# How Exits Have Changed in 2012

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# Investing is Easy

- One of the things I’ve learned about investing:

1. Making an investment is easy
2. Getting our money back is more challenging

# Why Exits are Difficult to Learn

- It’s harder to learn about exiting than investing because:

1. Exits just don’t happen very often

2. Many of our similar experiences ‘mislead’ us

3. The exits market is changing quite quickly

# Learning from Experience

- Most of the things we learn about business we learn through experience
- It wouldn’t be difficult to make five investments in a year
- You’d learn a lot about investing
- But I haven’t met any investor, or entrepreneur, who has been involved with five exits in a decade

# Exit Rates for Angel Investments

- Not only do exits have a long time delay
- Exits just don't happen very often
- From Scott Shane, author of *Fools Gold*:
  - Only 1 to 1.5% of Angel backed companies exit (based on decades of US data)
  - More recently: 5.9% of Angel <u>group</u> deals exited in 2008

# Recent BC Data on Exits

- Thomas Hellmann from the Sauder School of Business at the University of British Columbia
- Published an analysis in late 2010
- “An Evaluation of the Venture Capital Program in British Columbia”
- For BC companies 2001-2008:
- 1.9% of the companies did an IPO,
- 7.3% of the companies were acquired

# Other Experiences Mislead Us

- Another thing that makes exits challenging is that our other life experiences often mislead us
- For example, what we learn from the other large asset sales we’re all familiar with – real estate
- We’ve all bought and sold homes and talked to relatives and friends about their experiences
- After years of relatively frequent observations, we learn a lot about real estate
- The M&A market is very different

# Real Estate vs. M&A Markets

| | Real Estate | M&A |
|---|---|---|
| Myths and Misperceptions | Few | Surprisingly Many |
| Transparency | Highly | Almost Opaque |
| Depth | Very Deep | Opposite of Deep |
| Market Efficiency | Very Efficient | Highly Inefficient |
| Probability of Sale | 90+% | 8% to 75% |

# Financial Markets are Changing

- As we recover from the ‘mortgage crisis’
- And worry about the European debt problem
- All investors are all trying to adapt to:
  1. Poor equity returns for over a decade now
  2. The lowest interest rates of our lifetimes
  3. Concern about the future value of money
- The result is an enormous amount of capital looking for better returns and reasonable safety

# Types of M&A Buyers

- Active M&A buyers today include:
  1. Big Companies
  2. Medium Sized Companies
  3. Private Equity Funds
  4. Boomers (individuals, or small groups)
  5. Family offices
  6. VCs operating like P-E Funds – very new
  7. International Buyers – small but growing

# Big Companies

- Very visible but not the most likely acquirers for most of your companies
- Spending more on M&A than R&D
- Best way for them to increase shareholder value
- Have teams of people dedicated entirely to buying companies
- Compensation plans are designed to motivate executives to acquire companies

# Big Company Thinking Today

- Many have so much cash it's a problem
- And more pressure than ever to deliver a better return to their shareholders
- Noticing increased competition for acquisitions in their 'sweet spot'
- Generally feel this is a good time to buy
- And that prices and competition will increase

# Medium Sized Companies

- For every Fortune 500 company that might acquire a company,
- In the $10 to $30 million range
- There are probably ten times as many medium sized companies
- That might be interested and can afford to buy
- Selling CEOs are surprised to see how many companies they hadn’t thought of, or even heard of, end up bidding to buy their company

# Medium Company Attitudes

- Similar to larger corporations
- Know they are in a competitive environment for acquisitions
- Understand that one of their competitive advantages is that they can move faster
- Have a narrower strategic focus
- Often create more complex deal structures

# P-E Funds are Back

- P-E funds are like VCs but buy 100%
- They use a combination of equity and debt
- Before the mortgage crisis, almost 40% of M&A volume was related to P-E funds
- Last year it was only 13%
- Today’s fiscal stimulus has pushed the cost of debt lower than it has been in our lifetimes
- In the past few months, the P-E funds are back

# P-E Fund Attitudes

- These fund managers get paid to invest
- And share in ‘the carry’ on their funds
- Have been sidelined for much of the past four years
- Feel pressure to ‘make up the lost time’
- Keenly aware that competition, and prices, are increasing

# Boomer Buyers

- A relatively new category of buyers that I call the Boomer buyers – much like Angels
- This group is showing up more and more often
- Haven't been getting good returns on either their debt or equity portfolios
- Worried about the future value of their cash
- Like many of us, have been eating well and working out for decades now
- Many thought they had retired

# Boomer Buyer Thinking

- After a few years of retirement, they realized they could only play so much golf and drive so many expensive sports cars
- They were bored and realized that all that clean living could mean they could be active for several more decades
- These boomers have capital and have friends who with more (money not usually a problem)
- Many remember how much fun they had operating companies

# Boomers are Dark Horses

- The fascinating thing about the boomer buyers is that they can be the most aggressive and fastest moving of all
- Most of these buyers made their money successfully running companies
- They are often the ‘smartest guys in the room’
- They usually operate locally and are most interested in transactions under $20 million

# Family Offices

- Up until recently, was not a term we heard much in the US
- Refers to very wealthy families, or groups of families, that hire captive investment teams
- Some ‘high power Wall Street’ people are moving to family offices
- Build diversified classes of investment portfolios
- Allocating more assets to acquiring companies
- Just like P-E funds

# Family Office Thinking

- Like everyone else, feeling pressure to deliver returns and worried about the value of money
- Traditional debt and equity looking less and less attractive
- Operating businesses look like an asset class
- That should be more resilient to macro economic changes like inflation and deflation
- Only challenge is finding enough to buy

# VCs Operating Like P-E Funds

- New, very interesting and happening quietly
- VC funds that ‘appear’ to be investing
- Are actually acquiring all - or close to all
- Mostly anecdotal reports so far
- A few described in detail under confidentiality
- Cashing founders and angels completely out
- And not requiring the founders to come to work
- Clearly betting on the horse…not the jockey

# Speculation on VC Thinking

- Working hard to stay in stealth mode
- Not sure if their investors will approve
- Can only speculate on what they are thinking
- Likely the old VC model is permanently broken
- Have more cash than they can invest
- Corps and P-E funds increasingly competitive
- If we can’t fight them, maybe we should join them

# International Buyers

- Still a small, but growing group of buyers
- Very strategic
- Do not usually move quickly
- Balance of payments has created huge dollar surpluses in most of Asia
- Europeans would like to move money to the US
- Dollar holders are increasingly nervous
- So are moving to buying active businesses

# Big Corps Have So Much Cash

- Many big companies have so much cash that it’s a problem – shareholders complain
- For example:
- Google has $20 billion
- Microsoft has $35 billion
- Cisco has $43 million
- Apple has $97 billion ß cash and investments

# Cash for Acquisitions

| | Cash | Available for M&A |
|---|---|---|
| US Companies | $ 2 Trillion | Most |
| Global Companies | $ 8 Trillion | Most |
| P-E Funds | $0.4 Trillion | All |
| Boomers (US only) | $ 8 Trillion | Small but Growing |
| Family Offices (US) | $ 1 Trillion | Small but Growing |

# How Many is $1 Trillion?

- It’s difficult to put $1 trillion in perspective
- Most acquirers consider their ‘sweet spot’
- As somewhere around $20 million
- The median price is closer to $15 million
- Just one of these $1 trillion buys
- 50,000 acquisitions (at $20 million each)
- There are many times more buyers than sellers

# Buyers Practically Unlimited

- For many exits under $50 million
- The number of buyers is, for practical purposes, almost unlimited
- Often see three or four types of buyers
- Simultaneously bidding to buy the company
- Each type of buyer thinks and acts differently
- They all have lots of cash
- And there can only be one successful bidder

# A Sellers' Market

- The number of buyers and amount of cash available makes the current M&A environment:

1. A sellers' market
2. Fast moving and diverse
3. Talk is that prices are up 20% in a year

# Exit Timing

- There are several new characteristics of today’s M&A market
- I’d like to talk more about prices increasing
- Or the effects on deal terms and structures
- But I think the most valuable topic is
- How this new market has affected exit timing
- One change is that exits are happening faster

# A B.C. Really Early Exit

- This Vancouver company asked me to keep their details confidential – for now
- This startup wanted to test the idea for their first product, so they called on a medium US corp
- The prospect soon asked to buy the company
- The CEO called me for help
- Three months later the money was in the bank
- Company was less than 12 months from startup and still hadn’t launched the first product

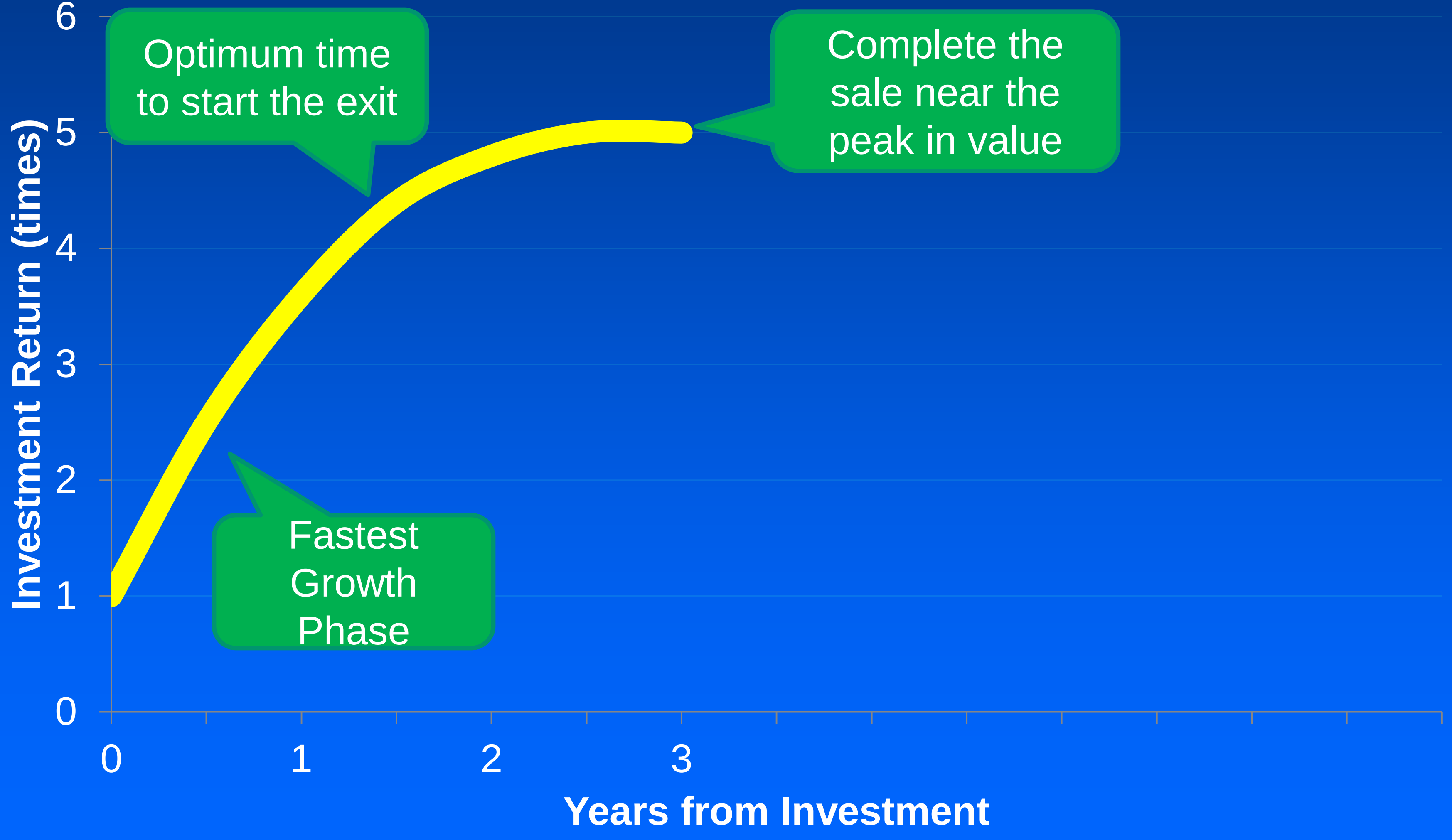
# A New Really Early Exit

- Anyone heard of the company PumkinHead?
- How about their product - About.me?
- About.me was acquired by AOL
- Just four days after its public launch
- That may be a new record
- Better way to measure is from startup = 1 year
- This illustrates what experienced entrepreneurs and investors can accomplish in this market

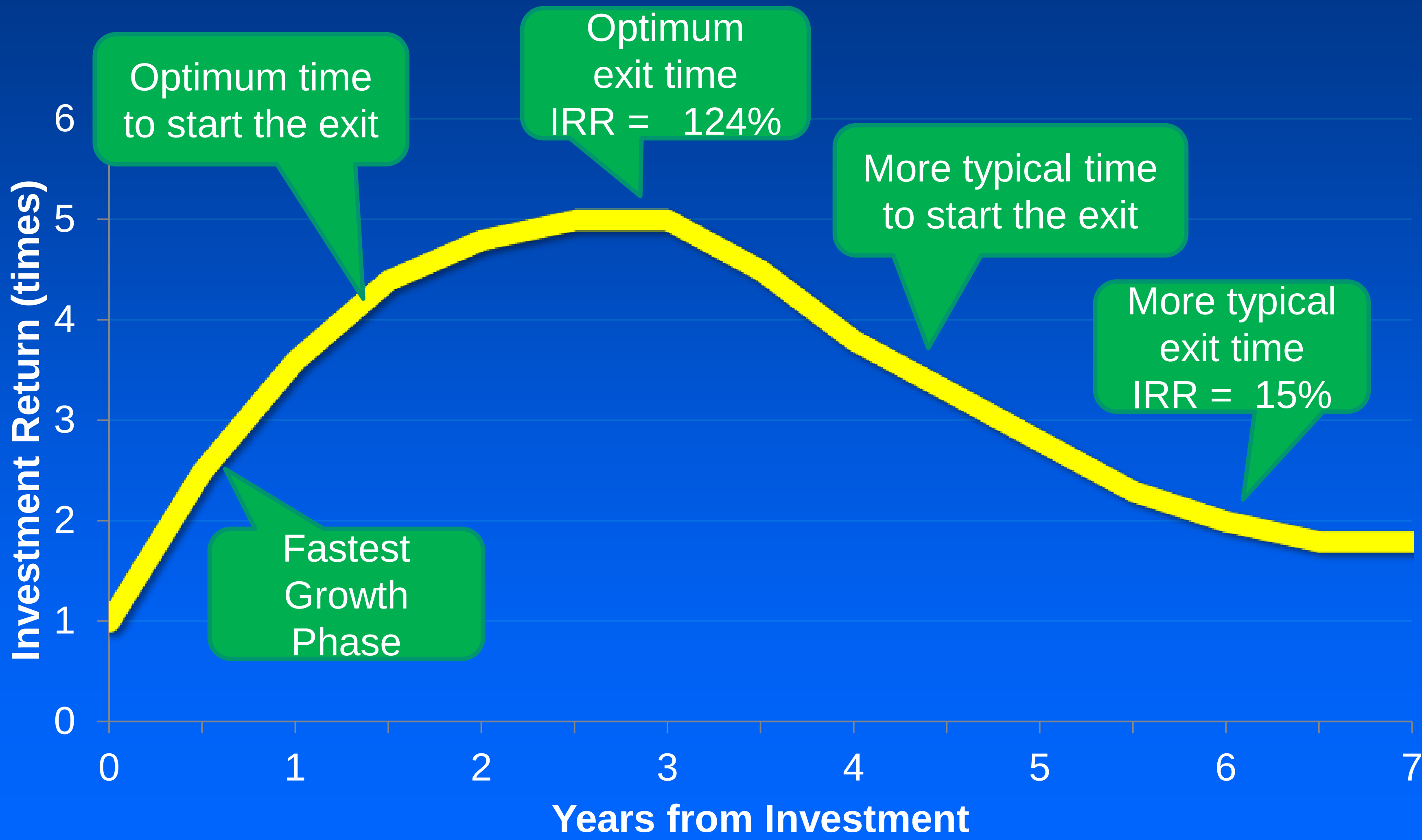
# Ideal Exit Timing

- It usually takes 6 to 18 months to sell a company
- In an ideal situation, the company would incorporate this delay
- Into the company strategic and operating plans
- Look forward in time and then start the exit
- 12 to 18 months before the peak in the company's exit value

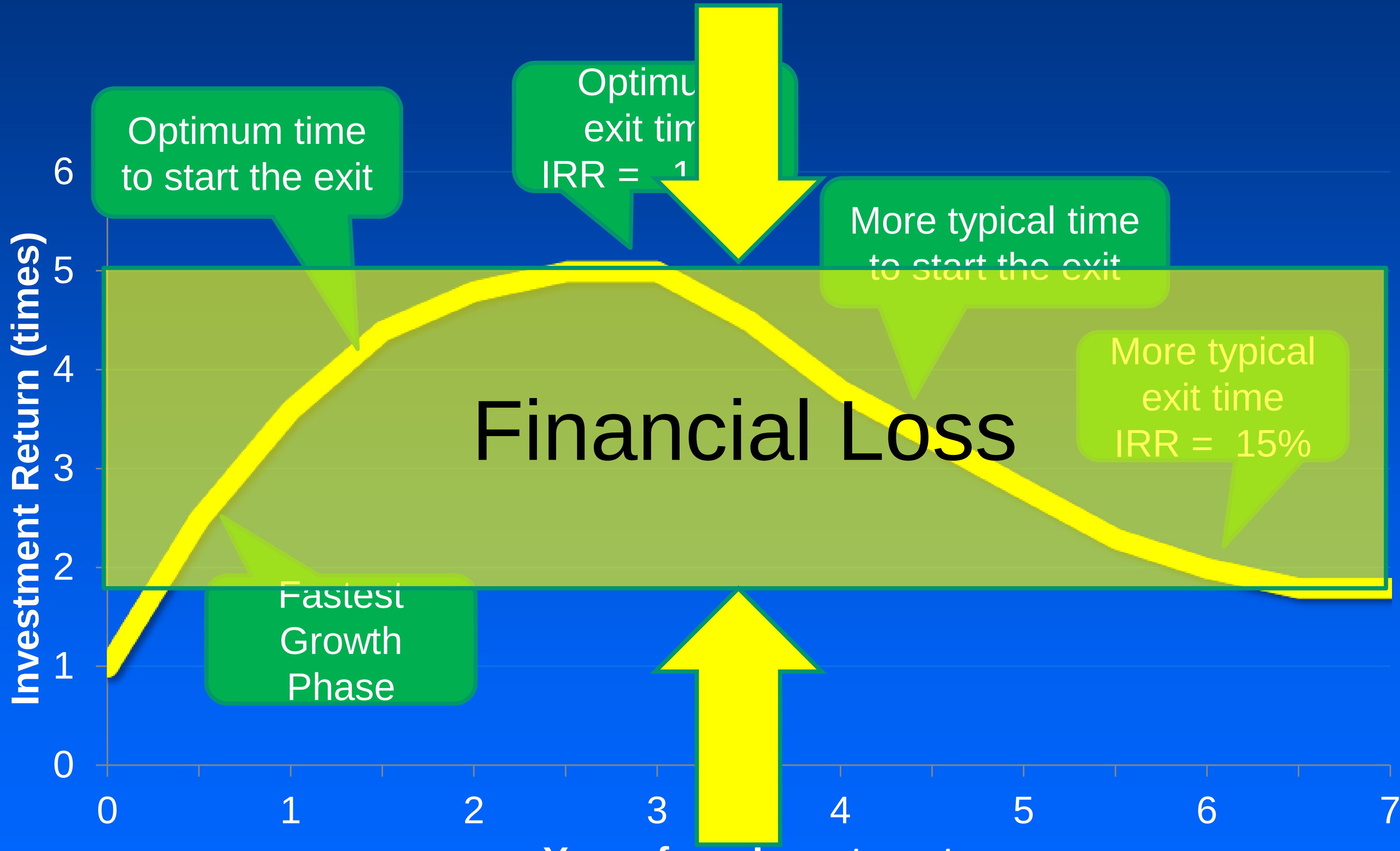
# Ideal Exit Timing



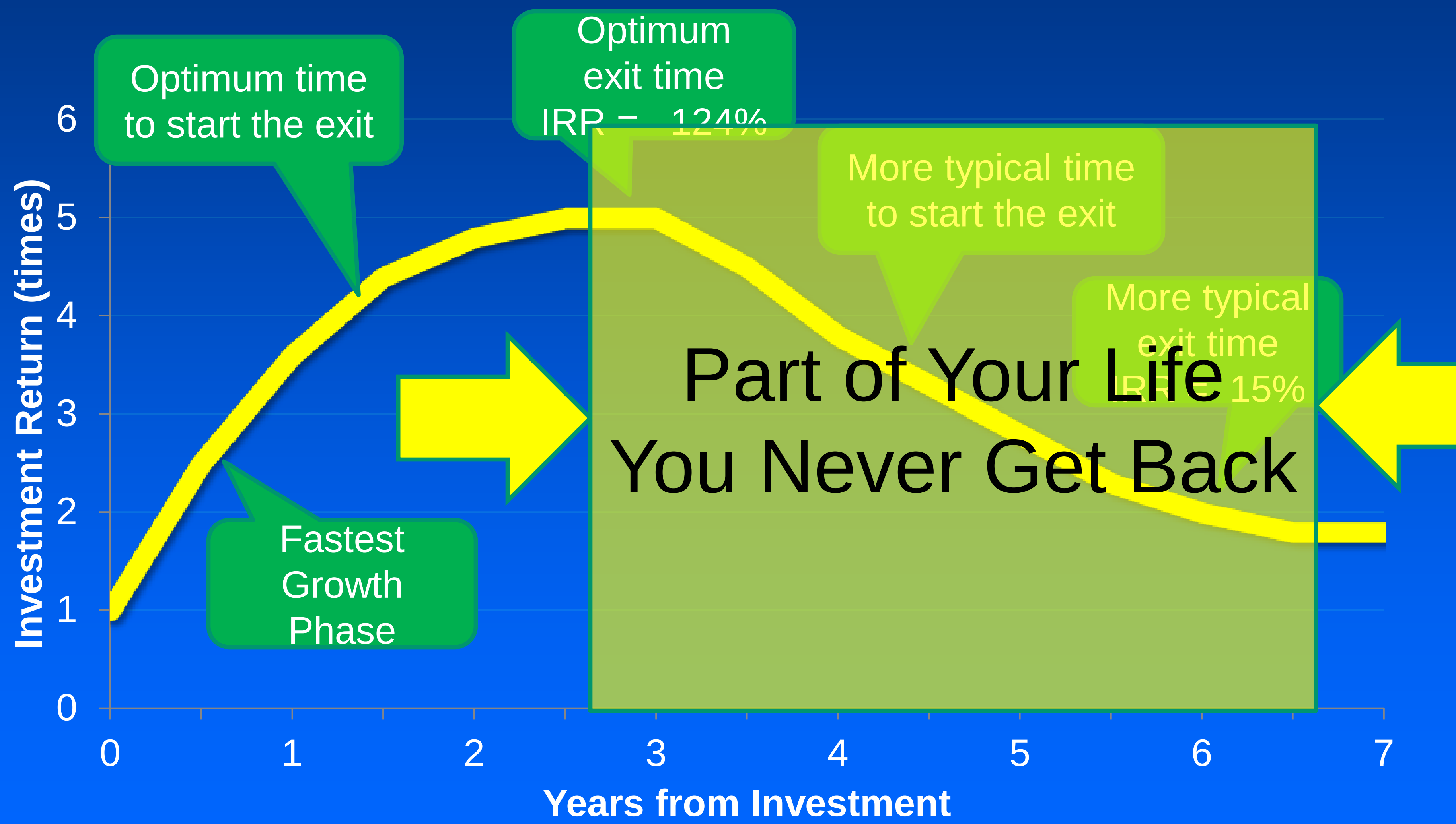
# "Riding It Over the Top"



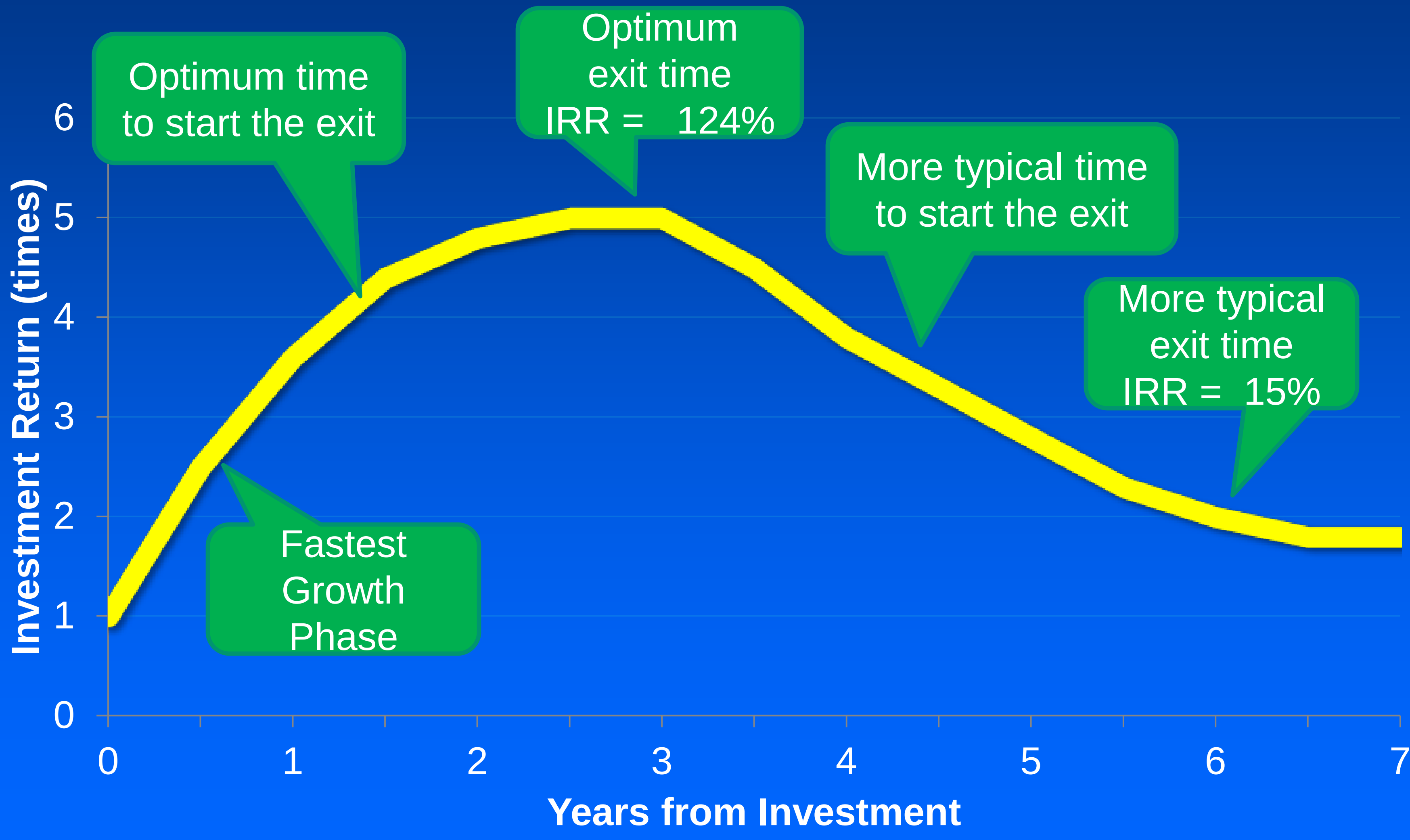
# The Financial Loss



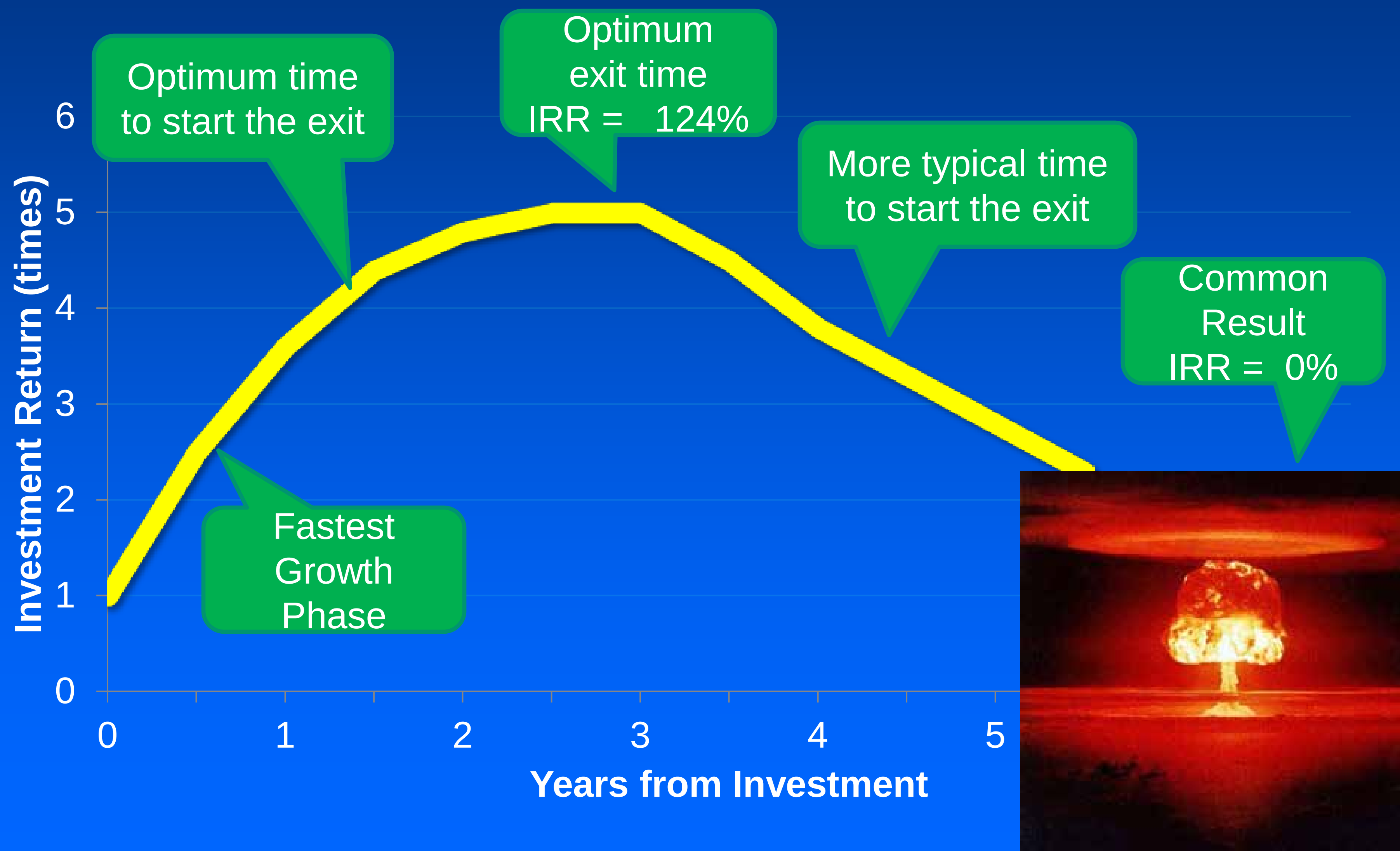
# Part of Your Life You Never Get Back



# This is Actually Optimistic



# What Often Happens



# Why ?

- After seeing this happen over and over again
- I started to recognize a few patterns
- And realized there were logical reasons
- Why if a company missed the ideal time to exit
- There was a good probability it would not just exit for less,
- But <u>end up never exiting</u>

# Reasons This Happens

1. Competition
2. Over-investment by VCs
3. Negative momentum
4. Waves of Consolidation

# Competition

- Competition is a surprisingly common reason promising companies end up never exiting
- Startups often succeed early because they apply a new technology,
- Or recognize a trend or new market opportunity
- Often their own success generates awareness and attracts new entrants into the market
- Just as the market is maturing and becoming more expensive to operate in

# Over Investment

- When a sector becomes “hot” many Venture Capital funds will invest simultaneously
- All hoping to fund one of the few winners capitalizing on the new technology or trend
- Most VCs have much more money than they can deploy well
- When they find a new opportunity, they typically invest very aggressively - $10s millions
- Often driving early innovators out of business

# Negative Momentum

- It’s not easy to see the stock price graph in a private company
- But after a while, the team gets a sense that value has peaked and is decreasing
- The fun and excitement are gone
- The best and brightest leave first
- Followed by the other most valuable people
- Ultimately causing the company to lose even more momentum

# Waves of Consolidation

- A more devastating reason that companies that miss the ideal time often end up never exiting is
- “Waves of Consolidation”
- This is a relatively new phenomena driven by:
  1. The huge amounts of cash
  2. The growing number of buyers
  3. And the internet
- Missing this is almost always fatal

# The Beginnings of a Wave

- Today, we are all connected by
- The internet and especially social media
- Lets us see what's happening in the world and our businesses better and faster than ever
- In business today, most competitors have immediate access to the same information
- Which creates a tendency for execs to make similar decisions at almost the same time

# They All Get Interested

- M&A buyers all work in the same global market
- If an acquisition makes sense for one of them
- It usually does for others too
- M&A advisors work to get several buyers interested
- And develop a competitive bidding situation
- Which is good from the seller's perspective

# But From the Buyers' Side

- Buyers are smart too
- Regardless of whether they got the idea from an M&A advisor, or some other way
- Once they decide they want to acquire a business in a certain area, they
- Look at most of the companies in the field
- Let M&A advisors know they are looking
- And make direct, unsolicited offers to acquire

# Why The Buyers Do This

- Buyers have several motivations:
- To determine which company is most attractive for them to acquire – i.e. price
- To give them more choices and therefore more negotiating leverage
- To ensure that if they don’t win the auction on their first choice,
- They have a backup acquisition opportunity

# And People Start to Notice

- This starts a cascade of events
- The big company’s competitors hear they are interested in acquiring a certain type of company
- They don’t want to be late, so they also start
- And get their corporate development teams and M&A advisors looking
- Soon every company in the industry has received unsolicited interest

# The Wave

- Which creates the beginning of the wave
- Buyer interest brings in more buyers
- And more M&A advisors – sell and buy side
- Which flushes out more companies that could be acquired
- Starting them on their own exit process
- All building to a flurry of acquisitions in the sector

# It’s Too Late When You See It

- From the outside, it looks like this happened very quickly
- Often just within a quarter or two
- But it had actually been going on for much longer
- But because public companies, and NDAs, are involved it’s not easy to see from the outside
- Once a company sees the wave it’s often too late

# What Happens After the Wave

- The wave ends with most companies who want to buy completing a transaction
- Almost overnight the buyer interest stops
- If a company did not get acquired during the wave, it is virtually impossible after
- And that’s not the worst news

# The Market After the Wave

- After the buying crescendo
- Each of the successful buying companies have just paid a lot to enter this new sector
- Typically $10 – 50 million
- Most of the buyers will plan to invest a similar amount in growing their new acquisition
- And competing for market share against the competitors

# Killing the Small Companies

- The companies that were not acquired are now in a very difficult situation
- Their market has become much more competitive
- Instead of fighting with other small, underfunded companies, they are up against giants
- With enormous investment capability and highly effective brands

# Killing the Small Companies

- The small companies cannot afford to compete
- Or to operate in an industry where everyone is willing to lose money – possibly for years
- Often small businesses that were very profitable become unprofitable almost overnight
- And at the same time, their ability to raise capital disappears because the investors saw the wave
- And don’t want to fund a fight with the big guys
- And know a future exit is very unlikely

# An Unsolicited Offer

- One of my saddest jobs is to explain this to CEOs
- They often contact me all excited about a big company talking about an unsolicited offer
- I start by saying that’s not usually good news for the shareholders
- After learning more, I dread seeing the signs of a wave of consolidation
- At that point they are dangerously late

# Missing the Wave

- Missing the Wave of Consolidation is a particularly heartbreaking error
- Many of the companies that missed it were quite profitable and very valuable
- The wave destroys both
- For CEOs that have built successful businesses
- Not missing the wave might be their most important job

# In Summary

- The M&A markets are continuing to heat up
- There are many more buyers than sellers
- And more types of buyers
- And more available cash than ever before
- Acquisitions are happening earlier and faster
- Which is all excellent news
- As long as you’re on the right side of the wave

# Learning More and Sharing

- Angel investing is still new
- We are about where the VC industry was in the mid 1980s
- We still have much to learn
- And the world keeps changing
- Our best hope is education and sharing

# How We Can All Be Better

- My hope is that we'll all:
- Encourage more groups to join the ACA
- Take advantage of the excellent programs provided by ARI to educate more angels
- Support the research at ARI
- That produces new data like the Halo Report
- So we can all be better angel investors
- Thank you.