Early Exits Workshop
Part 1
Angel Investing in the 21st Century

Angel Capital Association
San Francisco

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by Basil Peters

Early Exits Workshop Outline

- Part 1 - Introduction
- Part 2 - Strategy
- Part 3 - Execution
- Part 4 – Valuation Exercise
- 10 minute breaks between parts
- Time allocated for questions in your workbook
- Will move fairly quickly
- Goals - ‘take home value’ and resources

Qualifiers On This Presentation

- I'm an Electrical and Computer Engineer
- I was a technology entrepreneur
- And now I'm a technology investor
- My comments are from my tech background
- Some aspects of investing in, and exiting, life science and energy companies are different

How I Got Started on Early Exits

- I became fascinated by early exits in 2002
- When co-founding a seed / early stage VC fund
- Our local government provides a 30% tax credit to investors in qualified VC funds
- Under this legislation, investors can get their money back in just five years
- Less than half the time for typical VC funds

Building a “5 Year” VC Fund

- As a fund manager, I knew I would need to focus 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

Successful Investing

- I’ve learned (expensively) that successful investing requires two things:

1. Investing Right:
   - In the right companies
   - At the right valuation
   - With the right terms
2. Exiting Well
   - At a good price
   - In a reasonable time

More $ and More J

- We spend a lot of time on the investing part
- I believe Angel investors and entrepreneurs
- Would have:
  1. More Fun, and
  2. Make More Money
- If we focused more on our exits

Angel Investing Is Still New

- Organized angel investing is still quite new
- The early angel groups started around 1994 - 97
- Angel investing today is where traditional Venture Capital was in the early 1980s
- We are still discovering the best practices
- Still don't have anywhere near enough hard data
- That's why meetings like this, and associations like the ACA, are so important

What Angels Used To Think

- In the past, most angel investors would:
  1. Find a company
  2. Write a check
  3. Hope a Venture Capital fund followed
  4. Wait 10 to 15 years for an exit
- That may have worked in the 90's
- But it certainly doesn't work anymore

The Economy Has Changed

- That doesn't work anymore <u>in tech</u> because
- <u>Traditional</u> Venture Capital doesn't work
- When I wrote "Early Exits" in 2009, that was a controversial statement
- It's not anymore
- When VCs invest they set the terms, so our returns suffer with theirs - or worse

Section 1.1

For Technology Companies, The Traditional Venture Capital Model Doesn’t Work Anymore

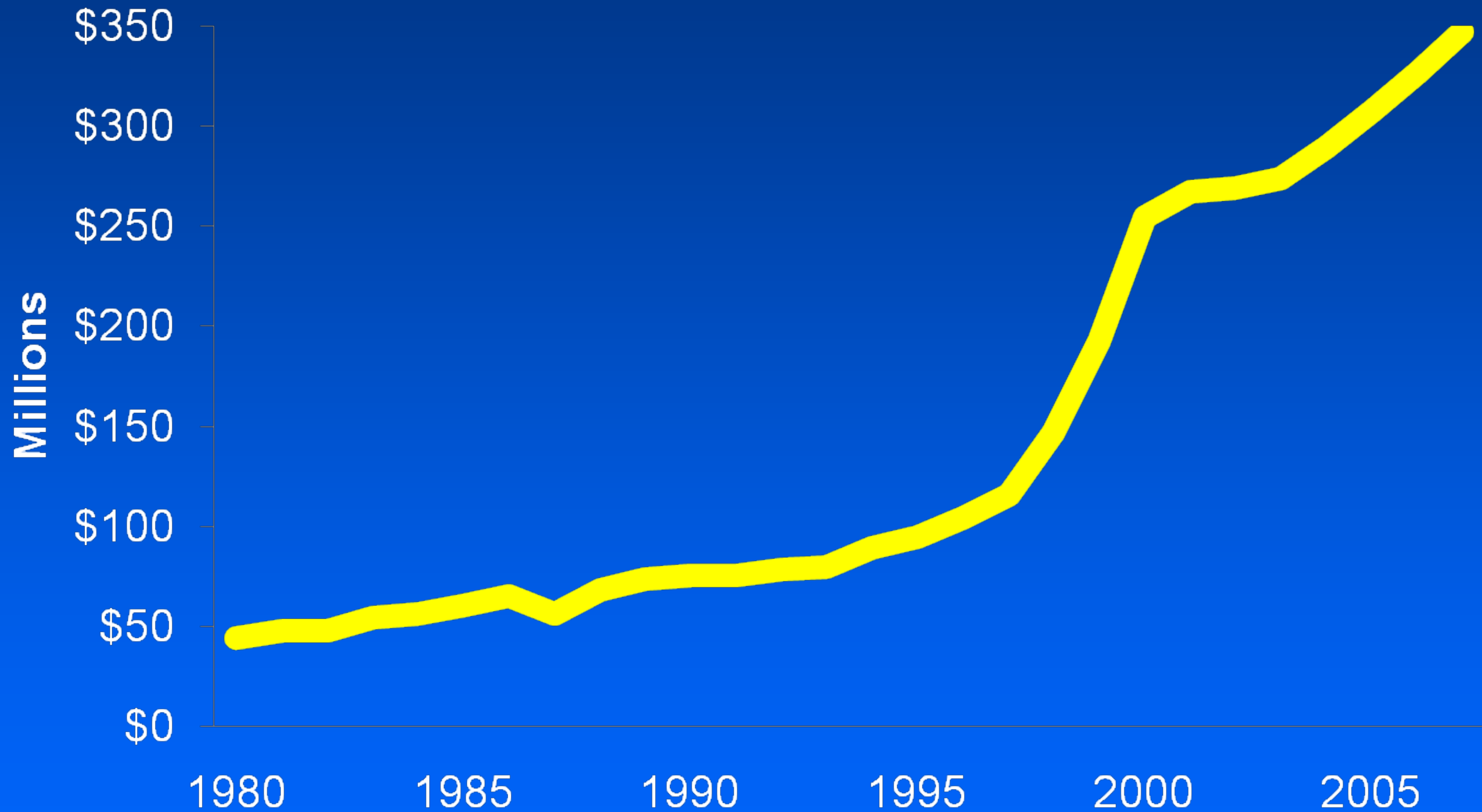
Venture Capital Doesn’t Work

- The summary of why traditional VC funds don’t work anymore (in tech):
  1. Today’s VC funds are far too large
  2. Too few IPOs and Huge M&A exits
  3. Start-ups don’t need that much money
  4. Big companies consider VCs competitors

Angels and VCs - More Different

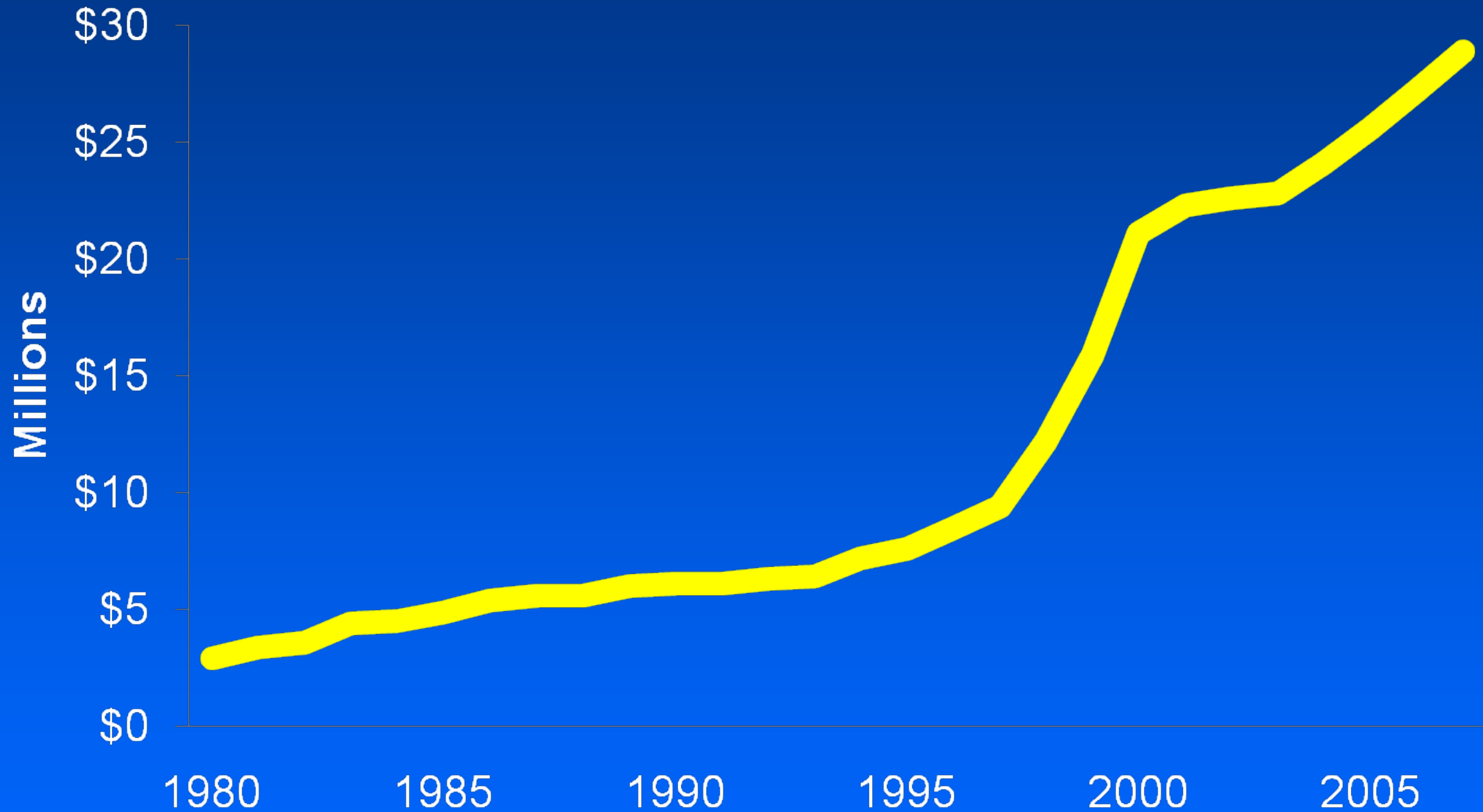
- This new environment is creating a much clearer understanding of how different angels and traditional VCs really are
- From an exit perspective, there are three important differences:
  1. Minimum investment size
  2. Minimum return required
  3. Acceptable time to exit

Size of Average VC Firms



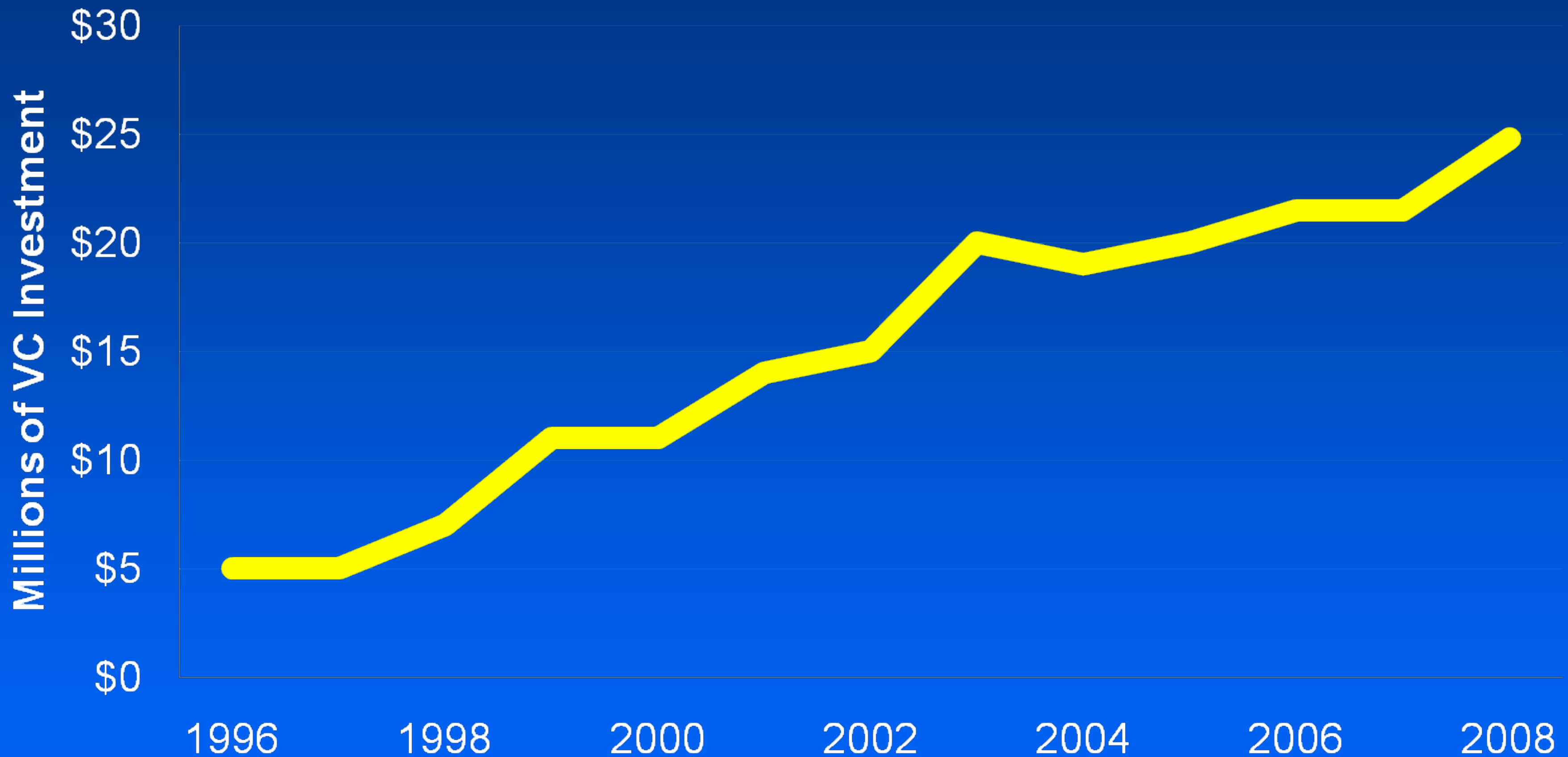
Source: US National Venture Capital Association, Thomson Financial

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 only invest money once
- 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 average 30x return

92% of M&As Don’t Work for VCs

Data from Mergerstat

What Happened to IPOs?

- There have been very few big tech IPOs
- Not just for the past few years, since the mortgage crisis
- There have been very few VC backed IPOs since the tech equity bubble burst in 2000
- And it's not likely that the IPO market will ever return to what it was in America
- Until Sarbanes Oxley is repealed or modified

What About Big M&A Exits?

- The media distorts our perception by focusing on the multi-billion dollar M&A deals, like
- YouTube and Skype
- The dirty secret is those huge transactions rarely work anymore
- And corporate America is figuring that out
- So huge M&As aren't happening as often either
- Fascinating comment by Charles Rim of Google

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 need to get their money back
- 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 term sheet at $50M post-money [which might be only $30 million pre-money] you’ve basically signed up for at least a $200M exit target

More on the old VC Model

- If you are interested in reading more on why the traditional VC model doesn't work anymore:

  http://www.angelblog.net/The_VC_Model_is_Broken.html

Discussion on:

For Technology Companies, The Traditional Venture Capital Model Doesn’t Work Anymore

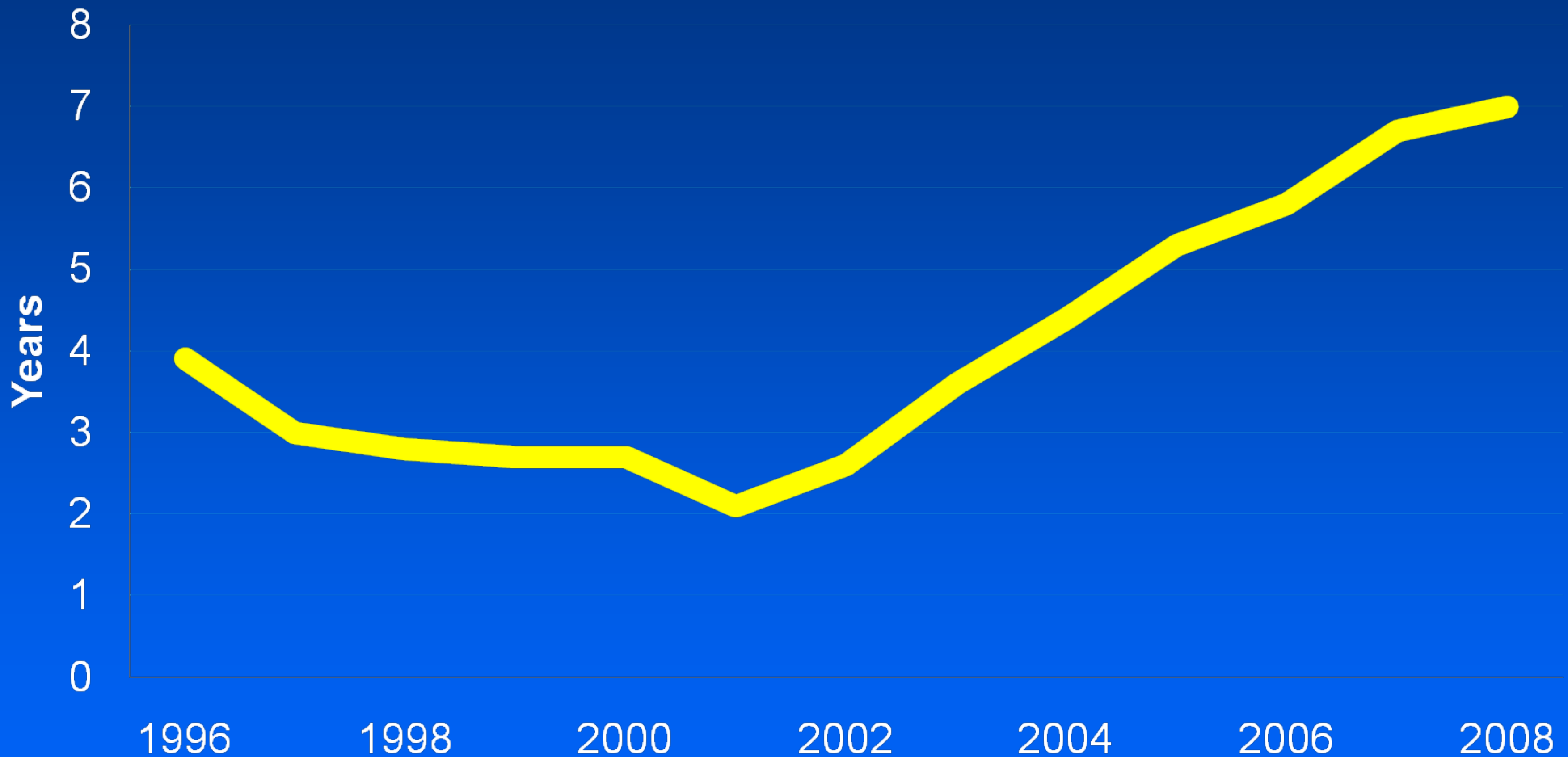
Section 1.2

What happens to Angels when traditional VCs invest in our companies?

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

Time from VC Financing to M&A Exit

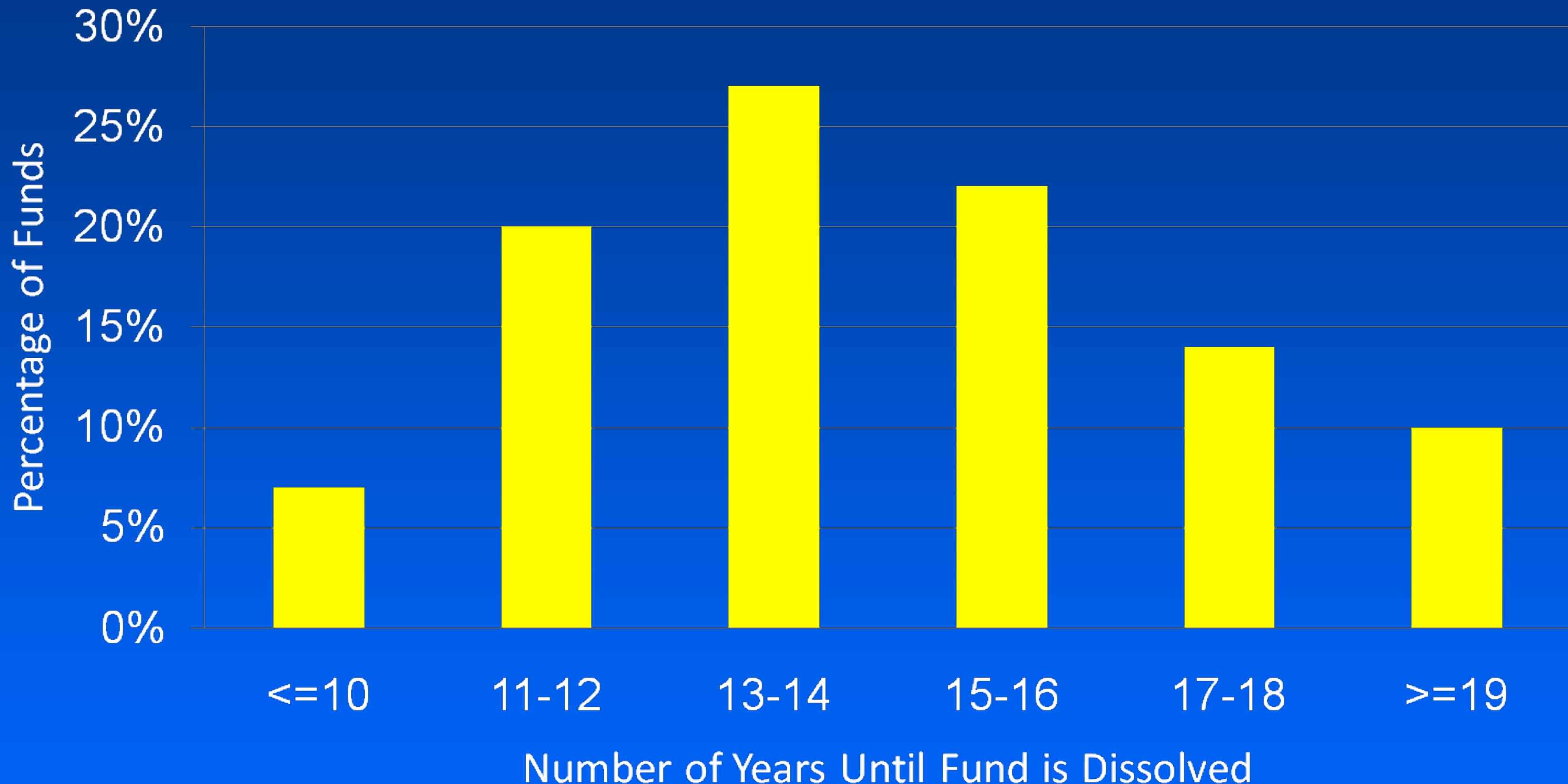


Median Time from initial VC financing to exit in years. 2008 data for Q1.
Source: Jeffries Broadview, Dow Jones VentureSource

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 this equates to about <u>10 years longer for the angels</u>
- At first glance this 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.

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
- Significantly <u>increases the risk of failure</u>

Angel Investor Math

- Investments as small as $10,000 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 traditional VCs

Investor Time Horizons

- VCs can wait a decade or more - and often need to for their math to work
- Angels today increasingly want an exit in 3 to 5 years
- Especially in today's economy
- Is a fundamental incompatibility between angels and VCs in today's exit environment

Angels or VCs But Not Both

- Fascinating new research May 2008 from the University of Maryland Business School
- 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”
- I believe current data would favor the angels

Angels, VCs and IPOs

- 2009 research report by Jeffrey Sohl from the University of New Hampshire
- Analyzed 665 IPOs from 2001 to 2007
- 13% had only angels, 33% only VCs, 16% both
- VC backed firms had “higher underpricing”
- “Angels’ incentives are more closely aligned with pre-IPO shareholders”
- “managers may prefer to obtain early stage financing from Angel investors”

More Validating Research

- April 2010 research report by Kerr and Lerner from the Harvard Business School
- Assisted by James Geshwiler, Warren Hanselman, Richard Sudek and John May
- “Angel funded firms are significantly more likely to survive at least four years and to raise additional financing”
- “Angel funded firms are also more likely to show improved venture performance and growth”

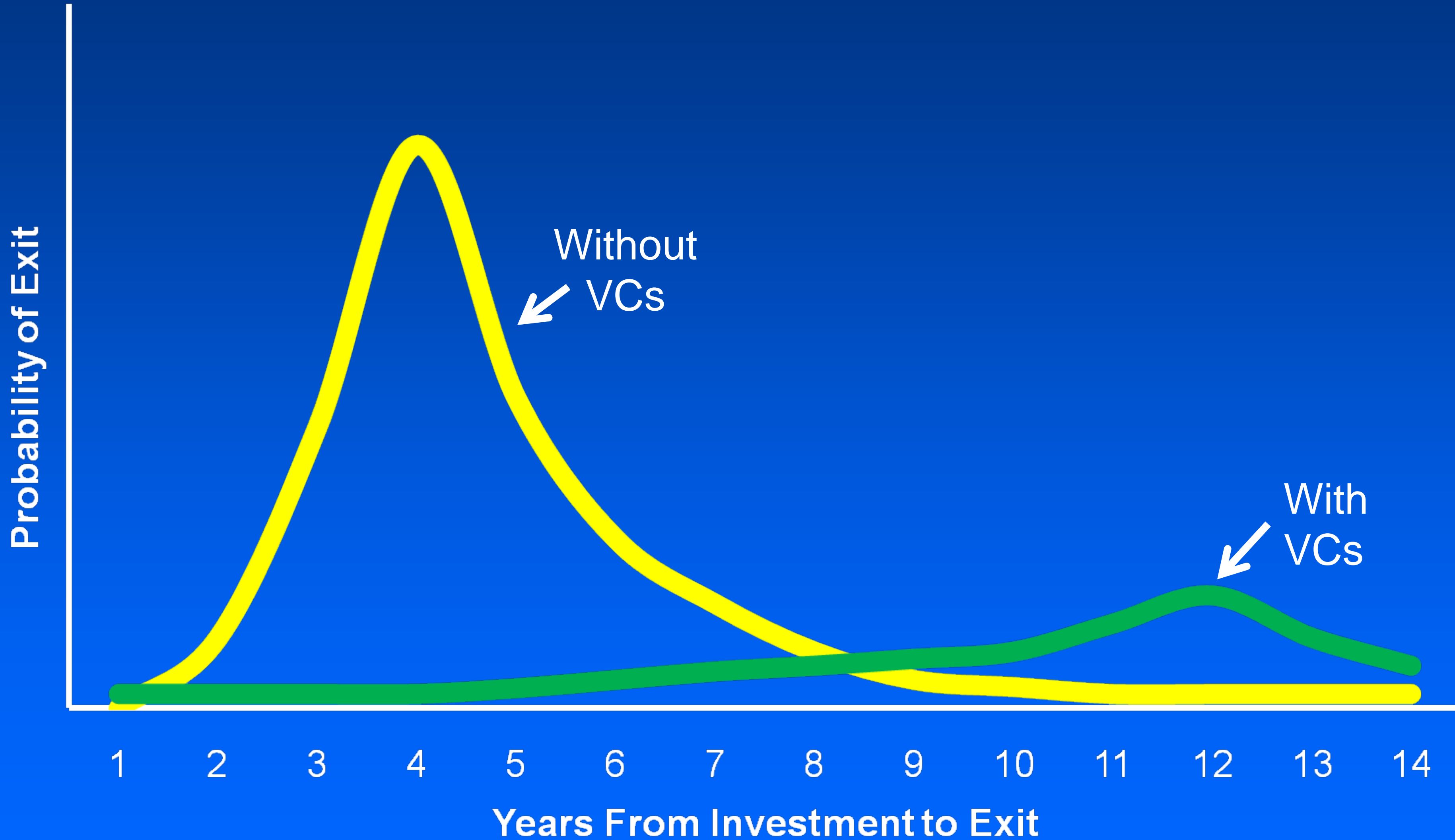
What Happens When VCs Invest
New insights from Wiltbank Data

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

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 lower average returns for both the angels and entrepreneurs when VCs invest

Exits Without and With VCs



Are VCs Ever a Good Idea?

- Does this mean angels should never let VCs invest in their companies?
- Is it ever a good idea to invite VCs to invest?
- Many of my good friends are VCs
- 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

When Do VCs Make Sense?

	Angels	VCs
Amount of capital required to prove the business model	Under $5 -10 million	Over $5 -10 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

Not an option, or preference, this is determined by the ‘type’ of company

Just say “No” to Moon Shots

- So please don’t invest in too many deals that need a $multi-hundred exit
- Or invest in companies that might accept subsequent investment from funds that need ‘moon shots’
- Like most traditional Venture Capital funds
- Unless you really understand the risks
- (There are new VC 2.0 funds that are OK)

Discussion on:

What happens to Angels when traditional VCs invest in our companies?

Section 1.3

Most M&A Exits are under $20 million

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

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)

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 businesses 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

Big Companies Have 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
- Yahoo has $3 billion
- Microsoft has $35 billion
- Apple has $25 billion

Big Companies = VC Competitors

- Another fascinating new development
- Big company corporate development and M&A teams now consider VCs their competitors
- Big companies have lots of cash
- And don’t see VCs as adding a lot of value
- They know VCs will hold on for huge exits
- So they plan to acquire the good companies before the VCs can invest

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.angelblog.net/Google_Wants_Even_Earlier_Exits_Than_in_Early_Exits.html

Who Else Is Buying?

- 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 many individuals not ready to retire
- All combining to create a very healthy market for exits under $30 million

Discussion on

Most M&A Exits are under $20 million

Section 1.4

Investing in Internet Time

Investing 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

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’
- For example, prove what a customer is worth and what they cost to acquire

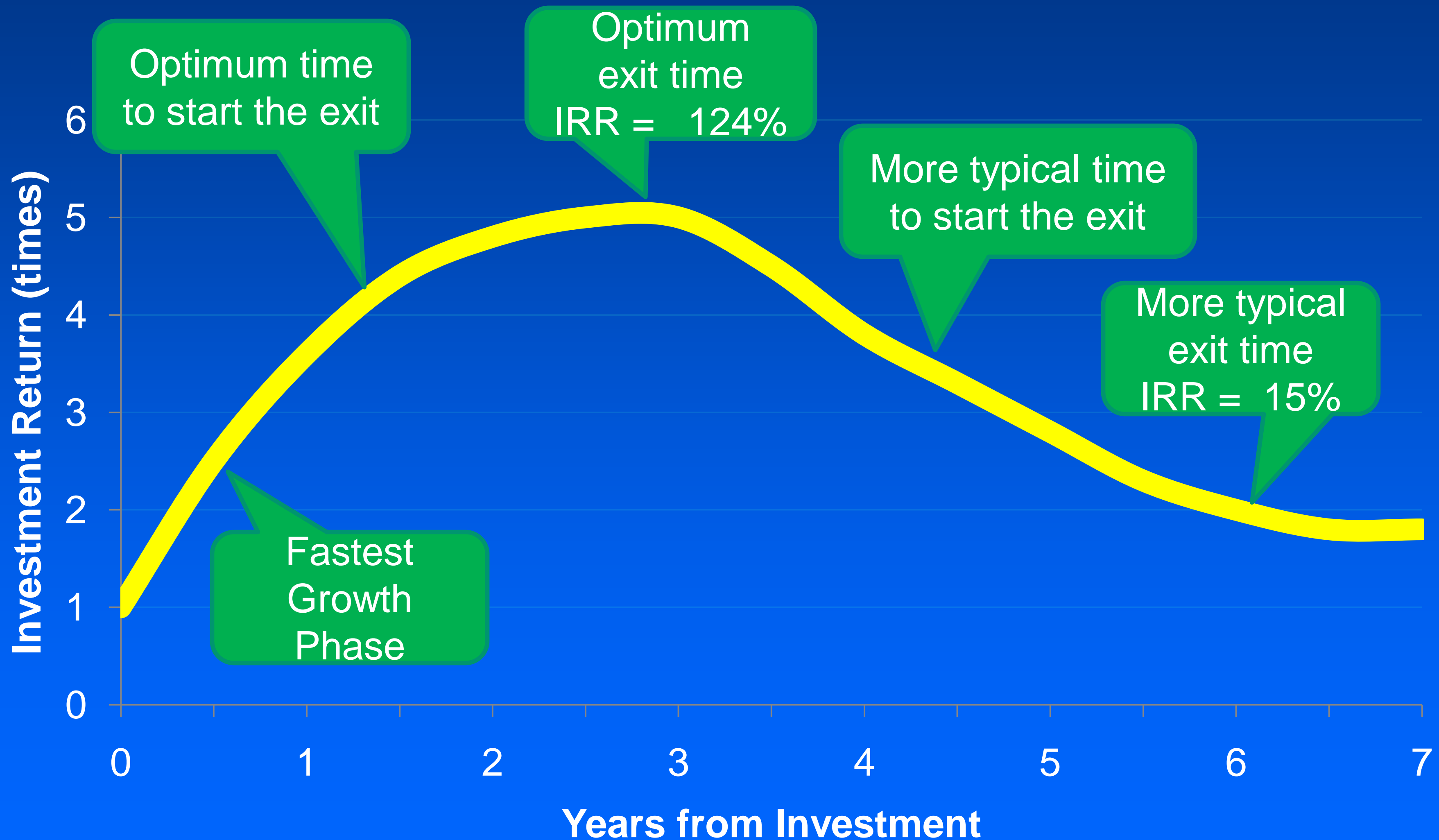
Proven Model and Value

- 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"



Discussion on:

Investing in Internet Time

Section 1.5

Startup Economics and Other Changes

Startup Economics Have Changed

- An even bigger change than the disappearance of big exits is
- How little it costs to build a tech company today
- Back when I was an entrepreneur, hardware and software companies cost $10s millions
- Which gave rise to the huge VC funds
- Today, entrepreneurs can build companies for $100,000s and in some cases $10,000s

Why It Costs So Little Today

- The biggest change in the history of man
- Is not the railroads, the telephone or air travel
- It's the internet
- It's not just instant access to the entire global market,
- The internet is fundamentally changing how we work
- For example, open source software

Open Source Software

- I did not think that open source software could be a threat to companies like Microsoft or Adobe
- I could not imagine how a large software project could be planned and executed without managers and meetings, or
- Without paying developers or charging customers
- Today, software systems that would have cost $100,000’s and taken years a decade ago, take $1,000s and just weeks – on the internet
- One of the biggest changes in mankind’s history

Other Fundamental Changes

- Crisis of Governance
  - It is much harder today to build and retain an excellent board
  - Especially with companies needing less capital
- The Equity Effect
  - The younger generations have much shorter attention spans
  - Most startups have to sell in 3 to 5 years or the equity effect will slow them down

Discussion on:

Startup Economics
and Other Changes

Section 1.6

Angel Investing in Our 21st Century Economy

Our 21st Century Economy

- What works today:
  1. Startups innovate
  2. Angels, Friends and Family finance them
  3. Big companies, and others, buy them early
  4. The buyers then grow the business
  5. Entrepreneurs and Angels recycle the gains

The Tech M&A Golden Era

- There has never been a time before when
- It was so easy for entrepreneurs to create
- Such valuable companies
- On so little capital, and
- Sell them so early
- For so much money

‘New’ Angel Model

- Find promising companies, do due diligence
- Check the founders alignment on the exit
- Term sheet designed to facilitate the exit
- Possibly syndicate with other groups
- Ensure they won’t accidentally take VC money
- Work with the company as a financial partner
- Exit in 3 to 5 years

Discussion on:

Angel Investing in
Our 21st Century Economy

Break