

Early Exits Workshop  
Part 2  
Exit Strategy

Angel Capital Association  
San Francisco

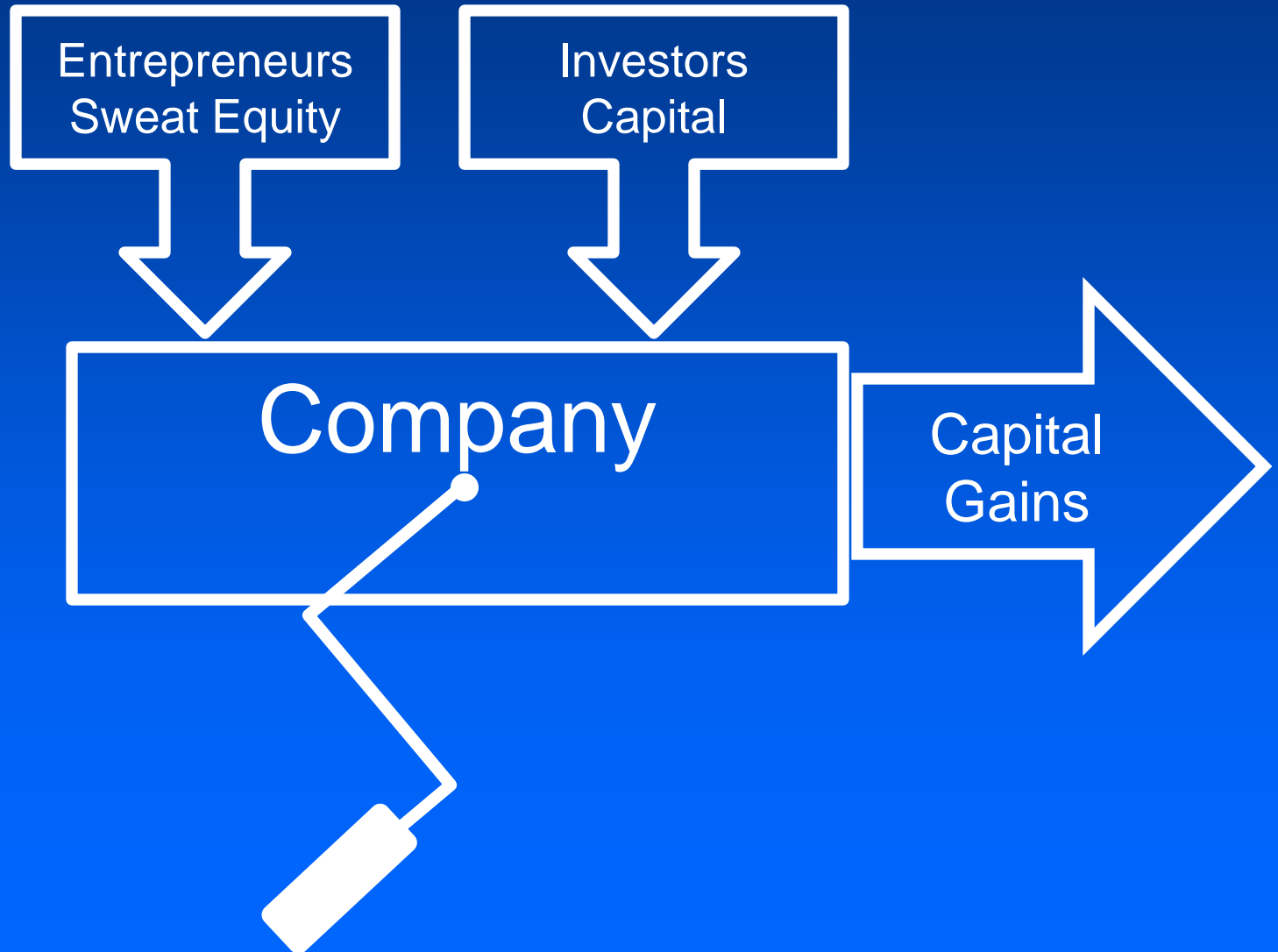
May 5, 2010

by Basil Peters

# 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

# Simple Model of a Company



# Planning for Early Exits

- 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
- What are the steps?
- Where do we start?

# 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)

# 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
- Optimum exits require an active sales process

# 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
- The exit strategy is the plan for the business – the entire business
- The plan should start at the end (the goal)
- Every company should have an exit strategy

# Planning for Successful Exits

- What should we be doing to plan for more successful exits?
  1. Company selection (by type)
  2. Understand the exit strategy
  3. Test the exit alignment
  4. Design the term sheet to facilitate the exit
  5. Especially the vesting
  6. Don't let VCs change the exit strategy
  7. Help maintain focus and execute the exit

# What Type of Company Is It?

	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

This is not easy – few entrepreneurs have enough experience

# Section 2.1

## Building Alignment on the Exit Strategy and Secondary Sales

# 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 serious 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

# 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

# Successful Secondary Sales

- Secondaries can be successful, if:
  - The price is reasonable (-30 to - 40%), and
  - There is a clear exit strategy, and a
  - Good team in place to execute the exit
- For example, the ParaSun case study
- In that case, the buyers were angels and other accredited investors (about a dozen)

Discussion on:

Building Alignment on  
the Exit Strategy and  
Secondary Sales

## Section 2.2

# Financing Today's Startups

# Who Actually Finances Startups?

- The majority of entrepreneurs still believe traditional VCs finance most startups
- Probably due to the NVCA's PR program and lobbying efforts
- The data shows that Angel Investors finance 27x more startups than traditional Venture Capital Funds
- More at:  
[www.AngelBlog.net/Angels\\_Finance\\_27\\_Times\\_More\\_Start-ups\\_Than\\_VCs.html](http://www.AngelBlog.net/Angels_Finance_27_Times_More_Start-ups_Than_VCs.html)

# Financing Today's Startups

- In America, Venture Capital Funds invest about \$20 billion/year – and this is declining
- Angel investors also invest about \$20 billion each year – I believe that number is growing
- Even more surprising, Friends and Family investors invest about 3 to 5 times more than either VCs or Angels
- From “Fools Gold” by Scott Shane 2009
- I predict Angels will be 4X \$ VCs in 10 years

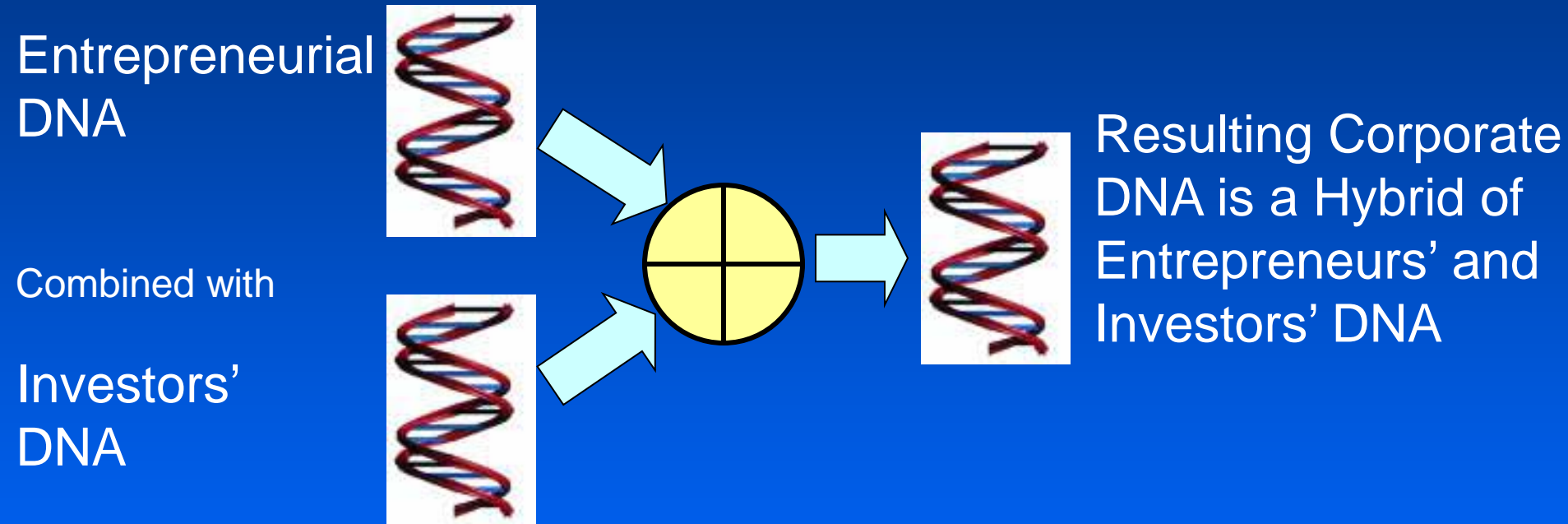
# First Exit Strategy, Then Finance

- 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

# Why The Exit Strategy Comes First

- Different types of investors are compatible with different types of exit strategies!
- Making a mistake about this early on can easily cost you the entire company
- It almost cost me my first
- A video of my war story is online at:
- [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)

# Check Financial DNA Before



Check the compatibility first

# Angel Syndication

- Just a couple of years ago, the conventional wisdom was that angel investment topped out at around \$1 to 2 million per company
- ACEF and ACA started talking about co-investment just a couple of years ago
- Now I often see groups of angels investing \$5 million to \$10 million in one company, over several rounds
- More than enough for today's companies

Discussion on:

Financing Today's Startups

## Section 2.3

# Term Sheets and Exits

# Term Sheets and Corporate Structure

- The term sheet is the most important agreement between the company and investors
- It establishes the framework for their interaction and the company governance
- Has a significant impact on the success of the entire company
- And on the prospects for a successful exit

# Term Sheets Can Kill

- One of my frustrations is finding a promising company that I would like to invest in
- That has been using a term sheet that is completely inappropriate - or detrimental
- And having to spend months of hard work to build consensus among the founders, board, lawyers and other investors to change it
- The wrong term sheet can be deadly

# My 'One Page' Term Sheet

- I started to develop the One Page Term Sheet while I was CEO of BC Advantage Funds – a seed stage venture capital fund
- My strategy was to co-invest with local Angels
- Which required a common term sheet
- I've used it over a dozen times and it has not gotten me into trouble - yet

# Foundational Philosophies

- The One Page Term Sheet:
- Assumes good governance and corporate structure
- Is based on alignment and fairness
- KISS (and on one piece of paper)
- Online for anyone to use at:  
[www.AngelBlog.net/The\\_One\\_Page\\_Term\\_Sheet.html](http://www.AngelBlog.net/The_One_Page_Term_Sheet.html)

# Capital Structure Alternatives

- Some angels have been using the National Venture Capital Association “Heavy Preferred” term sheet - unfortunately
- Angels also used convertible debt – which is almost never fair to the investors
- Common shares create the best alignment, governance and KISS
- Exchangeable shares – an interesting alternative

# Share and Option Vesting

- All stock options, and all nominally priced previously issued shares, will vest on the following basis:
- 50% of the shares will vest daily and linearly over a three year period; and
- The other 50% will not vest unless and until there is a sale of the Company
- All vesting accelerates on a sale

# Liquidity Event – Drag Along

- To ensure that a return can be provided to all of the shareholders
- The investors require a "drag-along" right be added to the Company's constating documents
- To allow the holders of 51% of all the issued shares of the Company to cause the sale of the Company – think carefully about this

# The Board of Directors

- Total of five members: the CEO, one nominee of the Fund,
- And three independent of management
- That the Company and the Fund agree on
- Each director must have made a meaningful investment in the Company
- If you believe in the board, common shares are just fine - you don't need preferreds

# Challenges with Boards Today

- My writing on term sheets and corporate structure was based on my belief that a good board would always be in place
- That worked well up until a little while ago
- In the past five years it has become much more difficult to build and retain an excellent board for an early stage company
- Causing me to re-think my simple term sheet

# Where The One Pager Works

- The One Page Term Sheet works well if:
- Total capital required is between \$0.5 million and a few million
- Then the company plans to exit
- There will always be a very good board
- A Heavy Preferred financing is not contemplated

# When Rosen's Light Pref is Better

- My thinking is evolving
- I still like my One Page Term Sheet
- But I am not confident about companies' abilities to recruit and retain a good board
- Many modern companies don't need much money, so its even harder to build a board
- In many current situations the Dan Rosen Light Pref term sheet is better

# The Rosen Light Pref for Angels

- Dan Rosen is the Chair of the Alliance of Angels in Seattle
- He's been working with Angels in the North West to build a 'light preferred' term sheet optimized for today's angel investments
- Consensus is building nicely
- Facilitating syndication in the region
- Dan is teaching a workshop this afternoon

# Video on Dan's Term Sheet

- [Angel Term Sheet Evolution with Dan Rosen](#)  
Bellingham Angels Education, Bellingham
- Available from [www.AngelBlog.net](http://www.AngelBlog.net)

Discussion on:

Term Sheets and Exits

## Section 2.4

# Angels as Financial Partners

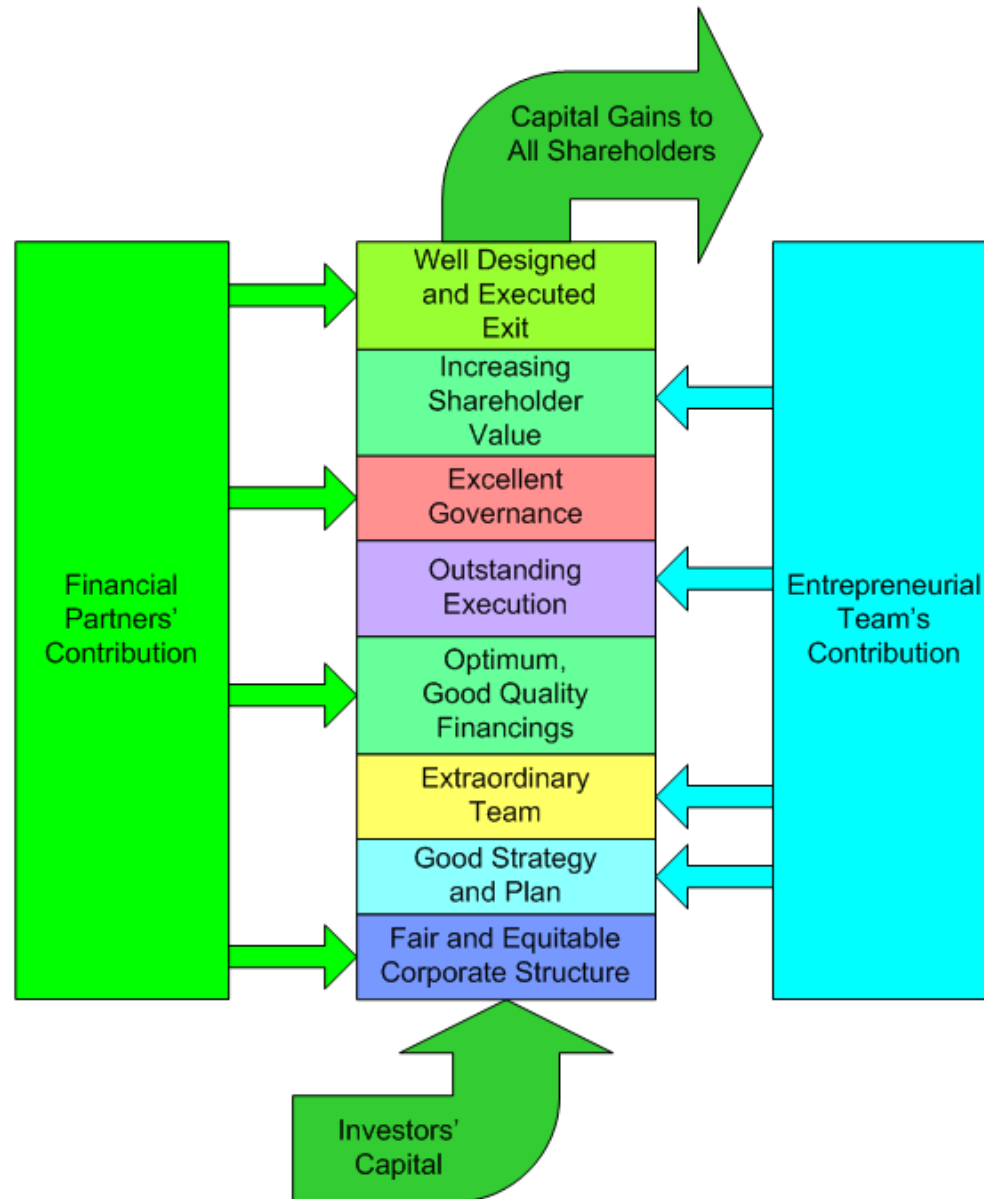
# After We Invest

- In our internet accelerated economy, I believe Angels are even more important to entrepreneurs' success
- Most young entrepreneurs don't have the experience to know whether their company is the next big thing, or a waste of their time
- That kind of perspective requires a lot of experience
- And is just one example of where Angels can make an invaluable difference

# Where Angels Can Help Most

- Many aspects of building, financing and exiting companies are the same from company to company
- Angels have often built and exited several companies
- We can help the most in the areas of:
  - Financing and structure
  - Governance and mentoring
  - Exiting

# Angels = Financial Partners



# Videos on Planning Exits

- Exit Strategies for Angel Investors  
North West Energy Angels, Seattle
- Exit Early – Exit Often  
South East ACA / Capital Connects, Greenville
- M&A Exits for Angels  
North West ACA Seattle, (coming soon)
- All available from [www.AngelBlog.net](http://www.AngelBlog.net)

Discussion on:

Angels as Financial Partners

Break