Financing Options and Exit Strategies for Technology Companies

UBC Sauder School of Business
Entrepreneurial Finance and
Private Equity Course

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Introduction

- BCIT Diploma of Technology, 1973
- UBC BASc Electrical and Computer Eng, 1977
- UBC Ph.D. in Electrical and Computer Eng, 1982
- Won 8 scholarships including UBC's top (then)
- Elected three times to the Board of Governors
- Led the UBC Engineering Project to build an Electric Vehicle in the mid 1970s
- Started my first company in 1982 in my lab at UBC while I was finishing my thesis

Introduction - 2

- Nexus grew to be the second largest manufacturer of cable TV headends in the world
- Sold to Fortune 500 company in 1993.
- Worked as a CEO in Silicon Valley for 2.5 years
- Started first hedge fund in BC
- Co-founded BC Advantage Funds (VC Fund)
- Now manage FTII – Angel Fund
- Just finished a book on Exit Strategies for Entrepreneurs and Angel Investors

Outline

- The Current Exit Environment
- Most Exits are Under $20 million
- M&A Exits are Happening Earlier
- Companies Don’t Need As Much Capital
- Differences Between Angels and VCs
- Optimum Strategies for Angels

Today’s Economy

- Recently, several things have changed in the economy
- OK, that’s a bit of an understatement
- The big investment banks are gone
- In Q2 2008, for the first time in history, there were zero venture backed IPOs in America
- Many writers are saying the venture capital model is broken – perhaps permanently

Angels and VCs Invest The Same $

- Most entrepreneurs think venture capital funds are the primary source of seed and startup capital
- Angel investors invest about the same amount as VCs each year ($25 billion in US)
- Angels finance 27 times more seed and startup companies
- Angels are more important to the economy

Entrepreneurs and Angels

- Here in Vancouver entrepreneur and angel activity is high
- The 11 year old Vantec Angels are having record numbers of companies present
- And record angel attendance
- The Bellingham Angels is so popular we decided to limit the number of members

We’ll Need More Data To Be Sure

- We just don’t have enough data to know whether this activity is a response to job loss in large companies, or something else
- But one theory is that it is a structural realignment in the economy
- Large doesn’t seem to work anymore – whether it’s companies or venture funds

Investment Requires Exits

- Investing only works if the investors can get their money back – even if it takes a while
- The traditional venture capital model doesn’t work anymore because the type of exits the VCs need to make their funds work just aren’t happening anymore, and haven’t been numerous for over a decade
- But it’s still quite a good time for entrepreneurs and angel investors

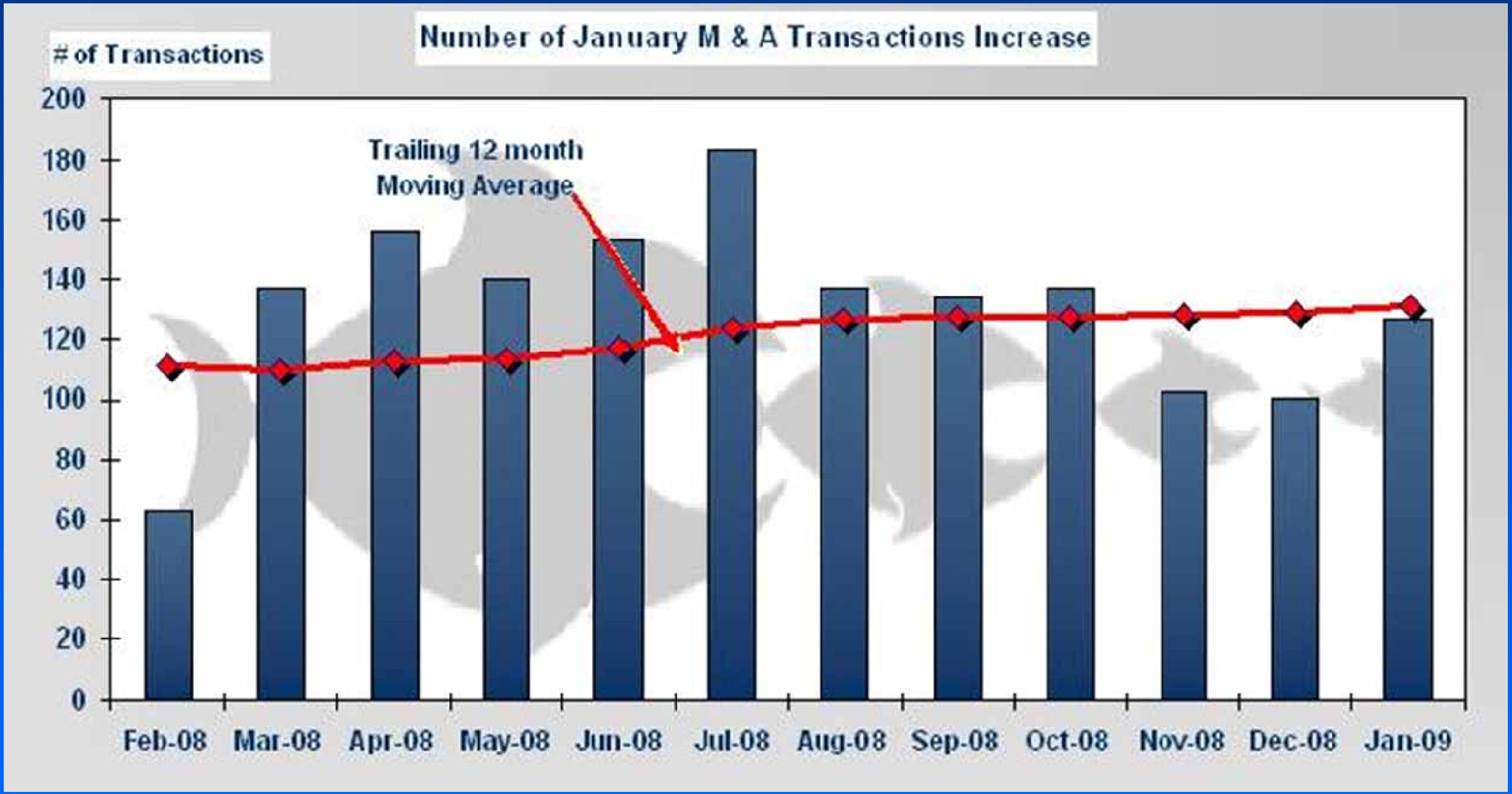
Lots of Doom and Gloom in Exits

- Lots written recently in the mainstream press about the bad news in exits
- IPOs have almost disappeared
- Total M&A transaction dollar volume has fallen by at least a third
- That's true, but it's only part of the story

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 $750 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

Small M&A Transactions



From: Current Environment for Exits by Brent Holliday, Capital West Partners

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 Under $30 Million

- 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 startups
  - 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
  - $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

VCs Real Competitors are Corps

- One of the important factors impacting the venture capital industry today
- Is that corporations are often the most aggressive competitors to VCs
- Many large companies are saying privately that they don’t see the VCs adding value
- So their preference is to buy at lower prices before VCs invest

M&A Exits Are Happening Earlier

- Today it’s not uncommon for companies to be acquired just a couple of years from startup
- Club Penguin, near where I live, is a website for 6 to 14 year olds
- It was sold to Disney for $750 million cash
- Just two years from startup

Companies Don’t Need Much $

- Another important trend is that today’s companies usually don’t need much capital
- In the 1980s and 1990s companies needed $ tens of millions – so VCs were essential
- Today, very valuable companies are being built on just tens of thousands of dollars
- Club Penguin, and many others, had no investors - except friends and family

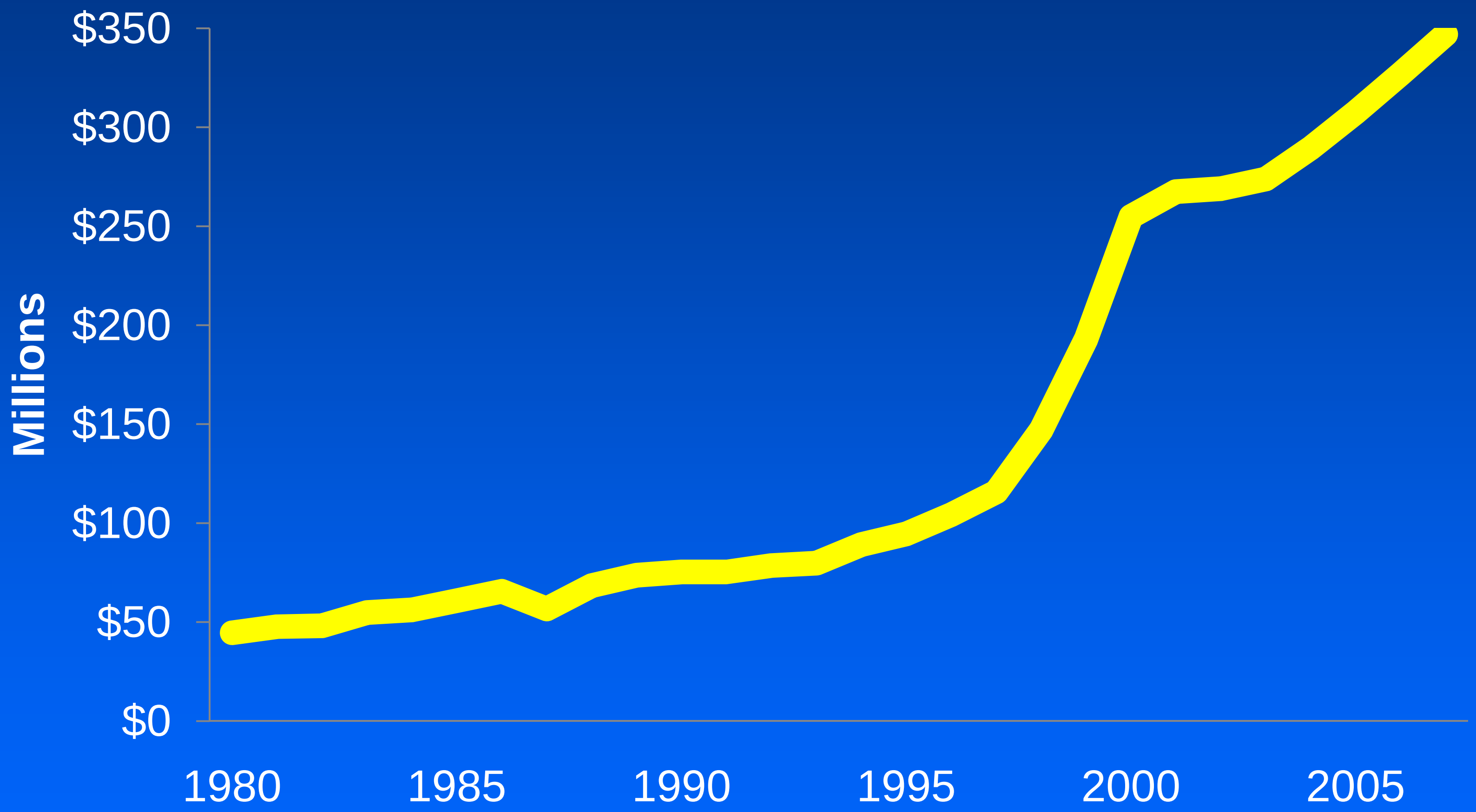
What This Means For Angels

- Most acquisitions are under $20 million in value
- And it’s much easier to get those transactions done - especially today
- Modern companies don’t need much capital
- <u>The optimum exit strategy is to target an exit for under $30 million</u>

Angels and VCs - More Different

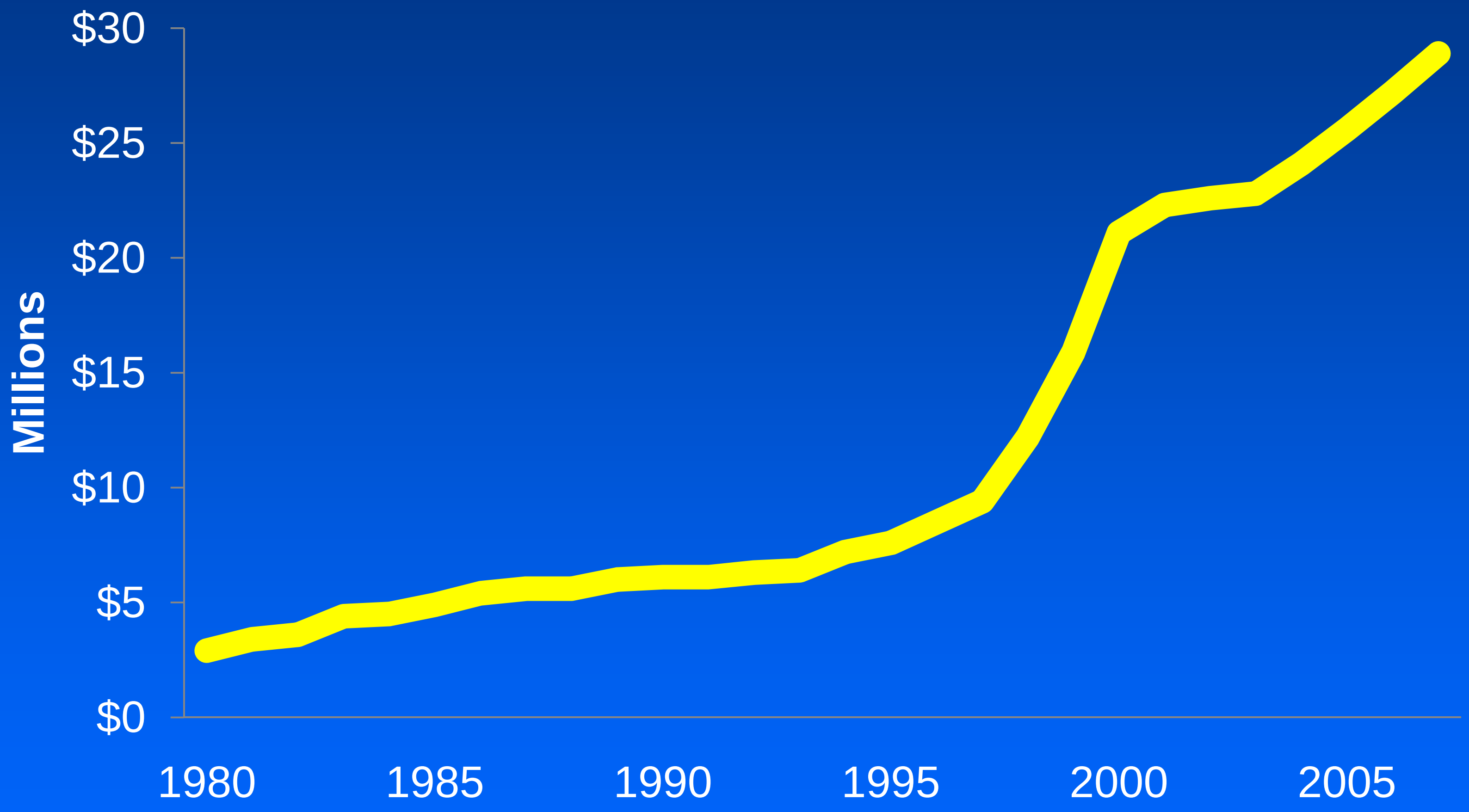
- This new environment is creating a clearer understanding of how different angels and traditional VCs really are
- From an exit perspective, there are three important differences:
  1. Minimum investment size
  2. Minimum return required
  3. Acceptable time to exit

Size of Average VC Firms



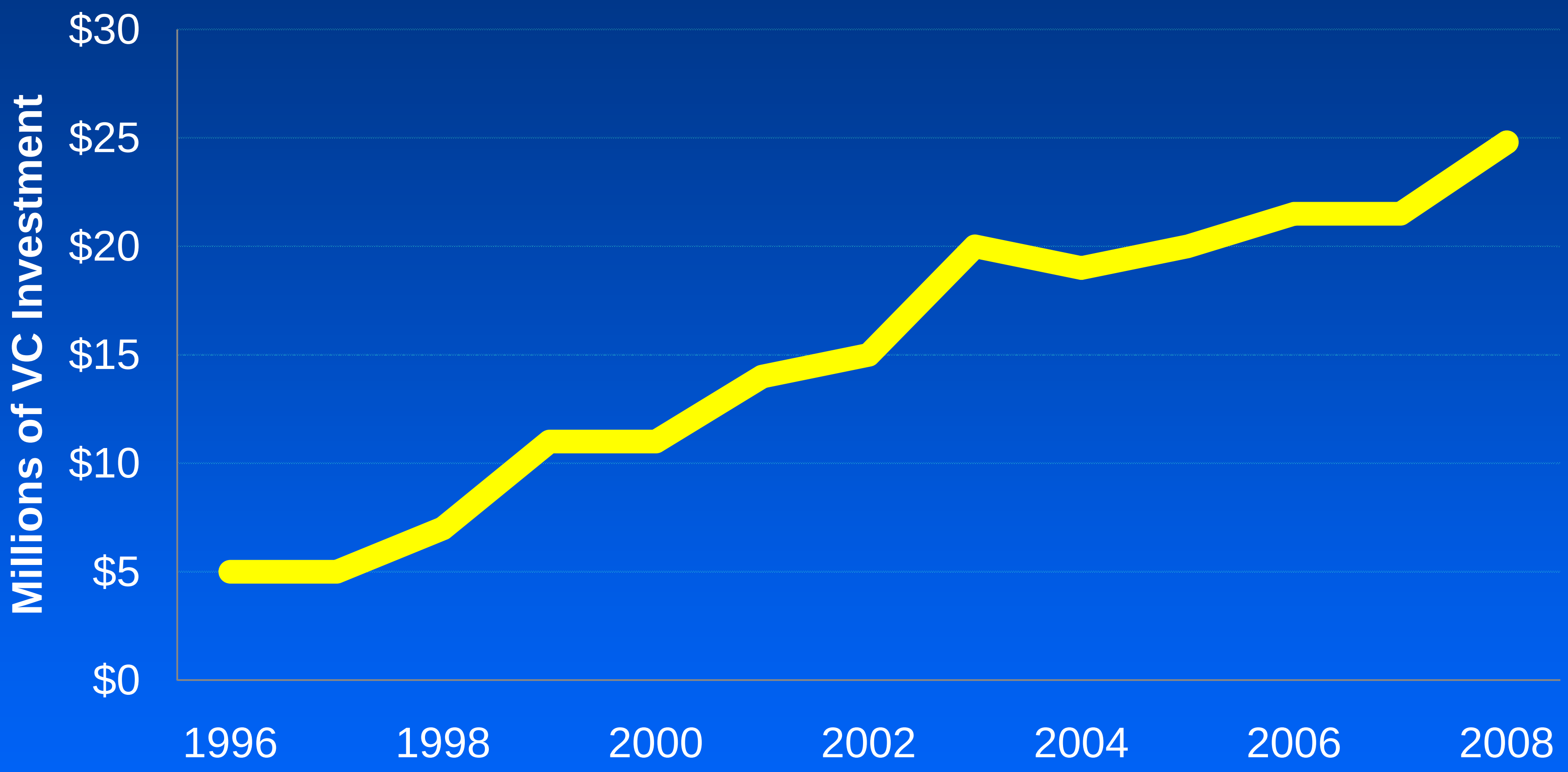
Source: US National Venture Capital Association, Thomson Financial

Average Capital per VC Principle



Source: US National Venture Capital Association, Thomson Financial

VC Investment Prior to M&A Exit

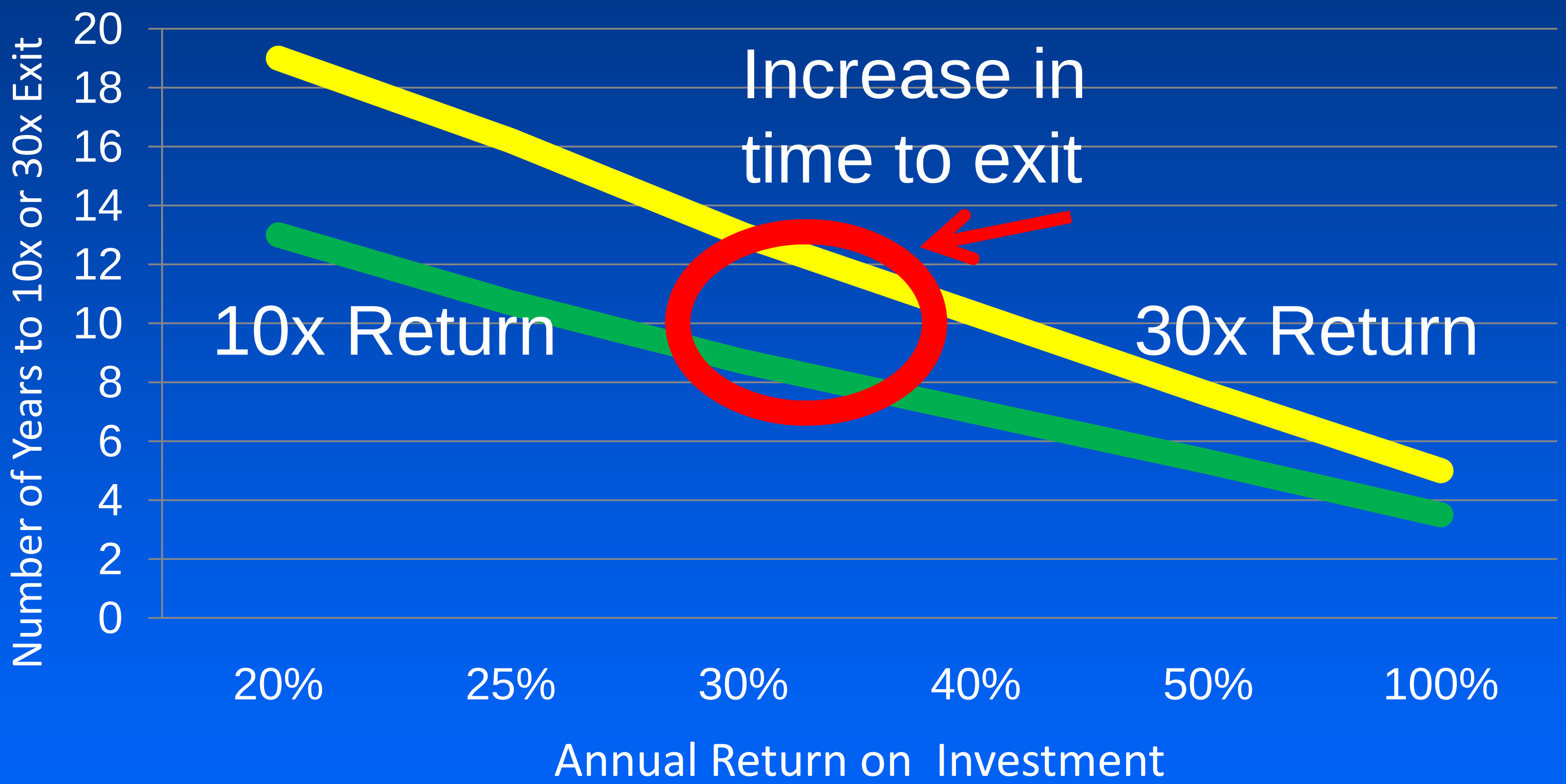


Amount of VC investment prior to M&A exit in millions. 2008 data for Q1
Source: Jeffries Broadview, Dow Jones VentureSource

VC Fund Math

- VC funds are larger and larger
- Can’t write a cheque 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 the winners have to produce an <u>average 30x return</u>

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

Unwritten Contracts with Investors

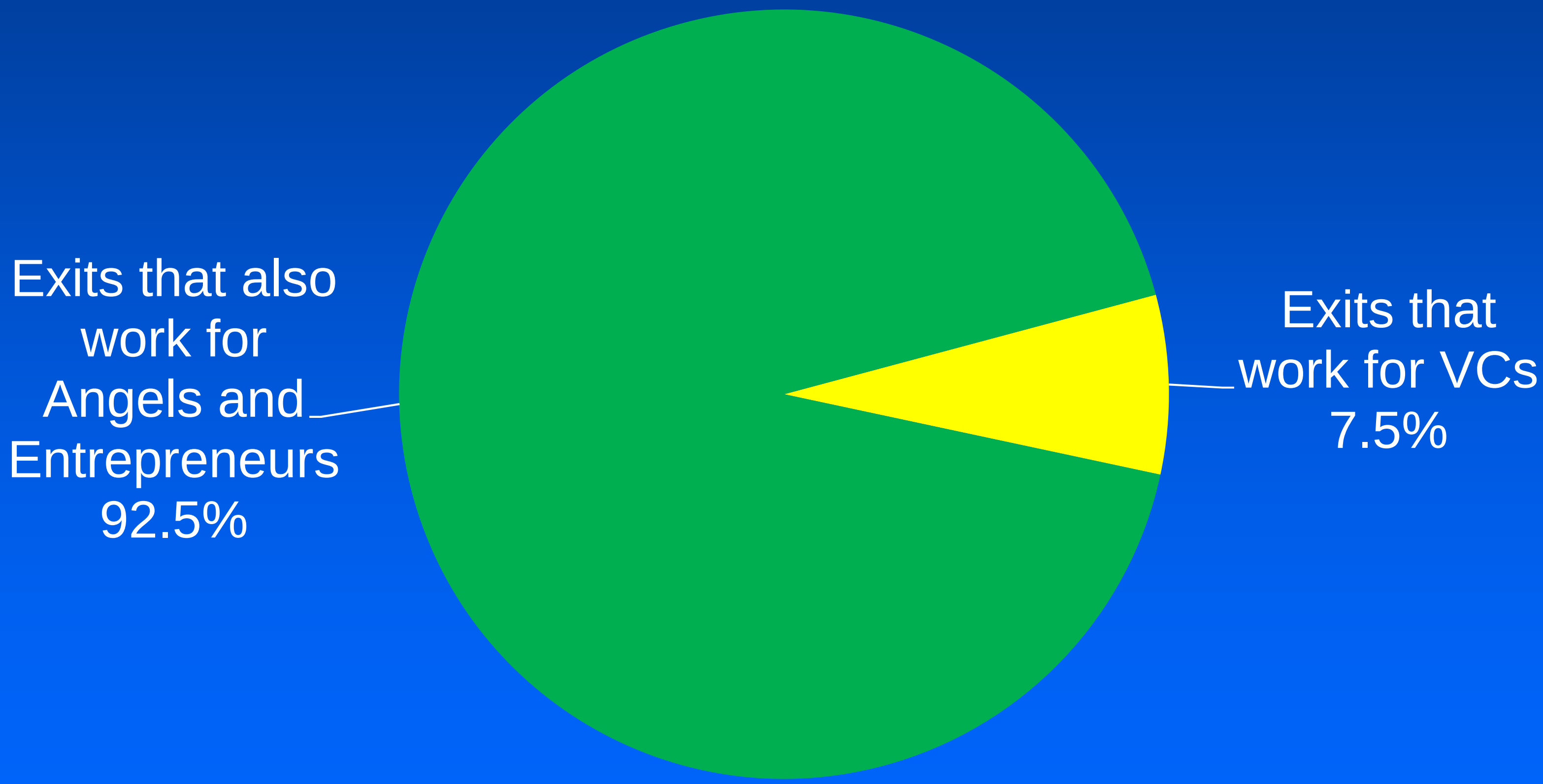
- Bloggers have helped entrepreneurs, angels and VCs understand each other better
- Entrepreneurs used to think it was simple
- Just increase the value of the shares
- But now realize that investors also need to get their money back
- Achieving an exit is part of the contract

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

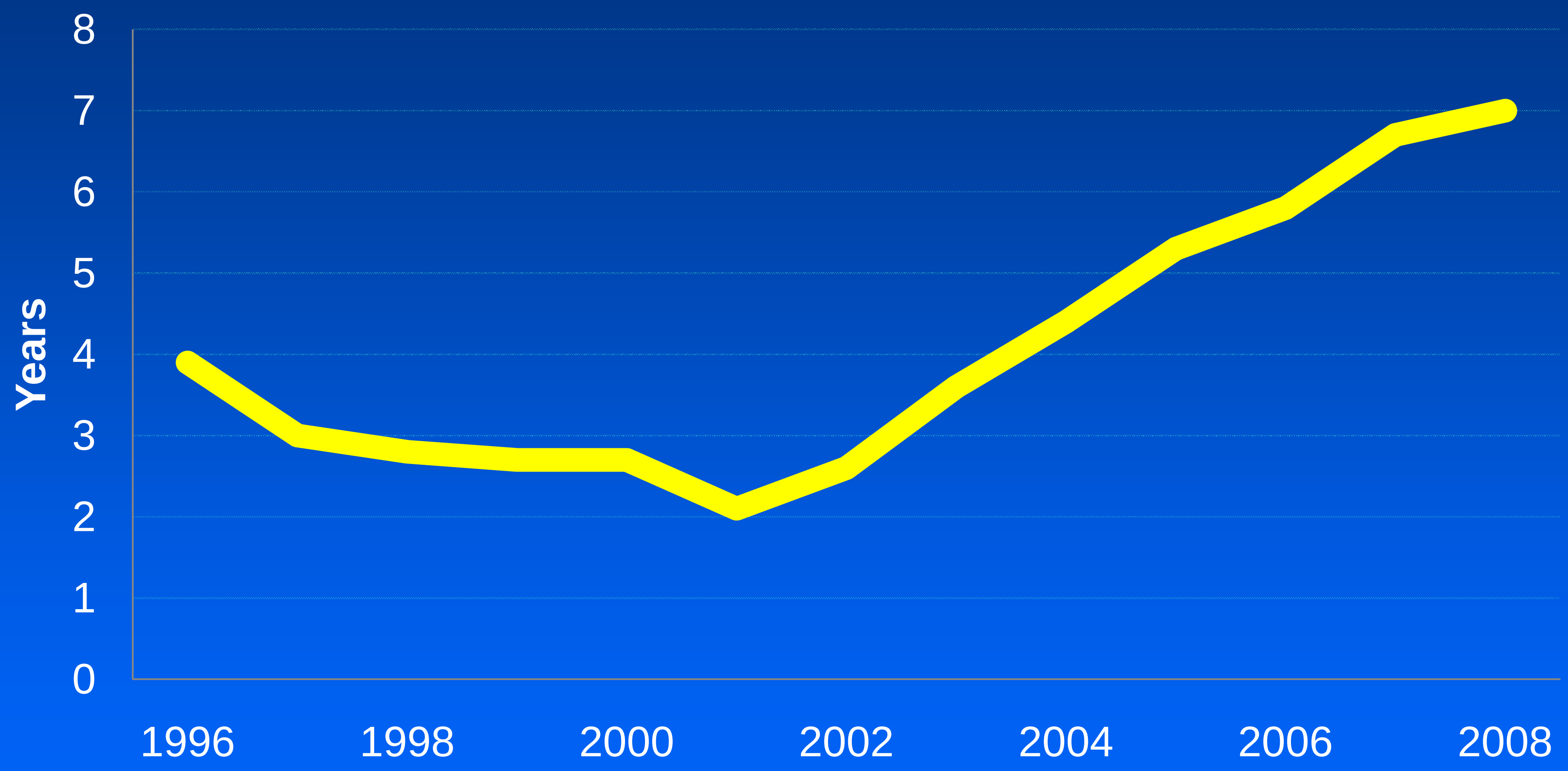
92% of Exits Don’t Work for VCs

VCs Need Exits over $100 million



Data from Mergerstat

Time from VC Financing to M&A Exit

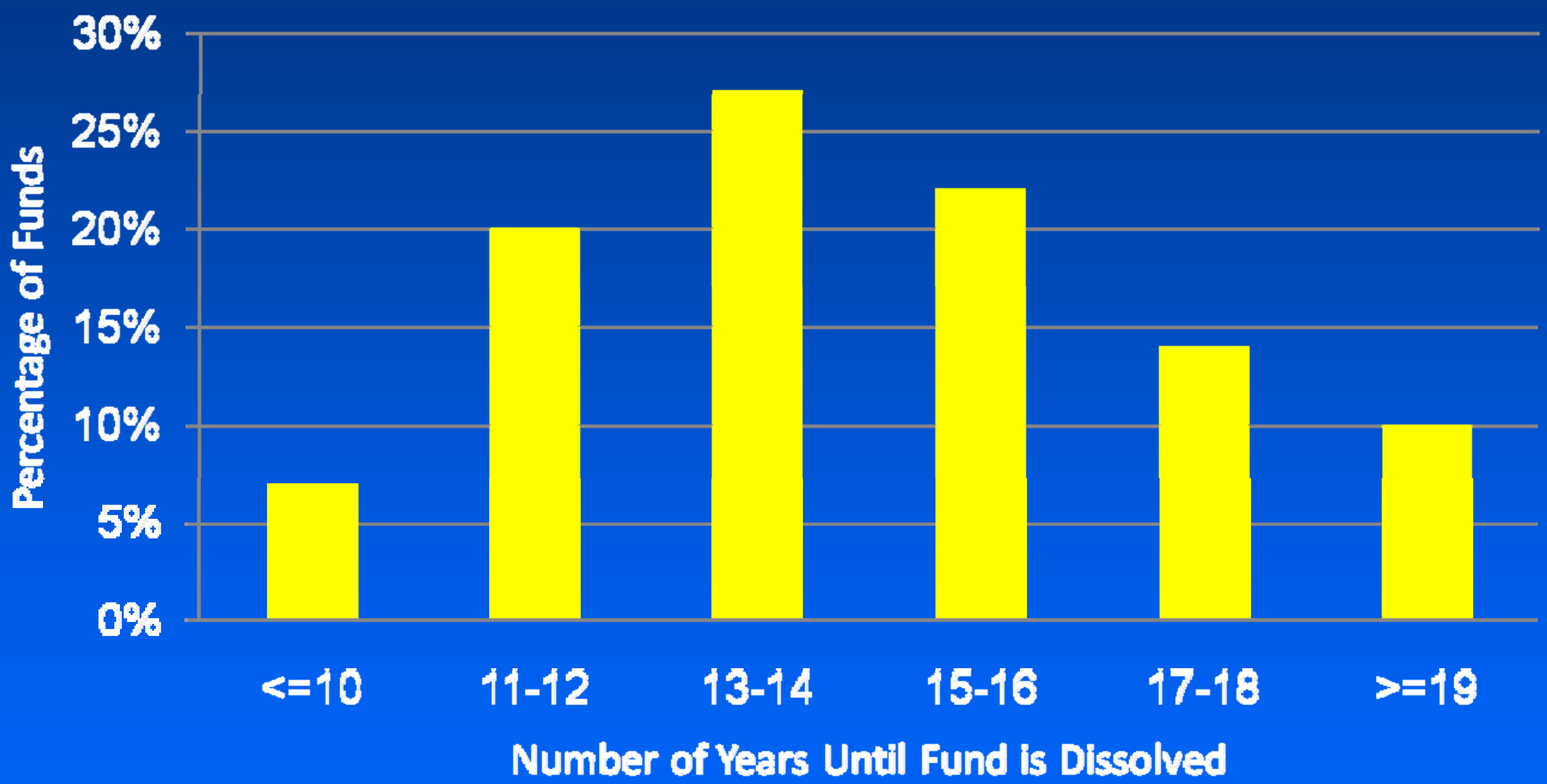


Median Time from initial VC financing to exit in years. 2008 data for Q1.
Source: Jeffries Broadview, Dow Jones VentureSource

What That Means for Angels

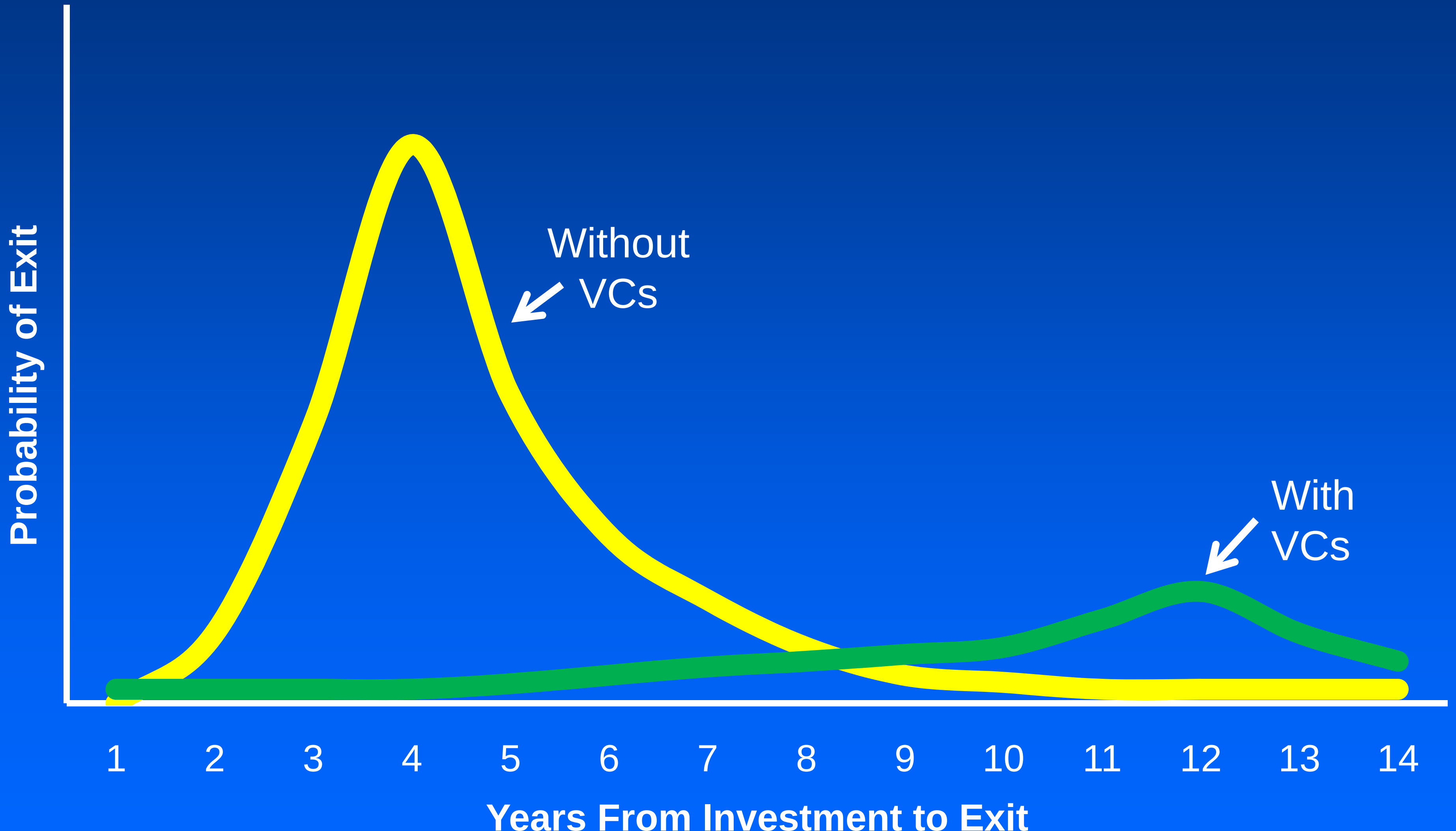
- A median of 7 years doesn’t sound so bad
- But the reality is quite a bit worse
- It’s 7 years across, A, B and C rounds
- A simple model suggests that equates to about 12 years longer for the angels
- At first glance that doesn’t seem possible
- Aren’t most VC funds 10 years?

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.

Angel Exits Without and With VCs



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
- Dramatically <u>increases risk of failure</u>

Angel Investor Math

- Investments as small as $25,000 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

Angel Co-Investment

- Just a couple of years ago, the conventional wisdom was that angel investment topped out at around $2 million per company
- Kauffman and ACA started talking about co-investment just a couple of years ago
- Now I regularly see groups of angels investing <u>$5 million to $10 million</u>
- More than enough for today's companies

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 unstable economy
- Is a fundamental incompatibility between angels and VCs in today’s exit environment

What happens when VCs invest

New insights from Wiltbank Data

Source: Robert Wiltbank, Ph.D Willamette University with Funding from the Kauffman Foundation

Angels or VCs But Not Both

- Fascinating new research May 2008
- Unique historical database of 182 Series A deals
- “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”
- Optimum is ‘<u>Angels or VCs but not both</u>’

Angel or VC Checklist

	Angels	VCs
Amount of capital required to prove the business model	Under $3 to 5 million	Over $3 to 5 million
Years before being able to exit	2 to 5 years	10 to 12 years
Most likely value of the company at the time of the optimum exit	Under $50 million	Over $100 million
Willingness to relinquish control of important financial decisions	Not always required	Almost always required

Summary

- VC backed IPOs and big M&As are gone
- When VCs invest, exits are much later and failures are higher
- Angels can now invest over $5 million
- Most companies don’t need much capital
- Most exits are now under $20 million
- Today, the optimum strategy for many companies is: <u>Angels to Early Exit</u>