Early Exits Workshop
Part 3
Exit Execution

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Increasing The Number of Exits

- We can all increase our successful exits by:
- Focusing on exits before we invest
- Helping entrepreneurs build alignment on the exit strategy (also before we invest)
- Designing our term sheets to facilitate the exit transaction - especially vesting
- Really understanding VC follow-ons

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

Section 3.1

The Exit Team

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
  - Legal and Accounting Professionals

Role of the Professionals

- The most important jobs of the M&A advisor or business broker are to:
  1. Protect the CEO and rest of the team
  2. Add the experience and strategy
  3. Be the bad guy
  4. Maximize the price and terms

Why The CEO Should Not Lead

- There are several reasons the CEO should not lead the exit process, they:
  - Rarely have the exit experience
  - Needed 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 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 startup
- Exit knowledge and experience is even more critical for these young companies

The Exit Coach

- 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 <u>exclusive</u>
- 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’

Every Deal Needs A Bad Guy

- M&A transactions are usually fun
- They always involve big money
- The job of both sides is to get the best price
- At some point in almost every transaction, things will get tense – and often much worse
- Every transaction needs a bad guy – a very good bad guy (who is not the CEO)

M&A Advisory 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

Failure is Quite Common

- One of the secrets of the M&A business is that M&A professionals often fail to complete the transaction
- There are no hard statistics on this and the professionals rarely talk about it
- I have been asking companies for years
- I am sure at least a third of transactions fail
- One industry expert says over 90% fail

M&A Advisors Should Be Local

- CEOs and boards often start to look for an M&A advisor in the big financial centers
- <u>The failure rate increases as the distance to the M&A advisor increases</u>
- Failure is most often the company’s fault
- The cause is usually the same: communication
- 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

Legal and Accounting Fees

- Legal and accounting fees vary widely depending on the complexity, not the size
- For a simple, clean transaction legals might only be $50,000
- But for a complex deal can easily be $1 million or more
- Accounting costs can be a few thousand to over $100,000 if audits haven't been done

Discussion on:

The Exit Team

Section 3.2

The Exit Timeline

Often the Biggest Question

- Many times in exits I have been involved with,
- The question that seems most important to the team and the board is
- Not “How much can we get?”
- It is “How soon can we complete a transaction?”

How Long It Usually Takes

- The short answer is usually 6 to 18 months
- From the time you engage the M&A professionals
- Until the cash is in the bank
- But it can often take considerably longer if the company isn’t ready, or if the structure needs to be cleaned up, or if the financials need improvement

When To Tell The Team

- Many CEOs have difficulty determining when they should tell the rest of the team that the company is for sale
- Some worry about the employee anxiety
- Others think it is ‘none of their business’
- Most of the time the internal grapevine is so efficient that they already know
- Best practice is to tell everyone fairly early

Timing is important

- The most common mistake is to “ride it over the top”
- Best time to sell is when everything is going really well
- That’s when you will usually get the highest price, even if the business can grow further
- The difficult thing is to start the process a couple of years before the growth peaks

Before You Start Selling

- About a third of the work includes:
  1. Building alignment around exit strategy
  2. Financial history and projections
  3. Selling document (like a business plan)
  4. Cleaning up the corporate structure
  5. Preparing the due diligence
- Usually takes 1 to 5 months

Building The Sales Funnel

- The second phase includes:
  1. Searching for prospects that match
  2. Develop tactics on strategic value
  3. Initial contacts to 50 - 100
  4. Responding to 10 - 20 interested
  5. Starting due diligence with 5 - 8
  6. To get to a stable short list of 3
- Usually takes 2 to 6 months

The Bidding Process

- The third phase is the most exciting and most intense
- Ideally three buyers will be in due diligence
- And actively negotiating, simultaneously
- The CEO will become the limiting factor even if the M&A advisor is doing well
- Usually takes 2 to 4 months

Negotiating and Closing

- Even after there is a binding term sheet and possibly a deposit
- It can take months for the M&A advisor, lawyers, accountants and board to complete the fine points of the definitive agreement
- And obtain all of the approvals from boards, shareholders and regulators
- This final phase is usually 1 to 3 months

Timeline Summary

- 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

Discussion on:

The Exit Timeline

Section 3.3

Cleanup and Preparation

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 and IP 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 lawyers 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
- 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
  - Possibly an online video

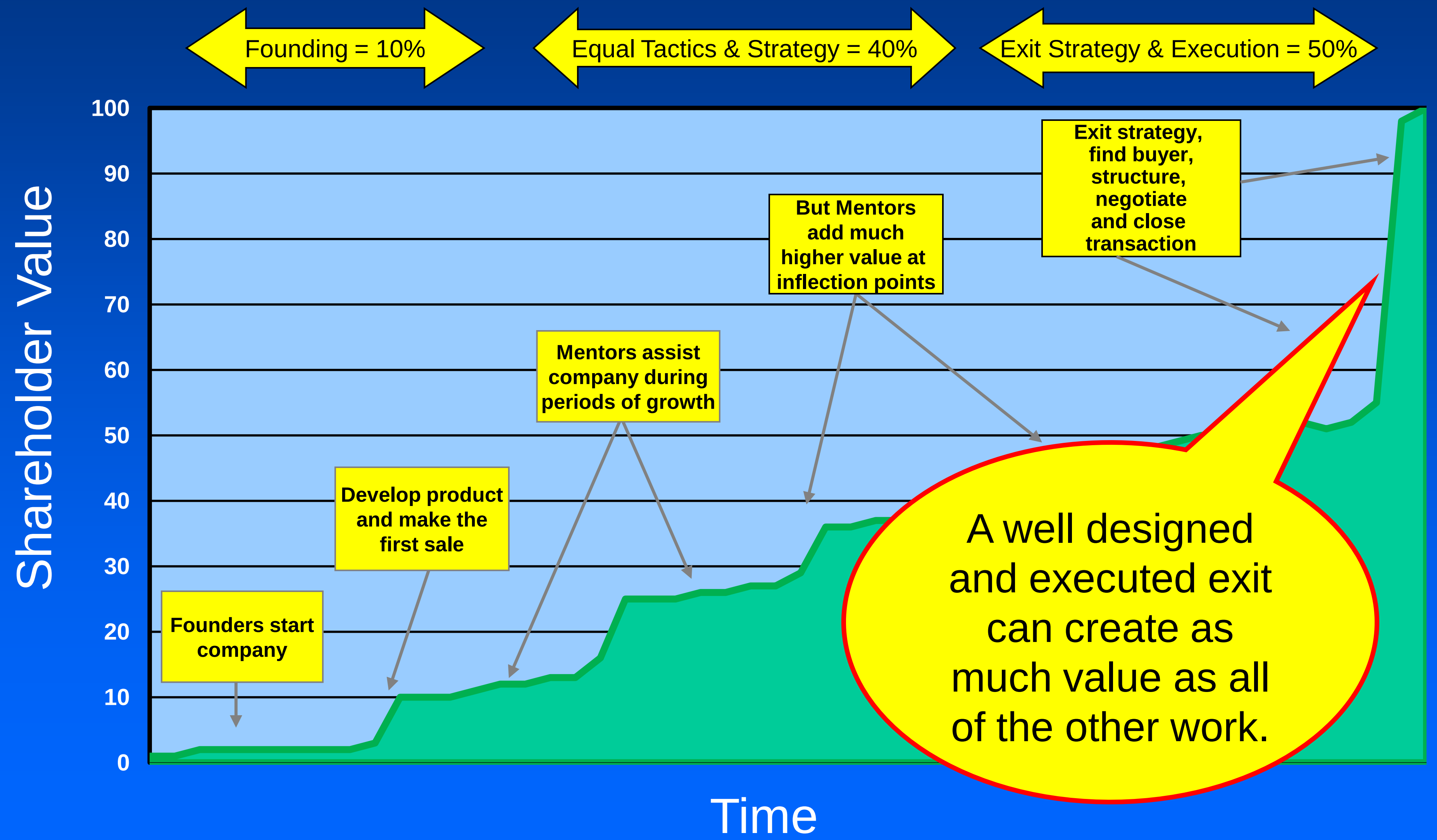
Discussion on:

Cleanup and Preparation

Section 3.4

Maximizing the Selling Price

Building Shareholder Value



Plan to Over-Achieve

- To get the best price for the business
- There should always be multiple bidders
- And a professional ‘auction’ process
- To maximize the price, the team should do everything possible to deliver results that are better than the projections
- An important reason the CEO shouldn’t lead

Maximizing Exit Value

- There are several non-operational 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

Structural Value Increase

- Often small tweaks in the corporate structure can increase the selling price by 10 to 35%
  - These can be balance sheet changes
  - Asset vs. share sales
  - Financing mechanisms like sub debt
  - Tax innovations
- Opportunities are almost endless but can often add $ millions

Illuminating Strategic Value

- Identifying strategic value often creates the largest fundamental increase in selling price
- It’s not actually creating strategic value, it usually has to be there already
- But it very often has to be illuminated for the potential buyers (often very challenging)
- This can often be the most valuable contribution from the M&A professional

Capitalizing on Inefficient Markets

- Markets for selling a business, especially for under $100 million, are very inefficient:
  - Information is difficult to access
  - There are a small number of buyers
  - The market is illiquid
  - Often very few for sale (like yours)
- All of which can be big advantages for the seller

Benefits of Multiple Bidders

- An unsolicited offer is almost always a lost opportunity
- Every business sale should have multiple bidders to:
  - Increase the final selling price
  - Increase the probability of completion
  - Close the transaction sooner
  - Demonstrate good governance

Selling and Negotiating Skill

- There is no question that some sales people are just better – often much better
- Selling a company is just like any other sale – but bigger and more complex
- An outstanding M&A advisor can often help to increase the final price by 50% or more

Discussion on:

Maximizing the Selling Price

Section 3.5

Closing and Life Options

Reps and Warranties

- A lawyer friend says more M&A transactions fail on reps and warranties than price and terms
- Basically a personal guarantee from the CEO and other major shareholders
- To protect the buyers against future liabilities or misrepresentations
- Start coaching the team early in the process

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 Life Options

- 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 entirely different with our money

Videos on Executing Exits

- Selling a Company – Guide for Angels
  National Angel Capital Organization, Toronto
- How Not To Sell a Business
  Entrepreneurs Organization, Vancouver
- Maximizing Exit Value Workshop
  Angel Capital Association Summit, Atlanta
- All available from www.AngelBlog.net

Resources on Exits

- 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 videos of my previous talks on exits (free and in high def)
- The Exit Strategies Newsletter (free) from the AngelBlog homepage

Good Luck With All of Your Exits!