The Easiest Way to Improve Returns for Angels and Entrepreneurs

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Basil Peters

The Title of this Workshop

- The title of this workshop is:
- “Investing in a World with Fewer Exits”
- I disagree with the question…
- Yes, I know most angels, and angel groups, have far too few exits
- At the same time, we are now in a time where exits have never been easier, or more abundant
- Why does this conflict with our perception?

Where's the Data?

- Perhaps the most difficult part of being an angel investor, or an entrepreneur,
- Is that we don't have the data we'd like to make better investment and business decisions
- You just heard from Rob Wiltbank
- He's certainly one of the most knowledgeable people in the world on angel outcomes
- Rob and I often talk about how wonderful it will be when we have more of the data we need

Data We Wish We Had

- We will be far more successful investors
- And help more entrepreneurs become millionaires
- When we have good data on:
  1. The number of exits
  2. The value of exits
  3. The ROI on exits
  4. Combined with some basic company data

We’re Trying to Build Datasets

- You might think the government would want to know this information
- Especially because entrepreneurial companies are such a big part of economic growth
- Or that some university professor (like Rob used to be until recently)
- Would find a way to fund the data collection
- It is much more difficult than it looks
- And is still years away

For Now – It’s Anecdotal

- Without useful data, we have to make decisions based on anecdotal evidence
- In other words, observation - not hard data
- Over the 20 years I’ve been a VC and angel,
- The most important observation I’ve made
- Is that….

Only 25% of Companies Exit Well

- I believe <u>only 25%</u> of all companies that could have been sold,
- Actually end up successfully exiting.
- Yes, the probabilities are 75% that if a startup succeeds, and becomes valuable,
- It will still fail to successfully exit.
- And then the <u>most likely result is that it will fail.</u>

Exit Probabilities for Saleable Companies

For <u>Saleable</u> Angel Backed and Bootstrapped Companies

What Are We Doing Wrong?

- If this is a time of abundant exits
- What are we doing wrong?
- How can we improve our probabilities of having a successful exit in our companies?
- Like most things in business:
  1. Strategy
  2. Planning
  3. Execution

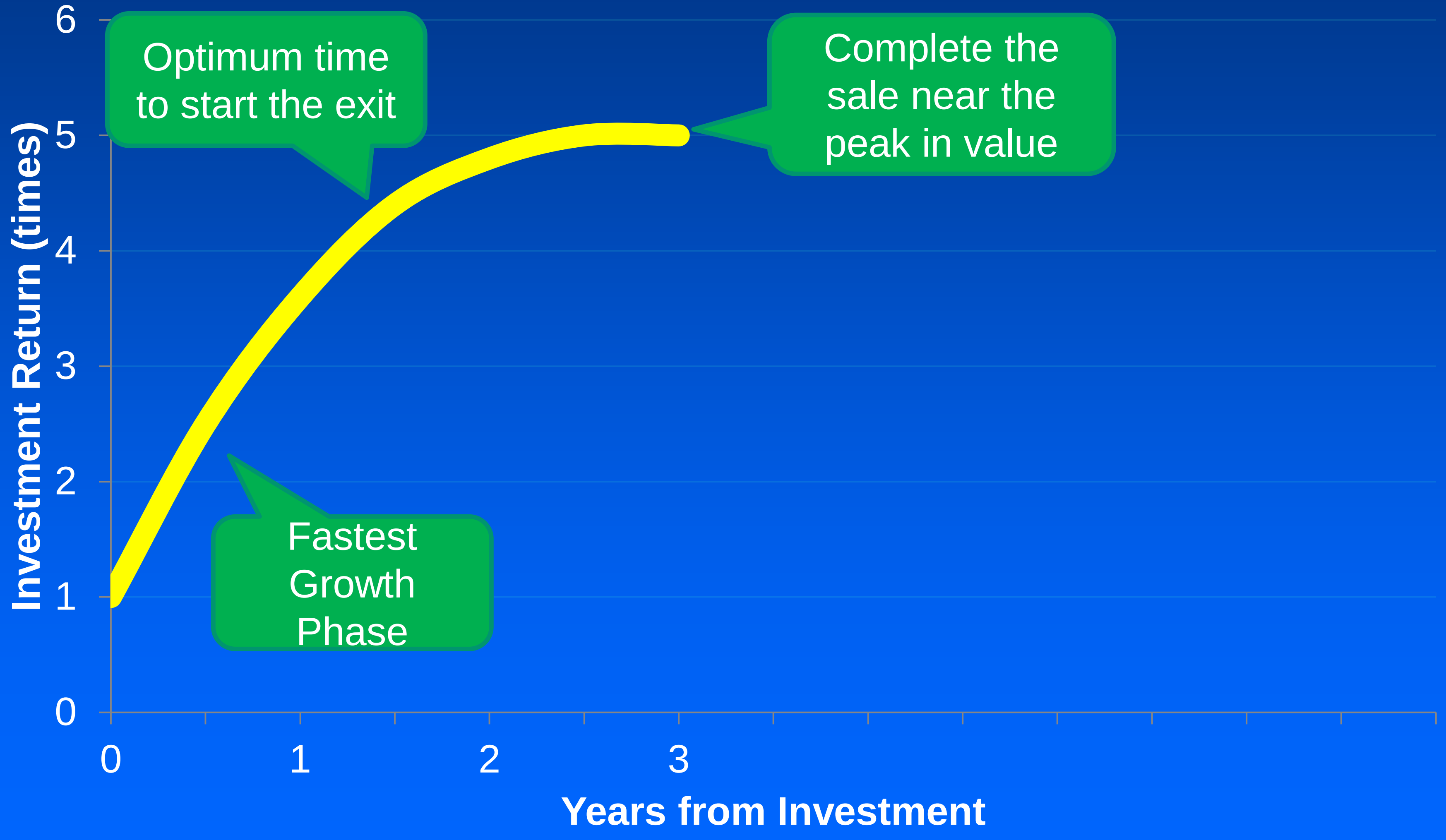
Strategy & Planning: Timing

- Timing is an important part of exit strategy and planning
- An exit usually takes 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 longer if the company isn’t ready, or if the structure needs to be cleaned up, or if the financials need improvement

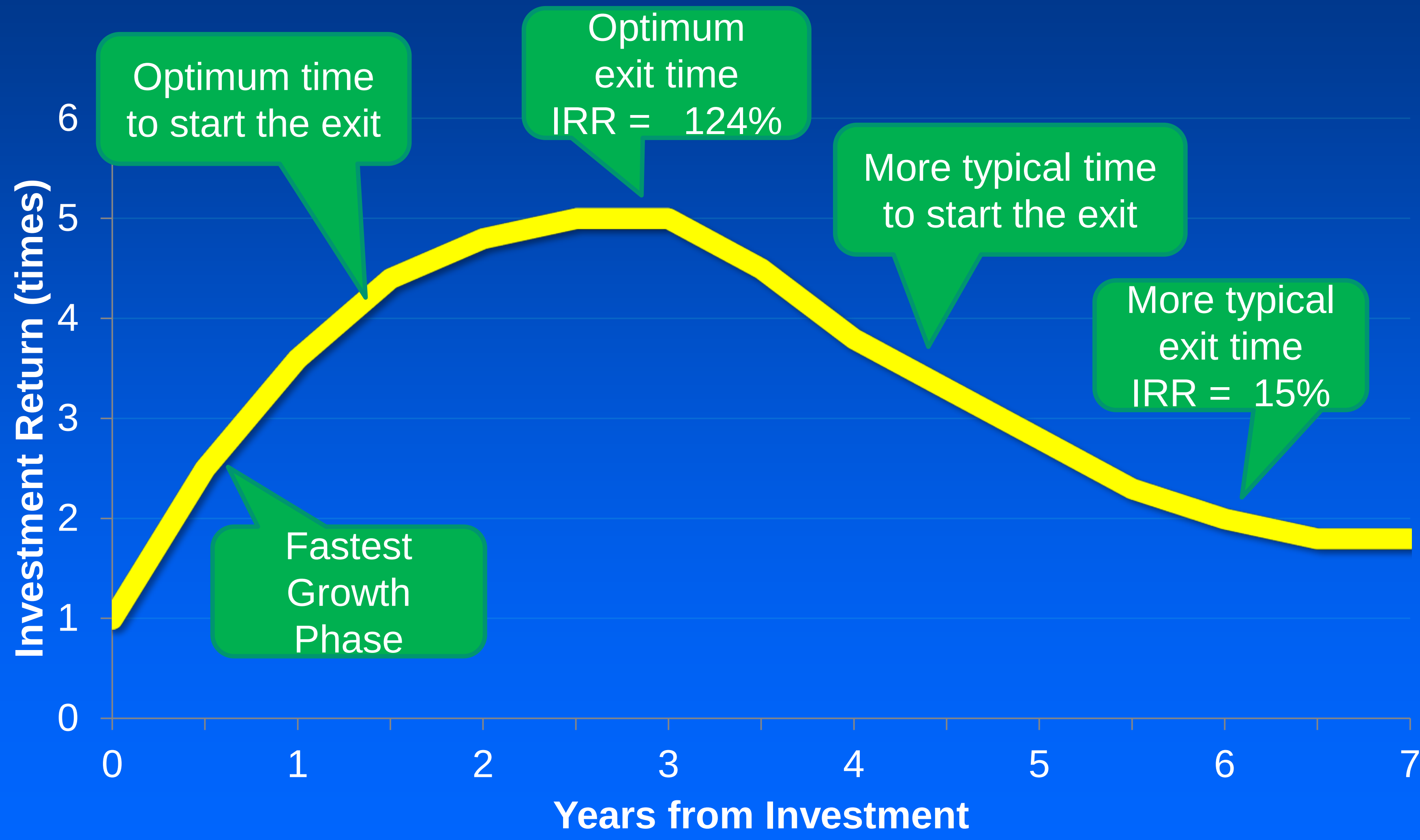
Ideal Exit Timing

- In an ideal situation, the company board would incorporate this 6 to 18 month delay
- Into the company’s 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

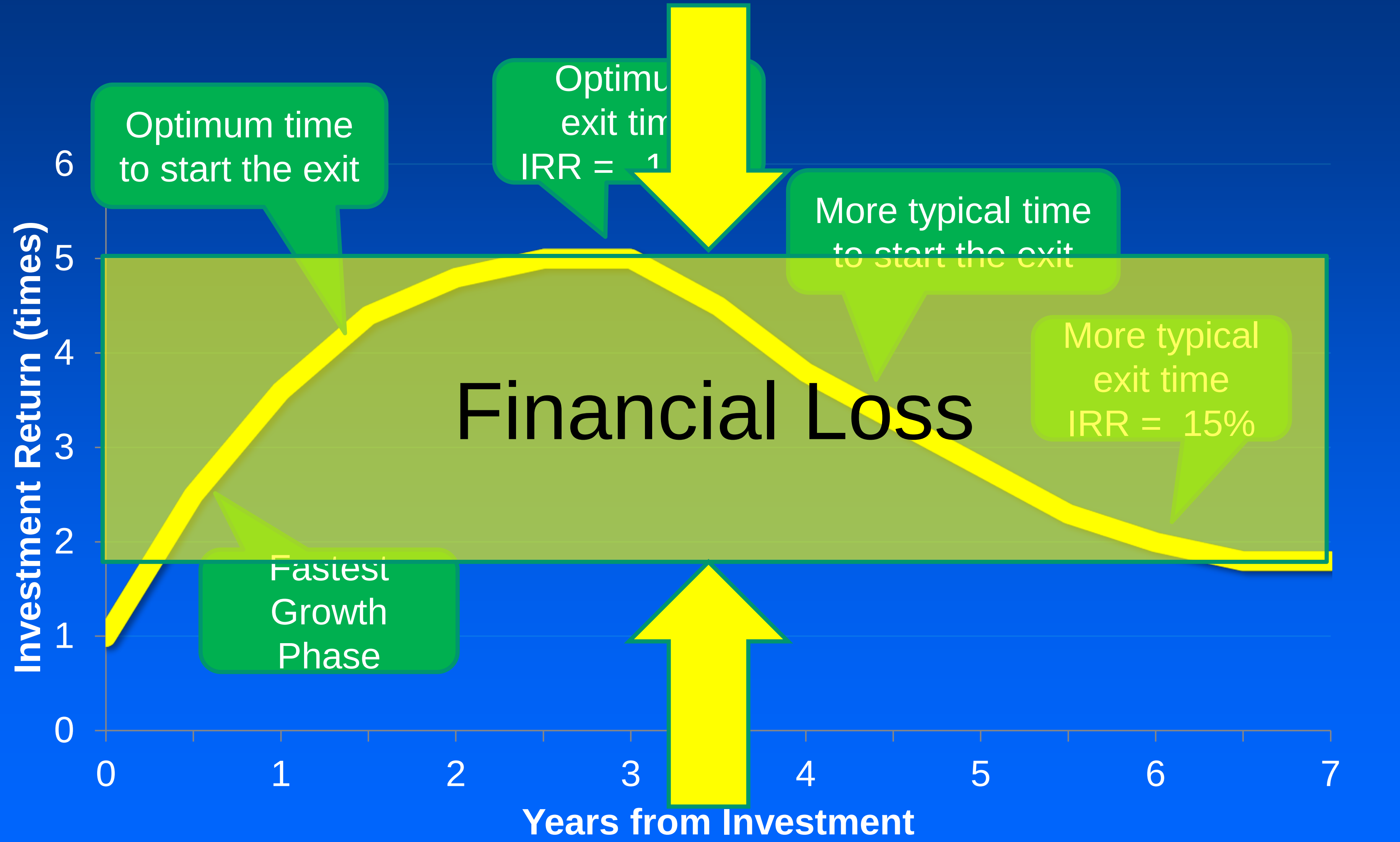
Ideal Exit Timing



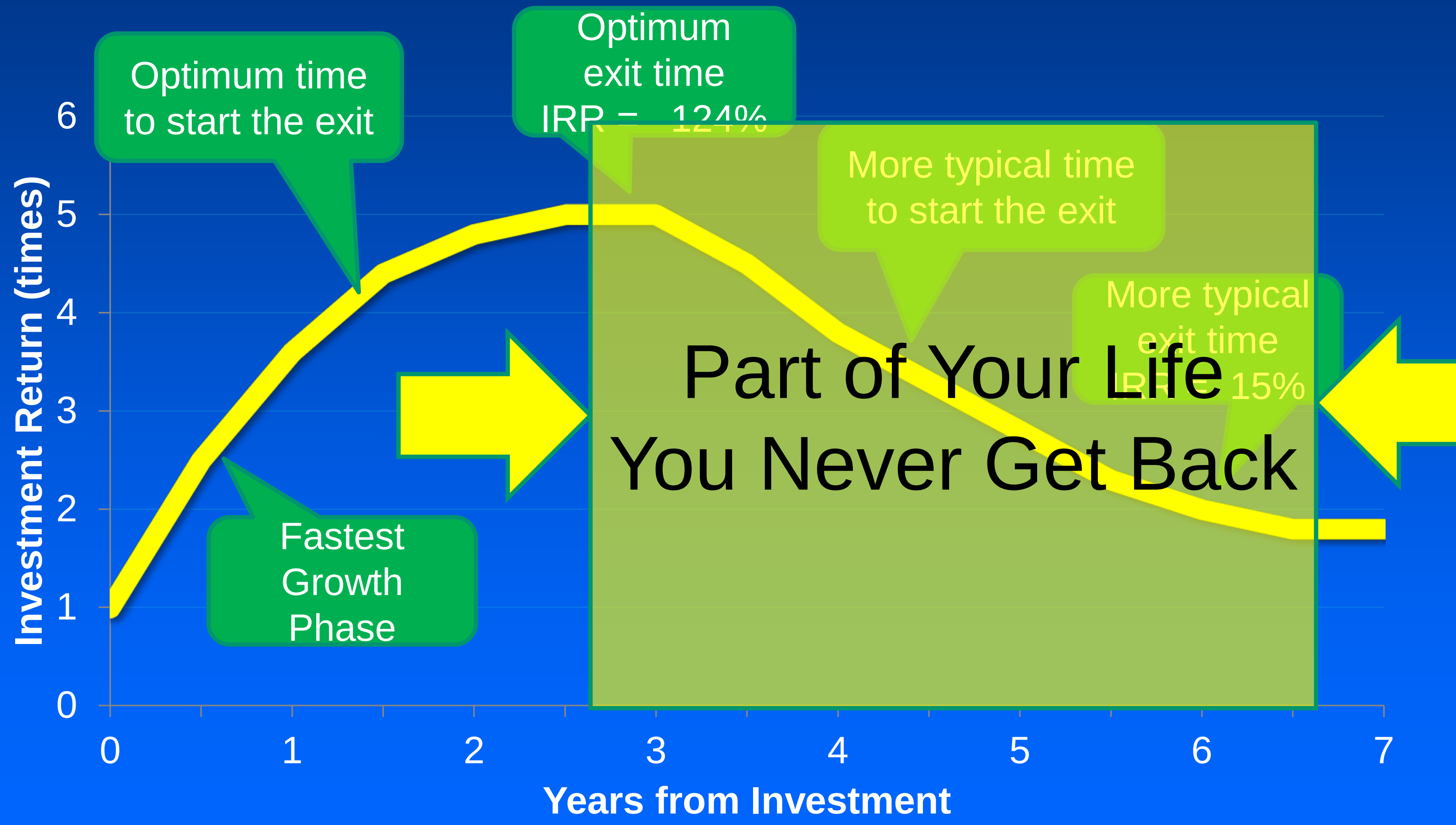
“Riding It Over the Top”



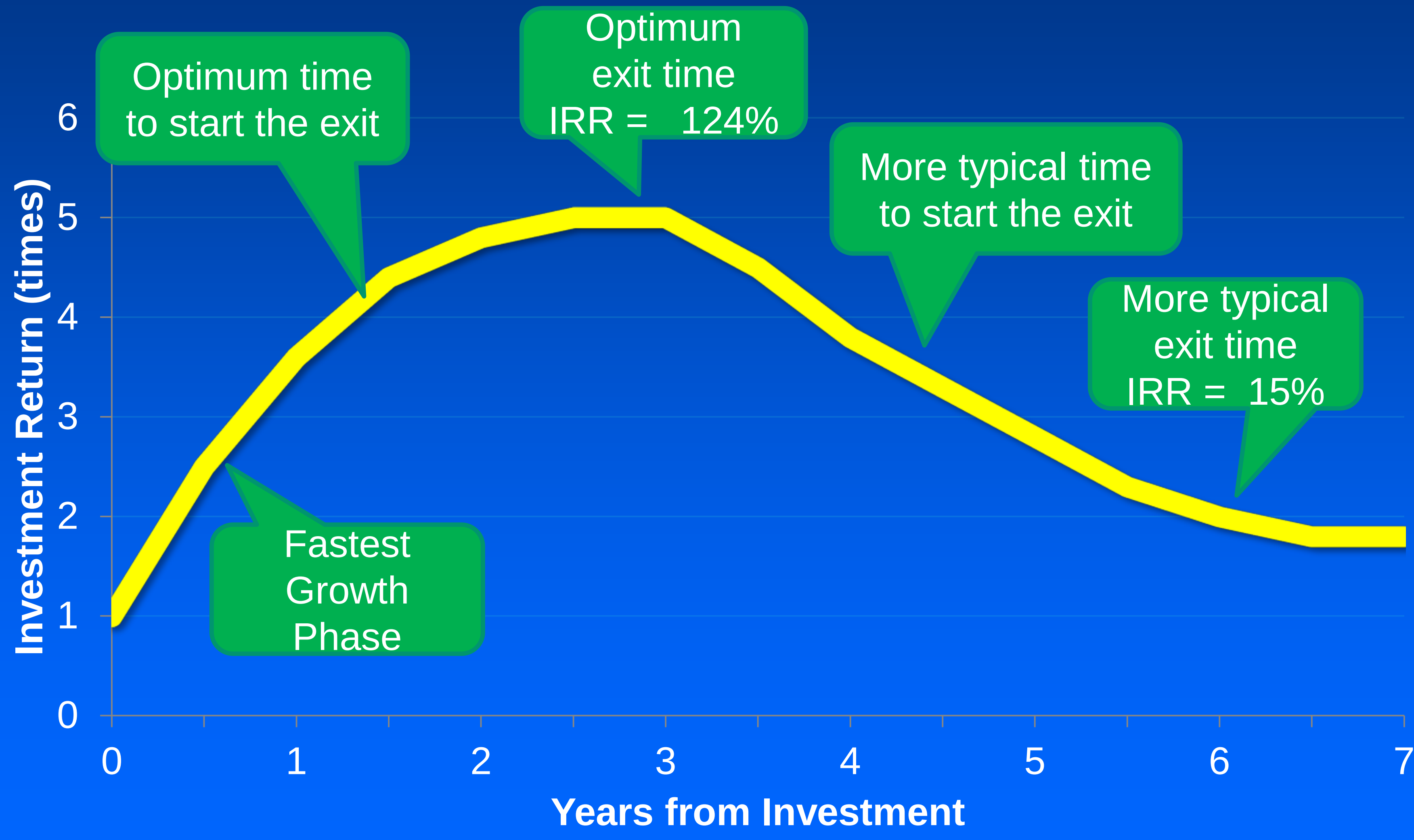
The Financial Loss



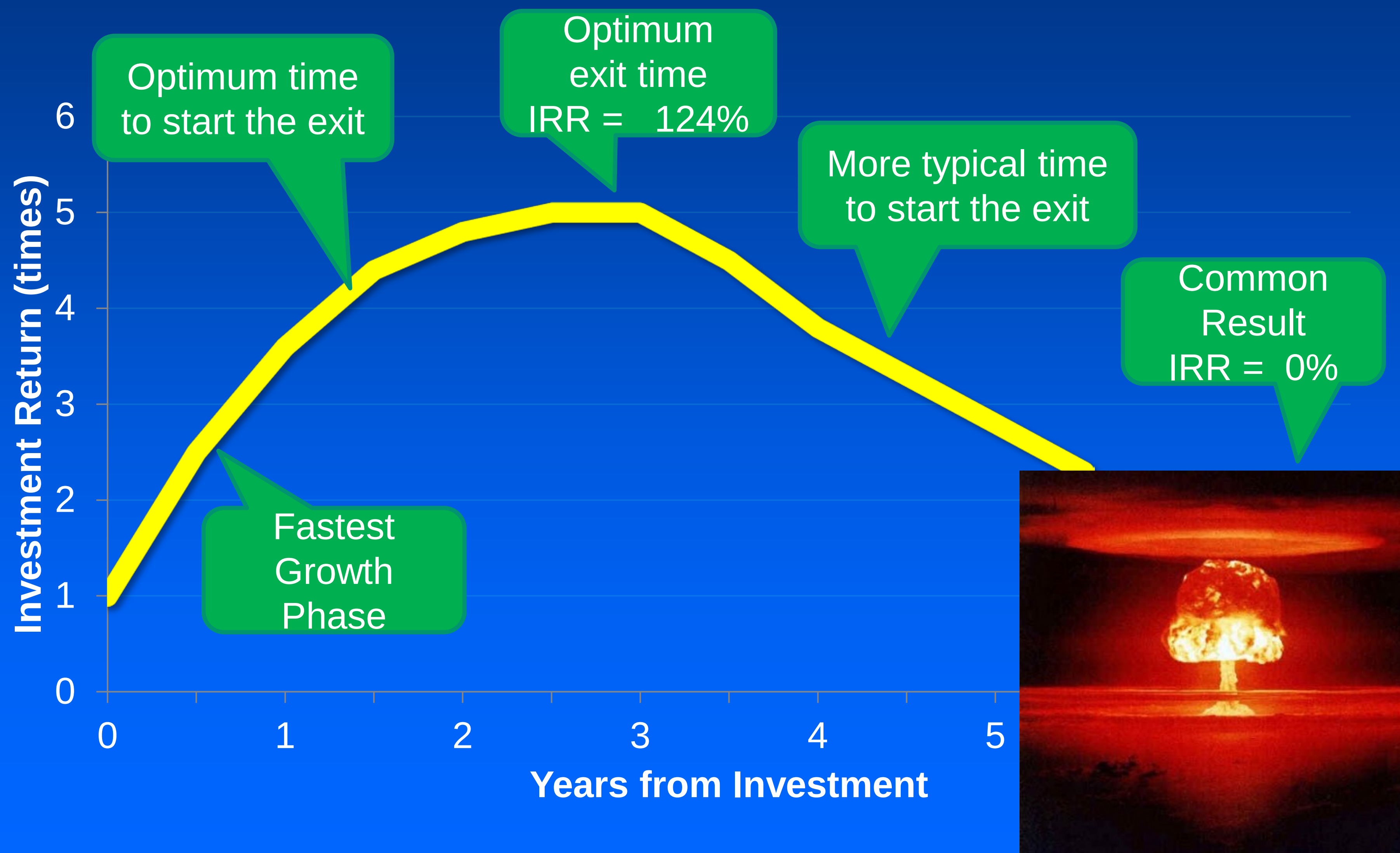
Part of Your Life You Never Get Back



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 misses the ideal time to exit
- There’s a significant probability it won’t just exit for less,
- But will <u>never exit at all</u>

Reasons This Happens

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

- Video of other talks on this are on my blog
- Let me quickly describe some examples of #3.

Patents and Successful Exits

- Patents have become a much more valuable tool for entrepreneurs and angels
- Attitudes about patents are changing – globally
- Here in America we now have a first to file system, no longer first to invent
- And a rapid approval process
- Patents can be filed quickly and economically

Patents – a Double Edged Sword

- Most of the legislative and common law changes benefit inventors and entrepreneurs
- Entrepreneurs have won big cases recently
- But some of the global attitude changes
- Create serious risks for smaller companies

Big Company Patent Attitudes

- One of the difficulties with patents is that you never really know if the patent is valuable
- Until after the appeal
- Which can easily take a decade
- Technology companies just can’t wait that long
- Many big companies - especially in Asia
- Take the attitude that they will just use the IP
- And let the lawyers figure it out later

Brightside Case Study

- Spinout from the University of BC working on LED backlights for liquid crystal displays
- I invested three times in Brightside
- About $7 million of angel money was invested
- Company successfully sold to Dolby
- For $28 million – again pre-revenue
- But…

Brightside Almost Didn't Exit

- I was in Best Buy a couple of weeks after the Brightside exit looking for a new LCD TV
- I'd gotten good at recognizing the Brightside technology
- It was right there on the shelf!
- The company had shown the technology to a big Asian display manufacturer
- Trying to negotiate a licensing deal

Brightside’s Near Miss

- Under a strong Non-Disclosure Agreement
- As near as we can determine, the big company must have put the design into their production process right after the meeting
- I have no doubt that if this happened a few weeks earlier,
- Brightside wouldn’t have had that exit
- http://www.exits.com/blog/case-study-the-brightside-exit/

What it Takes to Defend a Patent

- I’ve asked several patent lawyers what it would cost to prosecute a patent infringement like that
- It’s difficult to know exactly, but they say it would take $1 million just to get started
- And could cost $5 to 10 million
- And take 10 years

Outcomes are Not Perfect

- Even after spending $5 to 10 million
- And taking a decade
- To defend a very strong patent
- There is still a strong probability you will lose
- According to PwC’s 2012 Patent Litigation Study, patent holders have nearly a 40% chance of losing their case

Why Small Companies Lose

- One reason a lot of inventors and small companies ultimately lose
- Is simply the quality of the lawyers
- Some patent lawyers have said to me that the quality of the lawyers
- Is more important than the quality of the patent
- Especially if it is a jury trial

The Big Companies Know

- Many big companies employ hundreds of patent lawyers – really good ones
- They know that their lawyers will win a percentage of the time, no matter what the merits
- And they know they will win much more often against a small company that can’t afford to hire the very best legal team
- They also know that many times a small company can’t even afford to start the suit, so they will win by default

If You Have a Good Patent - Sell

- In my opinion, if you have a <u>good</u> patent,
- The only reasonable strategy is to sell the company
- As soon as possible after the patent is granted,
- Or when you have disclosed the technology
- Whichever is sooner
- The risks of not selling early just aren't a good business, or investment, decision

Improving Your Probabilities

- There are many strategies and tactics to improve the probability that any single company will have a successful exit
- IMO most important is to have an exit strategy
- Determine at the outset what the optimum exit and timing would look like for that company
- This takes some experience,
- But it can be done with a reasonable accuracy

Plan and Be Proactive

- Another easy way to dramatically improve the probabilities is to
- Plan the exit timing to match the company’s progression
- Plan to exit near the optimum time in the company’s value
- Don’t wait for an offer!
- Build an exit team early

Easiest Way to Increase Returns

- I believe the easiest way we can improve our investment returns, and help entrepreneurs
- Is to increase the probabilities of having successful exits
- Understand the exits market and the risks
- Have an exit strategy and an exit plan
- Build a good exit team early and be proactive
- Good luck with all of your exits!