

Exit Strategies for Entrepreneurs

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This is a Golden Era

- I believe that history will show that today we are in a golden era for tech entrepreneurs
- Yes, there is lots of doom and gloom in the press and the economy has been suffering
- I believe there has never been a time when it is so easy for entrepreneurs to create such valuable companies on so little capital and sell them so early for so much money

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)

Who are the Buyers Today?

- The most familiar buyers are Fortune 500 companies
- But medium sized companies are also aggressive buyers – especially public ones
- Private Equity funds are also coming back into the market now that debt is available
- Also individuals not ready to retire

M&A Exits Are Happening Earlier

- Flickr sold for \$30 million when it was just one and a half years old
- Delicious was sold for \$30+ million two years from start-up
- Club Penguin was sold for \$350 million when it was two years old
- YouTube sold for \$1.6 billion when it was two years old

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

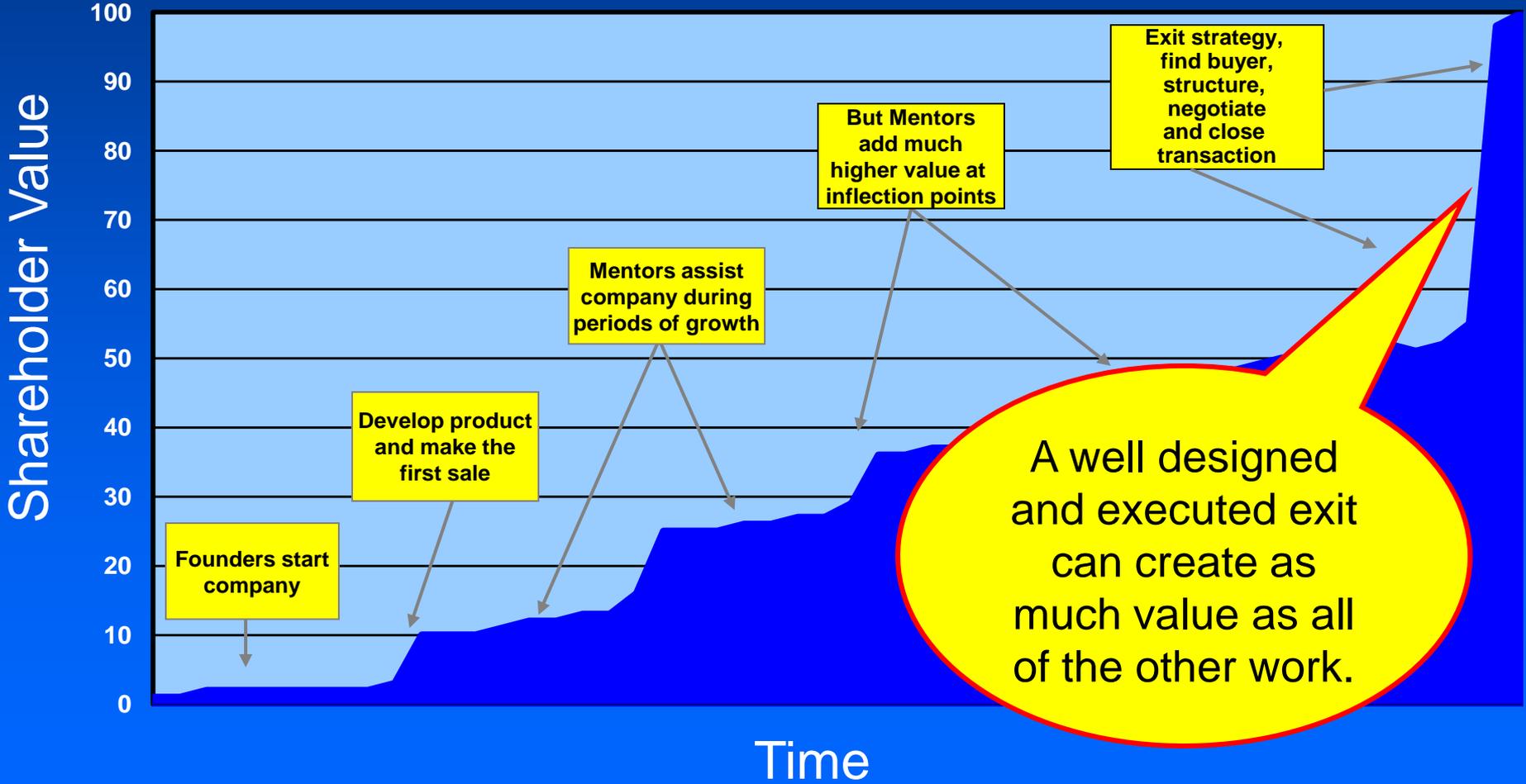
Under \$20 Million Is Easy

- 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
- It's also what their shareholders want

Focusing on Exits is Healthy

- A focus on exits is healthy - and in my strong opinion, does not distract the team from their primary function of maximizing shareholder value (a popular myth)
- For companies with external investors, executing a maximum value exit is the company's primary objective

Maximizing Shareholder Value



Companies Are Sold, Not Bought

- I often hear ‘companies are bought, not sold’
- People think that when ‘it’s time’, someone will knock on their door to buy their company
- While that has happened, it’s almost never a good thing for the shareholders
- It’s not just that the price will be much lower
- More importantly, the probability of success decreases because there is only one bidder

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)
- Every company needs an exit strategy

Steps to Completing an Exit

- The basic steps to completing an exit are:
 1. Build alignment on a realistic exit strategy
 2. Engage the best professionals
 3. Clean up the corporate structure
 4. Prepare for due diligence
 5. Do a secondary sale (in some cases)
 6. Build the sales funnel
 7. Manage the auction (multiple bidders)
 8. Negotiate and close

Developing an Exit Strategy

- The most important element in the business plan
- Every company has an exit strategy
- Even if nobody realizes it
- Even if it's a lifestyle business without investors
- It affects many daily business decisions

The Exit Strategy

- 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
- Entrepreneurs usually need advice on this

Check The Alignment

- It's surprising how often there is a misalignment 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

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. Gross margin per customer
 2. Customer lifetime (or churn)
 3. 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 best time to sell
- 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 wait too long to start

Don't 'Ride It Over The Top'

- It's human nature not to think about exiting when everything is going well
- We often wait to start the exit process once it is clear that the value has peaked
- And by the time the buyers are serious, it's obvious to everyone
- I did that - and recently told the story in "Don't Blow the Biggest Deal of Your Life"

Exits Are Not Well Understood

- Exits are the least understood part of being an entrepreneur
- Not surprising because it doesn't happen very often
- From Scott Shane, author of *Fools Gold*:
 - 1 to 1.5% of Angel backed companies exit
 - 5.9% of Angel group deals exited in 2008
- (Not yet clear if this is a trend)

The M&A Experience and Guidance

- When more tech companies had better boards there was often more than one director who had done a number of exits
- When VCs invested, their investment agreements always gave them control of the exit process and they had the relationships
- Today's capital efficient tech companies very rarely have 'built in' M&A experience

Why The CEO Should Not Lead

- There are several reasons the CEO should not lead the exit process, they:
 - Rarely have the exit experience
 - Need to maximize the financial results
 - Should be held in reserve for the final negotiation of price and terms
 - Are often conflicted
 - Need a good relationship with the new owners (cannot be the ‘bad guy’)

The Ideal Exit Team

- Almost every company needs a team dedicated to maximizing the price and ensuring the transaction completes
- The ideal exit team is:
 - The CEO
 - An M&A Advisor
 - Possibly an Exit Coach
 - A small committee of the board

The Exit Coach – A New Idea

- In the old, VC dominated, model CEOs and boards were less involved with the exit
- Very few directors, and fewer CEOs, have a lot of exit experience
- Often ‘new’ companies should start on the exit just a year, or two, after start up
- Exit knowledge and experience is even more critical for these young companies

The Exit Coach – Cost and Benefits

- This new environment has created a need for a new type of professional with the same depth of knowledge as an M&A advisor,
- Engaged on a financial model more typical of a 'coach' (\$0.5 to 2k /month)
- To work with the CEO before the company engages a full M&A advisor
- And to help select the M&A advisor

Selecting The M&A Advisor

- There is almost nothing written about selecting M&A advisors
- The majority make sub-optimum choices
- Relationships are always exclusive
- The most important criteria are:
 - Transaction completion rate
 - Track record of maximizing price
 - Proximity, knowledge and compatibility

The M&A Advisors Function

- The M&A advisor is really ‘the sales guy’
- Their important functions are to:
 - Plan and coordinate the process
 - Reduce the time to closing
 - Improve the probability of success
 - Protect the CEO (for as long as possible)
 - Maximize the price and terms
 - Do the selling and be the ‘bad guy’

M&A Advisor's Fees

- Fees for selling companies are not published but are surprisingly uniform
- Work fees usually \$50,000 regardless of the company size (less if learning or not busy)
- Success fee, including the work fee, from:
 - 7 to 10% for sales under \$5 million
 - 4 to 6% for sales from \$10 to 30 million
 - 2 to 3% in the \$100 million range

M&A Advisors Should Be Local

- CEOs and boards often start to look for an M&A advisor in the big financial centers
- Dirty secret is that about a third of M&A engagements fail to complete a transaction
- And the failure rate increases as the distance to the M&A advisor increases
- An M&A advisor relationship is intimate and intense – it requires a lot of face time

M&A Advisors Should Be Local

- For the last third of the process, the M&A advisor will almost live with the company
- Some firms say they can do this remotely
- But for transactions under \$100 million, the fees are not enough for the travel required
- Local M&A advisors will also work much harder to protect their reputations
- And are easier to do due diligence on

Consider a Secondary Sale

- A secondary sale is where new investors buy founders' and early investors' shares
- A secondary share sale can be almost 'magical' in finalizing alignment and solving structural defects
- Considered almost impossible a decade ago
- Today, secondaries are much easier to do
- Buyers are usually Angels and small funds

The Exit Timeline

- Once an M&A advisor has been engaged
- The exit usually takes 6 to 18 months
- Depends mostly on the company
- Most of the time is spent preparing the due diligence and sales collateral
- The next biggest time sink is scheduling
- Then waiting for lawyers

Before Contacting Buyers

- A common, and expensive, mistake is engaging with prospective buyers before the company is ready
- Then realizing that there is a lot to be done before due diligence can complete
- At worst, the buyer loses interest
- At best, it costs the company hundreds of thousands in professional fees

Clean Up The Structure

- In almost every exit I have seen
- There are structural defects that need to be cleaned up before the exit can complete
- Some are built into the corporate structure
- Others are contracts with unforeseen consequences during an exit
- Fix these before contacting buyers

Employment and IP Agreements

- Do the deep patent work early
- Every buyer will want senior and technical employees to have signed a good, modern employment agreement
- Many companies miss the contractors
- Both are essential for IP ownership
- Don't get held for ransom at the closing by an employee who doesn't want to sign

Corporate Records and Taxes

- Have a very experienced M&A lawyer review all of the corporate records early
- Shareholder and board meeting minutes are critical
- Taxes are different in each state and can be almost impossible to get certainty on
- Don't overpay your law firm to build the corporate record history at the last minute

The Shares and Share Register

- About half of the companies I've seen start an exit don't have their shares properly issued or properly recorded
- Far too often the sale proceeds will be in the lawyer's trust account before shareholders start to dispute the records
- And print out years old emails from the CEO
- Get everyone to sign confirmations early

Review or Audited Financials

- Most companies have notice to reader financial statements
- Post Enron, audit costs have skyrocketed
- Some buyers will accept review engagements, but others need audits
- Consider reporting in US currency & GAAP
- Don't pay your outside accountants double at the end to do the review or audit

The Sales Collateral

- Should all be complete before contacting the first prospects:
 - Complete due diligence online
 - Teaser document (2 pages)
 - Selling document (20 pages)
 - Financial history and projections (Excel)
 - PowerPoint for online and boardroom presentations

The Sales Funnel

- For most companies, the suspect list can be 50 to 100 buyers
- 10 to 20 might sign the NDA and get the selling document and financials
- 5 to 7 might visit and start due diligence
- Optimum short list is 3
- And is probably a practical maximum

Maximizing The Price

- There are many ways to maximize the final selling price:
 1. Structural value increase
 2. Illuminating strategic value
 3. Capitalizing on Inefficient Markets
 4. Maintaining multiple bidders
 5. Sales and negotiating skill
- Articles on each on AngelBlog

The Reps and Warranties

- A very experienced M&A lawyer friend says that in his experience,
- More M&A transactions fall apart on the Reps and Warranties than price and terms
- CEOs, and Directors, should be afraid to sign personal guarantees about things that are literally unknowable
- But they have to – so introduce it early

Closing and The Party

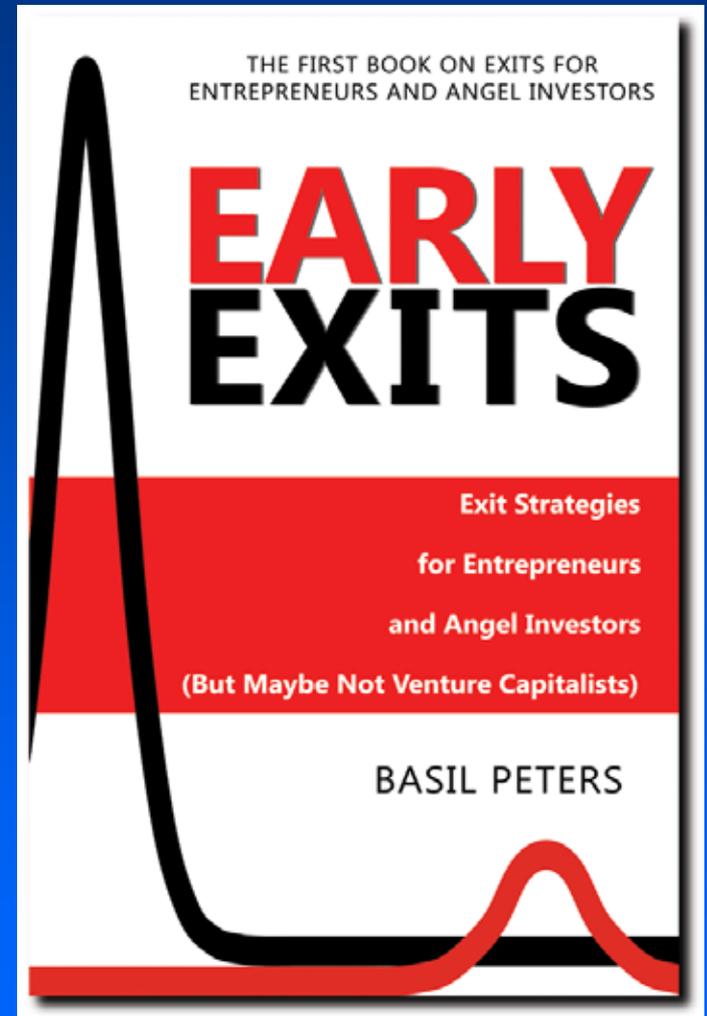
- Once everything is completely agreed to
- It still takes forever to close (4 to 8 weeks)
- There are hundreds of small sticking points
- And fate will have it that their lawyer is working on three closings simultaneously
- M&A closing parties are always the best parties (that I am allowed to go to)

Exits and Recycling

- I think exits are the best part of being an entrepreneur and investor
- It's when we get paid for all of our hard work and risk capital
- It's also when entrepreneurs and angels have the option of doing it all again,
- Or doing something else with our money
- Think of it as recycling.

Early Exits – The Book

- Started to share some of what I had learned about exits on my blog: www.AngelBlog.net
- That grew to be an entire book
- Available in hard copy or ebook formats at: www.Early-Exits.com



Earlier Talks on Exit Strategy

- Online videos of my recent talks on exits:
- [www.AngelBlog.net/
Exit Strategies for Angel Investors Video.html](http://www.AngelBlog.net/Exit_Strategies_for_Angel_Investors_Video.html)
- [www.AngelBlog.net/
Start at the End Your Exit Strategy.html](http://www.AngelBlog.net/Start_at_the_End_Your_Exit_Strategy.html)
- And what not to do:
- [www.AngelBlog.net/
Dont Blow the Biggest Deal of Your Life.html](http://www.AngelBlog.net/Dont_Blow_the_Biggest_Deal_of_Your_Life.html)

Good Luck With
All of Your Exits!