josh Kopelman
- Simple rule of thumb for minimum multiples:
  - Series A – 10x
  - Series B – 4 to 7X
  - Series C – 2 to 4X
- So, once you sign a Series B the term sheet at $50M premoney, you’ve basically signed up for at least a $200M exit target

How VCs Block Good Exits

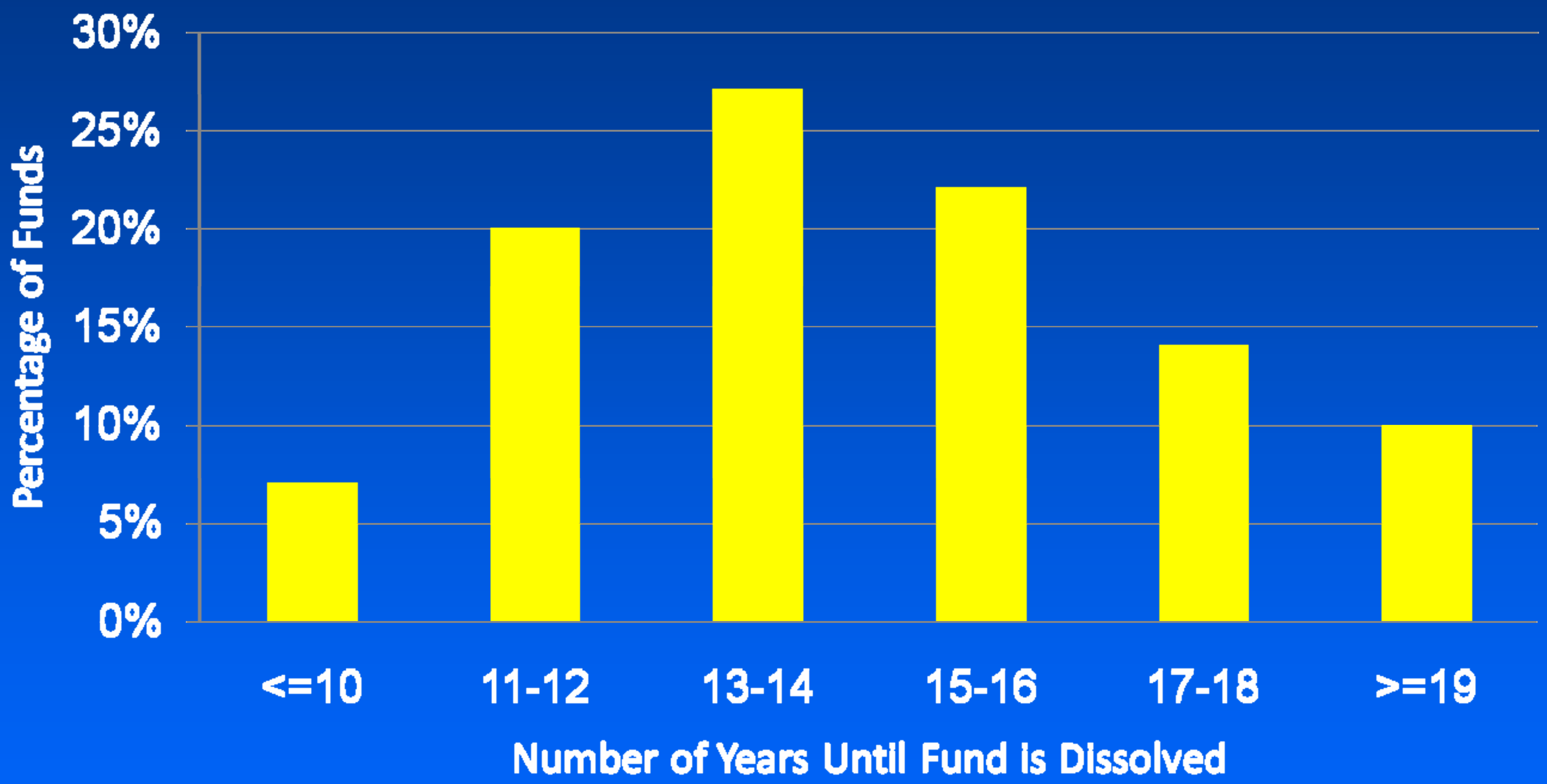
- Call from an entrepreneur asking for help in understanding why the VCs were blocking a great exit opportunity – he had no idea
- VCs have multiple mechanisms to block
- Board control, investment agreements, pref shares and votes
- Happens much more often than people think
- Dramatically <u>increases risk of failure</u>

Years to VC Exit



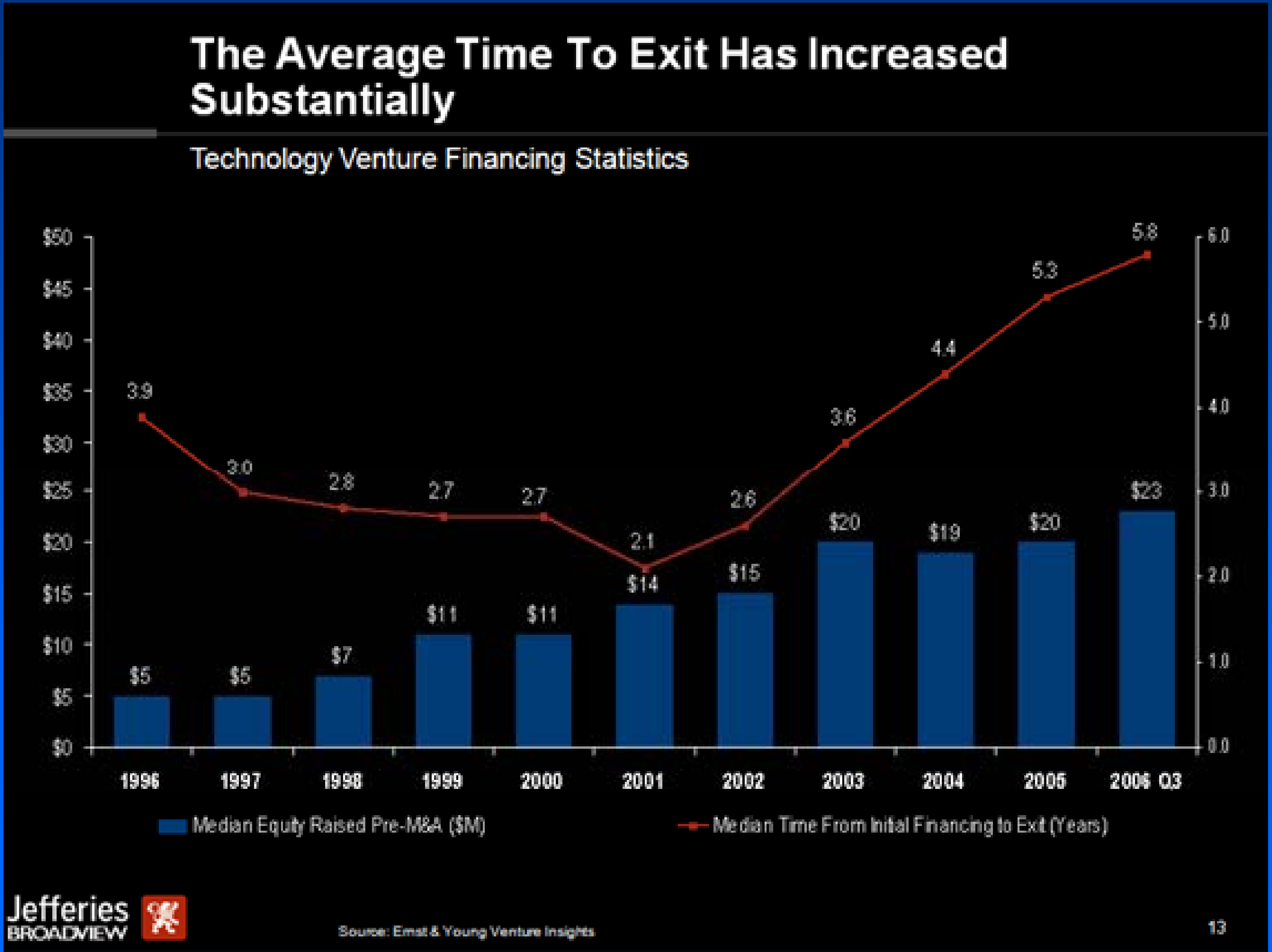
To achieve a minimally acceptable VC return of 20% per year and assuming all of the returns are from 20% of investments.

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.

Increased Time To Exit (VCs)



Angel Investor Math

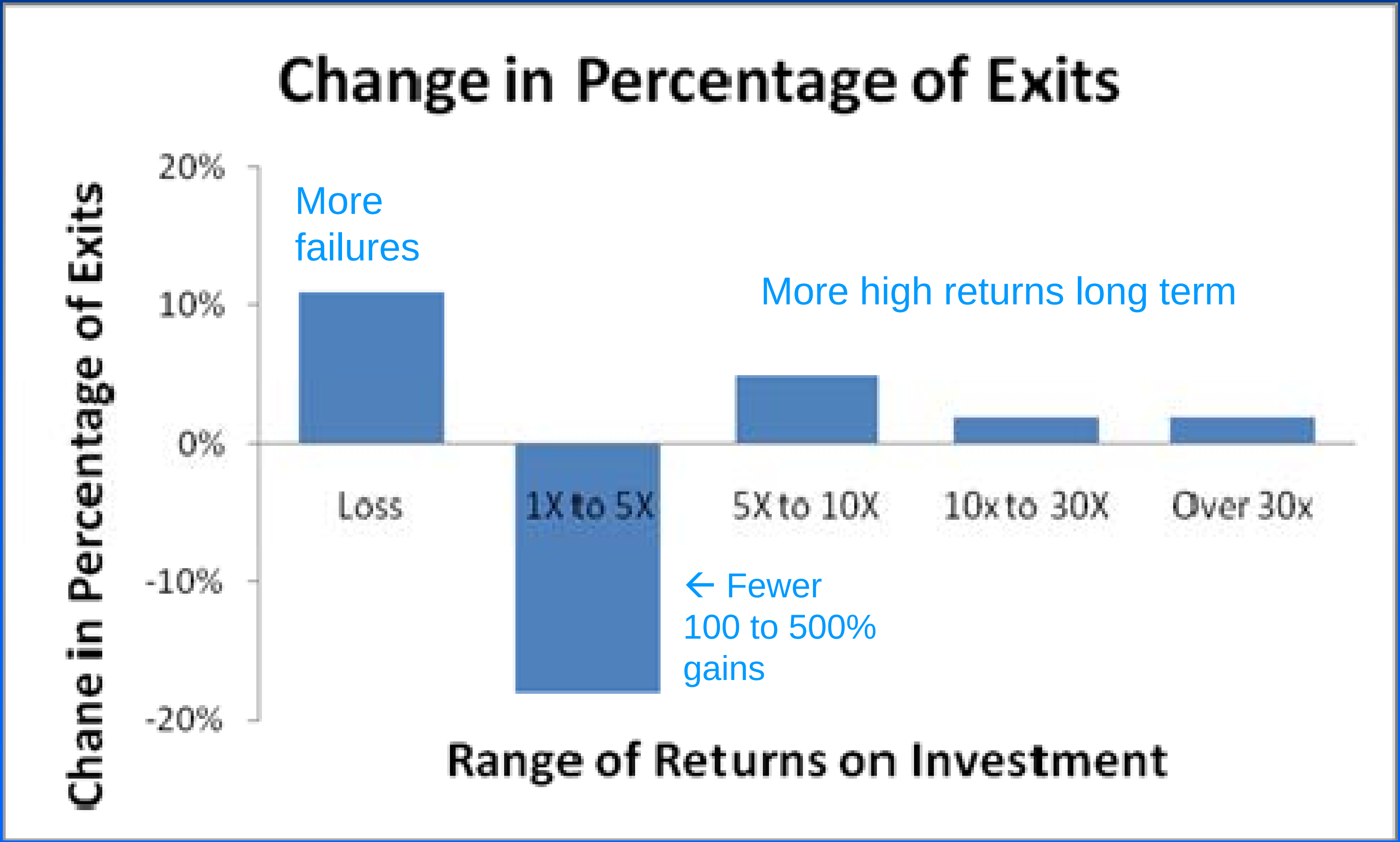
- Investments as small as $25,000 can make sense
- Returns as low as 300% over a few years are attractive
- Can easily reinvest the gains
- Exit objectives much more aligned with entrepreneurs than VCs

Investor Time Horizons

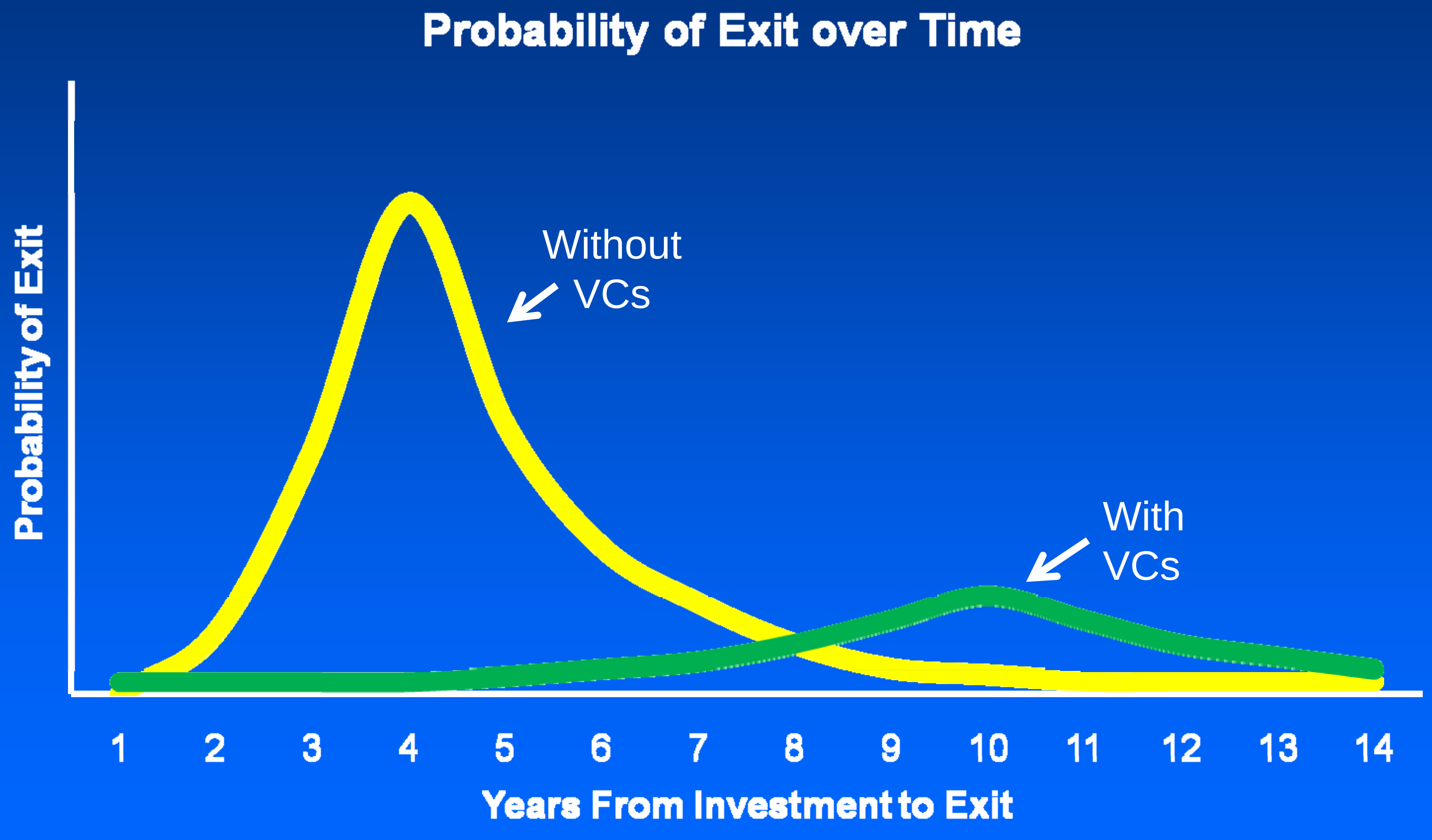
- Angels invest earlier than VCs
- VC’s happy to wait a decade or more and often need to for the math to work
- Angels today increasingly want an exit in 3 to 5 years
- Fundamental incompatibility between angles and VC’s in today’s exit environment

New Insight from Wiltbank Data

What happens to angel deals if a VC invests



Exits Without and With VCs



Angels or VCs but not both

- Fascinating new research May 2008
- Unique historical database of 182 deals
- “outcomes are inferior when angels and VCs coinvest relative to when VCs invest alone.”
- Angels alone “as likely as the VC-backed firms to have successful liquidity events and more likely to survive”
- Proves “Angels or VCs but not both”

Start At The End

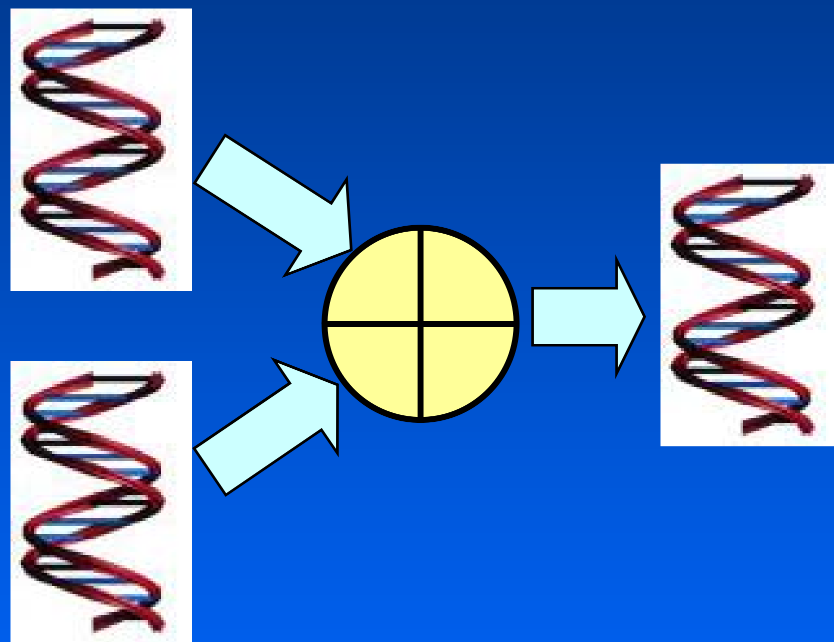
- Entrepreneurs and angels need a clear, and realistic, exit strategy before they think about venture capital.
- Investment from VCs will extend the time to exit, by as much as 10 more years
- And reduce the probability of success
- Early exits provide a much better portfolio return for angels and entrepreneurs

Adding Financial DNA

Entrepreneurial DNA

Combined with

Investors' DNA



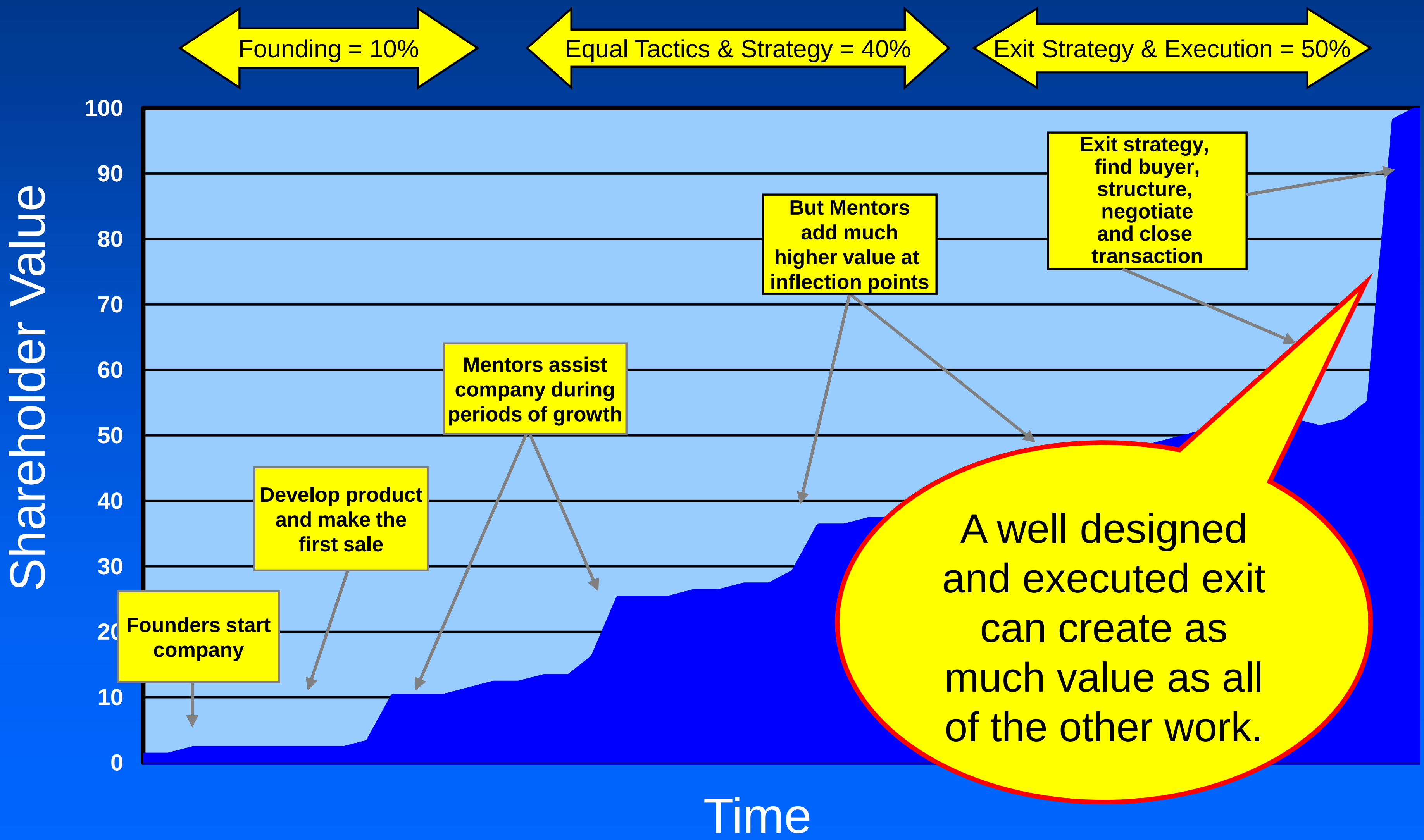
Resulting Corporate DNA is a Hybrid of Entrepreneurs' and Investors' DNA

Check the compatibility first

Selling Can Increase Value 50+%

- Another fascinating aspect of this new exit environment is that the markets are very inefficient
- A well designed and executed exit transaction can often add 50 to 100% to the final valuation of an investment
- How is the subject of my book or could be another breakfast seminar

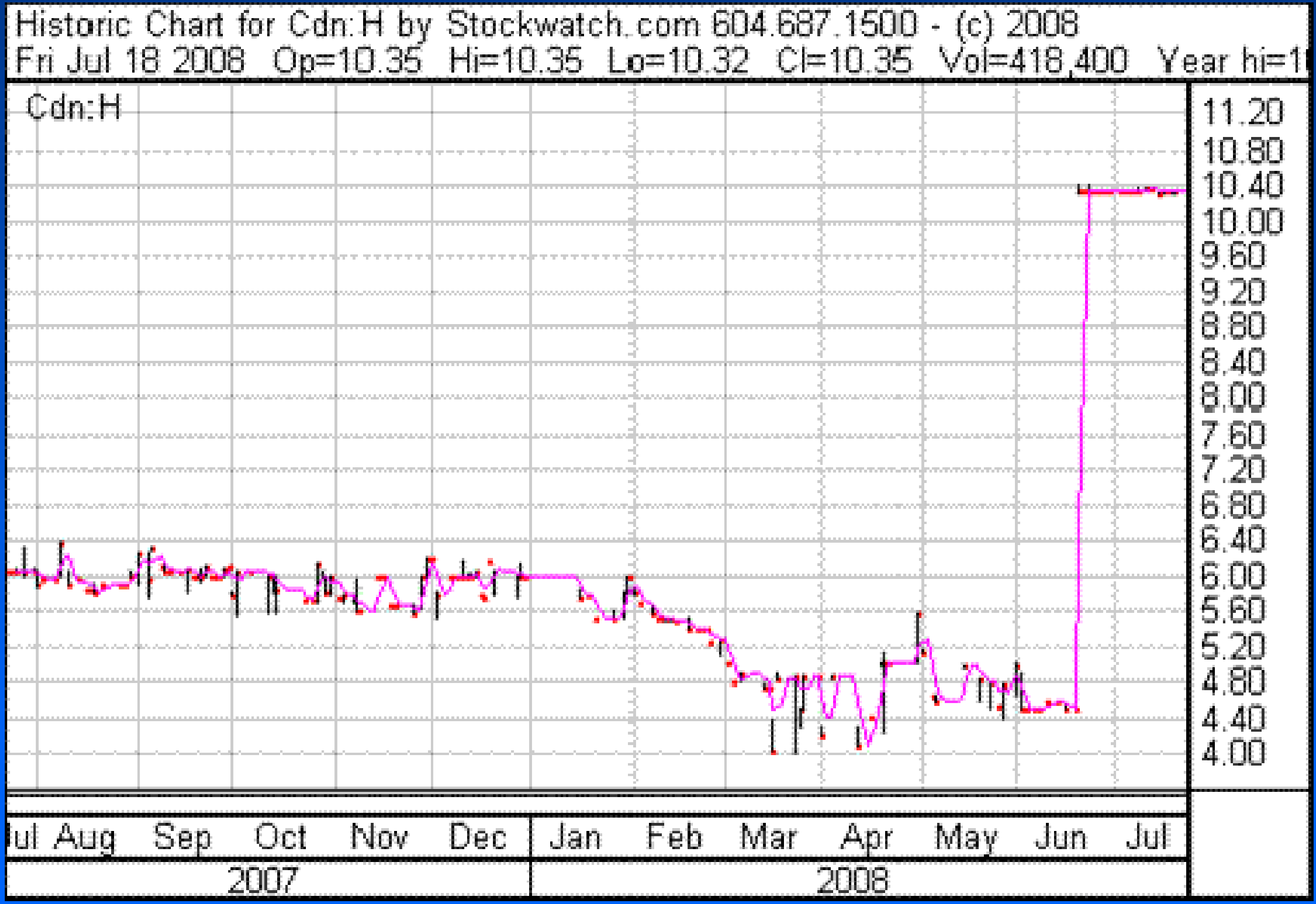
Building Company Value



Public Company Examples

- This extra 50+% of value is not easy to prove for private companies
- But there are lots of public company examples
- Over a wide range of valuations
- Showing an exit can increase valuation 50+%

Hostopia



Deluxe bought for $10.55 / share

Xantrex (and Statpower)

Schneider bought for $15 in July

Yahoo

Microsoft offered $31 in Feb

Early Exits in the BC Tech Fund

- My early-stage venture capital fund
- The BC Tech Fund, one of the BC Advantage Funds
- 16 investments in 9 companies in 3 years
- Three years after I started to invest:
  - Brightside was acquired in February 2007
  - Parasun was acquired in May 2007
  - MetroBridge went public in July 2007

Parasun Case Study

- The company provides high speed internet over cable TV to about 140 communities
- I invested $500,000 in April 2004 at a $3.4 million valuation = $0.40 per share
- Revenues were about $3.8 million with a $500k profit
- My new fund invested at $0.55 per share in June 2005

Parasun Exit Strategy

- I joined as Chair and agreed to do the exit
- The board set a target exit price at the 2005 strategic planning retreat
- The plan was to sell the company in 2.5 to 3 years (late 2006 or early 2007)
- Most of the work was on growing the business

Parasun Exit Valuation

- Started the sales process in the fall of ’05
- Revenues $8.2 million, profit $781k with 30% growth rate, 10 million shares
- Approached 100 companies, short listed 10
- Had several bidders through the final stages
- In Jan 2007 sold the company for 45% more than the target price

Brightside Case Study

- Spin out from the University of British Columbia Physics Applied Optics Lab
- Technology to make LCD displays brighter and higher contrast
- $15 billion /yr market
- Biggest opportunity was large screen devices for home TV applications

My Investments in Brightside

- I first invested when it was just two people and a few patents
- My fund invested three times:
  - $100,000 at $3.2 million valuation = $2.33 /sh
  - $125,000 at $4.2 million valuation = $2.90 /sh
  - $100,000 at $12 million valuation = $5.00 /sh
- In June 2004, Oct 2004 and Aug 2005
- All common shares

Brightside Financing History

- About $7 million was raised from angels
- Including one brokered round that used an Offering Memorandum to place with angels in Europe
- But despite being engaged with a dozen VC firms up and down the west coast, no VCs ever invested in the company
- The VCs wouldn’t invest in common shares

The Brightside Exit

- Without the capital to put the product into production, the only other strategy was to sell the company
- Still in R&D, zero revenues, 8 patents and 3.1 million shares
- The strategy was to sell to a large Asian consumer electronics manufacturer
- Dolby Labs acquired in Feb 2007 (2.75 yrs)

MetroBridge Case Study

- Intel promoting WiMAX aggressively in 2004
- MetroBridge was formed to consolidate all of the fixed broadband wireless companies in BC with a WiMAX strategy
- Raised about $5 million in total over 3 rounds all from angels and my fund
- Were not successful in trying to raise VC $

My Investments in MetroBridge

- I invested the first $200,000 to start the consolidation in Aug 2004 at $0.17 per share
- Then $300,000 at $0.30 per share in Dec 2004
- My new fund invested a small amount at $0.45/ per share in Mar 2006.

The MetroBridge IPO

- MetroBridge completed an IPO using a CPC raising $ 8 million in July 2007 (2.9 yrs)
- With 41 million shares outstanding and 61 million fully diluted
- Revenues were about $ 3 million annualized and losses running about $ 3.5 million/yr
- Growth rate about 100% per year
- IPO was units (share and full warrant)

No VC investments

- None of these companies had VC investment
- Both Brightside and MetroBridge tried to raise VC money, but did not succeed
- I have no doubt that if either had raised money from VCs these early exits would not have occurred

Summary

- Exit environment has changed dramatically
- Early M&A exits are hot
- VC backed IPO exits are non-existent
- When VCs invest in angel backed companies exits are much later
- And failures are higher
- Angels better off with early exits than VCs