A Golden Era in Technology M&A

New Opportunities for M&A Professionals

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My Background

- I’m a geek
- PhD in Electrical and Computer Engineering from the University of British Columbia
- Started my first company at grad school
- Nexus grew to be the world’s 2nd largest manufacturer of cable TV headends
- Sold in 1993 to Scientific Atlanta and is now part of Cisco

Tech Companies Then and Now

Nexus and many 1980s & 90s tech companies

Friends and Family Investors → Angel Investors → Venture Capital Investors → Institutional Investors → Exit to Fortune 500

10 – 14 years

Club Penguin, Flickr, and many 2009 tech companies

Friends and Family Investors → Exit to Fortune 500

2 - 4 years

History Will Call This a Golden Era

- It’s never clear when it’s happening, but
- I believe history will call this a golden era
- For entrepreneurs and angel investors
- The drivers are:
  - The global online market (aka the Internet)
  - Open source software
  - The boomer demographic à angel capital

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

M&A Exits Are Happening Earlier

- Flickr sold for $30 million when it was just one and a half years old
- Delicious was sold for $30+ million two years from start-up
- Club Penguin was sold for $350 million when it was two years old
- YouTube sold for $1.6 billion when it was two years old

There is No Shortage of Capital

- Lots of doom and gloom in the press
- Yes, the traditional Venture Capital model is broken and that industry is contracting
- But that won’t affect many tech companies
- Angel Investors finance 27x more startups than VCs today - and that’s increasing
- Friends and Family invest more than VCs and Angels combined

Sources of Equity for Tech

- In America, each year Venture Capital Funds invest about $20 billion - shrinking
- Angel investors also invest about $20 billion each year – and growing
- Even more surprising, Friends and Family investors invest about <u>3 to 5 times more</u> than either VCs or Angels
- From “Fools Gold” by Scott Shane 2009

Angel Syndication

- 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

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)

Who are the Buyers Today?

- 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 individuals not ready to retire

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 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 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

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’

What it Means to Prove the Model

- In a recurring revenue business, for example, you have a spreadsheet that clearly shows actual results for:
  1. Gross margin per customer
  2. Customer lifetime (or churn)
  3. Cost of customer acquisition
- In other words, how much is a customer worth and what do 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'

- It's human nature not to think about exiting when everything is going well
- We often wait to start the exit process once it is clear that the value has peaked
- And by the time the buyers are serious, it's obvious to everyone
- I did that - and recently told the story in "Don't Blow the Biggest Deal of Your Life"

Exits Are Not Well Understood

- Exits are the least understood part of being an entrepreneur, investor or director
- 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 <u>group</u> deals exited in 2008
- (Not yet clear if this is a trend)

Boards Today

- Much harder to recruit, and retain, any type of director today
- Today’s tech companies require much less capital
- So there are fewer investors who have each often invested less money
- Making it even more difficult to build really good boards for today’s tech companies

The M&A Experience and Guidance

- When more tech companies had better boards there was often more than one director who had done a number of exits
- When VCs invested, their investment agreements always gave them control of the exit process and they had the relationships
- Today’s capital efficient tech companies very rarely have ‘built in’ M&A experience

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 board committee (if there is one)

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 start up
- Exit knowledge and experience is even more critical for these young companies

The Exit Coach – Cost and Benefits

- 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

M&A Advisors Should Be Local

- CEOs and boards often start to look for an M&A advisor in the big financial centers
- Dirty secret is that about a third of M&A engagements fail to complete a transaction
- And the failure rate increases as the distance to the M&A advisor increases
- 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

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

New Opportunities for Professionals

- Companies need M&A advice almost from startup
- Directors and VCs no longer driving the exit
- Creating new opportunities for ‘Exit Coaches’
- Under $100 million transactions need local advisors
- M&A relationships now being formed at the entrepreneur and angel level

Earlier Talks on Exit Strategy

- Online videos of my recent talks on exits:
- www.AngelBlog.net/Exit_Strategies_for_Angel_Investors_Video.html
- www.AngelBlog.net/Start_at_the_End_Your_Exit_Strategy.html
- And what not to do:
- www.AngelBlog.net/Dont_Blow_the_Biggest_Deal_of_Your_Life.html

Resources

- 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 a online videos of my previous talks on exits

Good Luck With All of Your Exits!