

Maximizing Exit Value

Angel Capital Association
Annual Summit Workshop

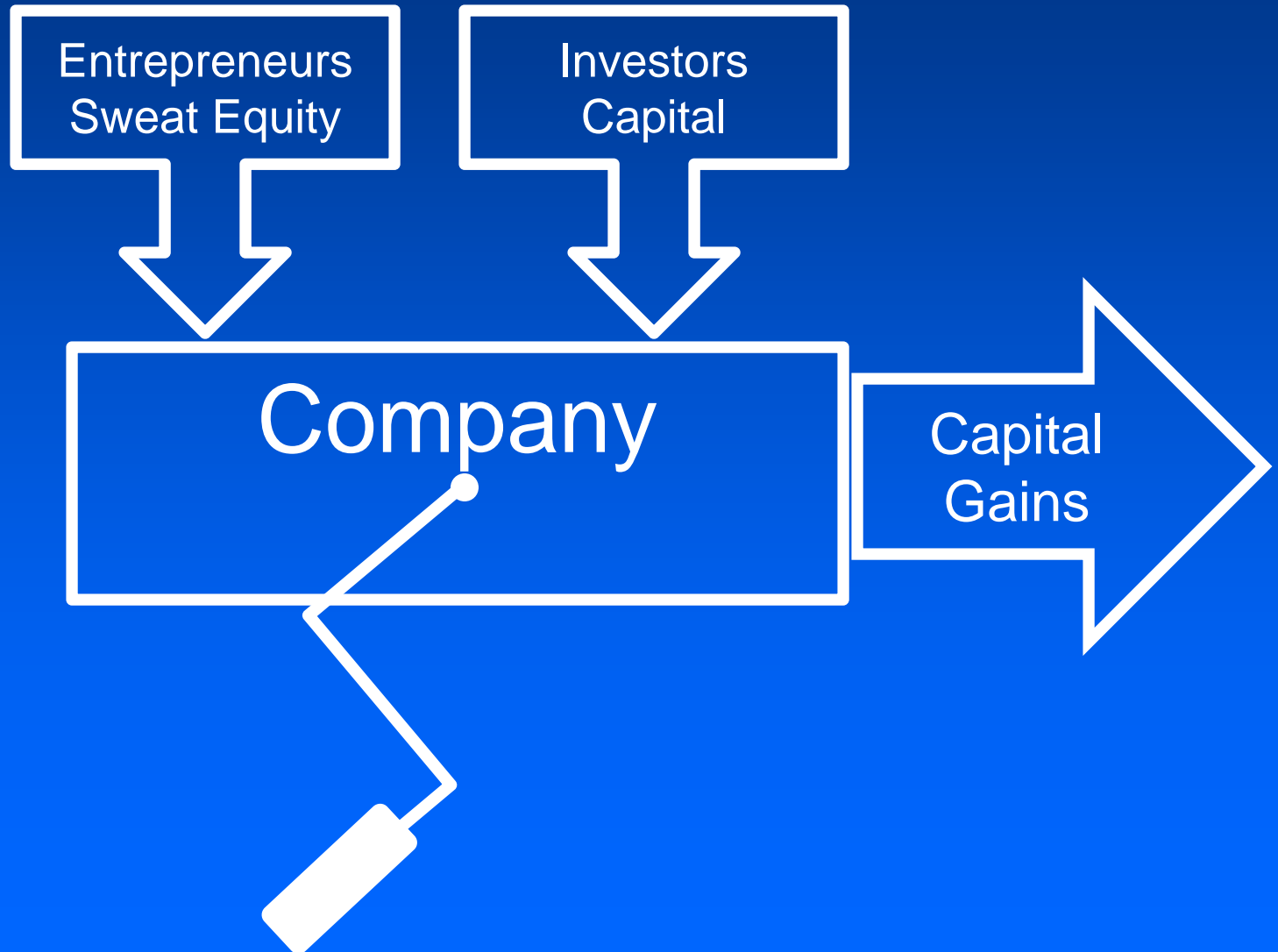
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Outline of Part 2

- When can you sell?
- Developing an Exit Strategy
- Maximizing Value
- Planning for a Successful Exit
- The Exit Timeline
- Summary
- Workshop on Exit Valuations

Simple Model of a Company



Two Types of Exits

- There are basically two types of exits:
 1. Going public (an IPO or RTO)
 2. Being acquired (an M&A transaction)
- Today, there is effectively no IPO market
- This workshop will focus on M&A exits

When Can You Sell?

Common Misunderstanding

- 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. Revenue per customer
 2. Gross margin per customer
 3. Customer lifetime (or churn)
 4. 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

That's When You Can Sell

- There are often additional factors like competitors and market changes
- But the important threshold to determine when you can sell is when you have proven the model
- That's when you can have a reasonable negotiation on value
- And sell the business

It's Often The Optimum Time

- As soon as you prove the model is often the best time to sell
- Always best 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 'ride it over the top'

Developing an Exit Strategy

Developing an Exit Strategy

- The most important element in the business plan
- Every company has an exit strategy
- Even if nobody realizes it
- Even if it's a lifestyle business without investors
- It affects many daily business decisions

The Exit Is Just Another Process

- Whether it's a financing, product development, marketing or sales goal
- The chances of success increase dramatically if you have a good plan
- Your exit strategy is the plan for your business – the entire business
- Your plan should start at the end (the goal)

The Important Elements

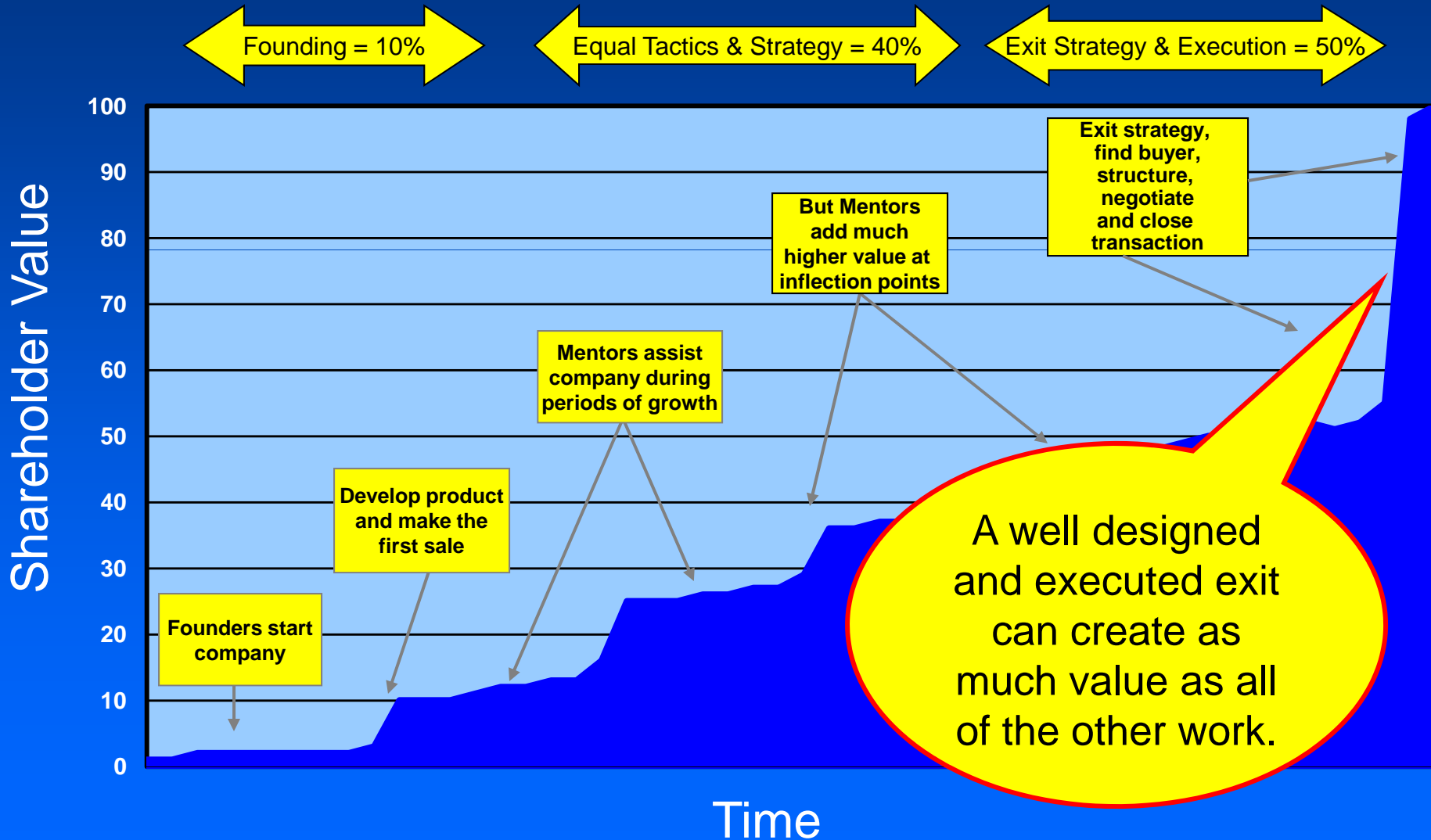
- An Exit Strategy could be as simple as:
- “Our exit strategy is to [sell the company] in about ___ years for around \$ ___ million.
- We plan to execute the exit by engaging a [mid market M&A advisor] by _[date]_.”
- Or it could be an IPO or RTO and I-bank
- Formally check alignment at least annually

Maximizing Value

You Can Often Get 50% More

- When the exit is designed and executed well
- It is often possible to increase the exit valuation by 50 to 100%
- This is especially true of early exits
- Where the market is much less efficient
- And valuation is driven by futures rather than the past five years of actual financials

Building Shareholder Value



Maximizing Exit Value

- There are several 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 final selling price by 10 to 15%
 - 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

Always Have Multiple Bidders

- There are two important reasons that every exit transaction should always have multiple bidders:
 1. To improve the probability of closing
 2. To maximize the price
- Optimum number is 3 near the end
- Also a practical maximum
- Usually creates the biggest increase in price

Selling and Negotiating Skill

- There is no question that some sales people are just better – often much better
- I hate to admit it - but I get ‘sold’ all the time
- Selling a company is just like any other sale – but bigger and more complex
- A really outstanding M&A advisor or business broker can increase the final price by 50% or more

Planning for a Successful Exit

Planning and Execution

- When the exit process is well planned and professionally executed:
 - The exit date, and
 - Exit valuation
- Are both reasonably predictable

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. Optimize the financial results
 7. Build the sales funnel
 8. Manage the auction
 9. Negotiate and close

Check the Alignment

Check The Alignment

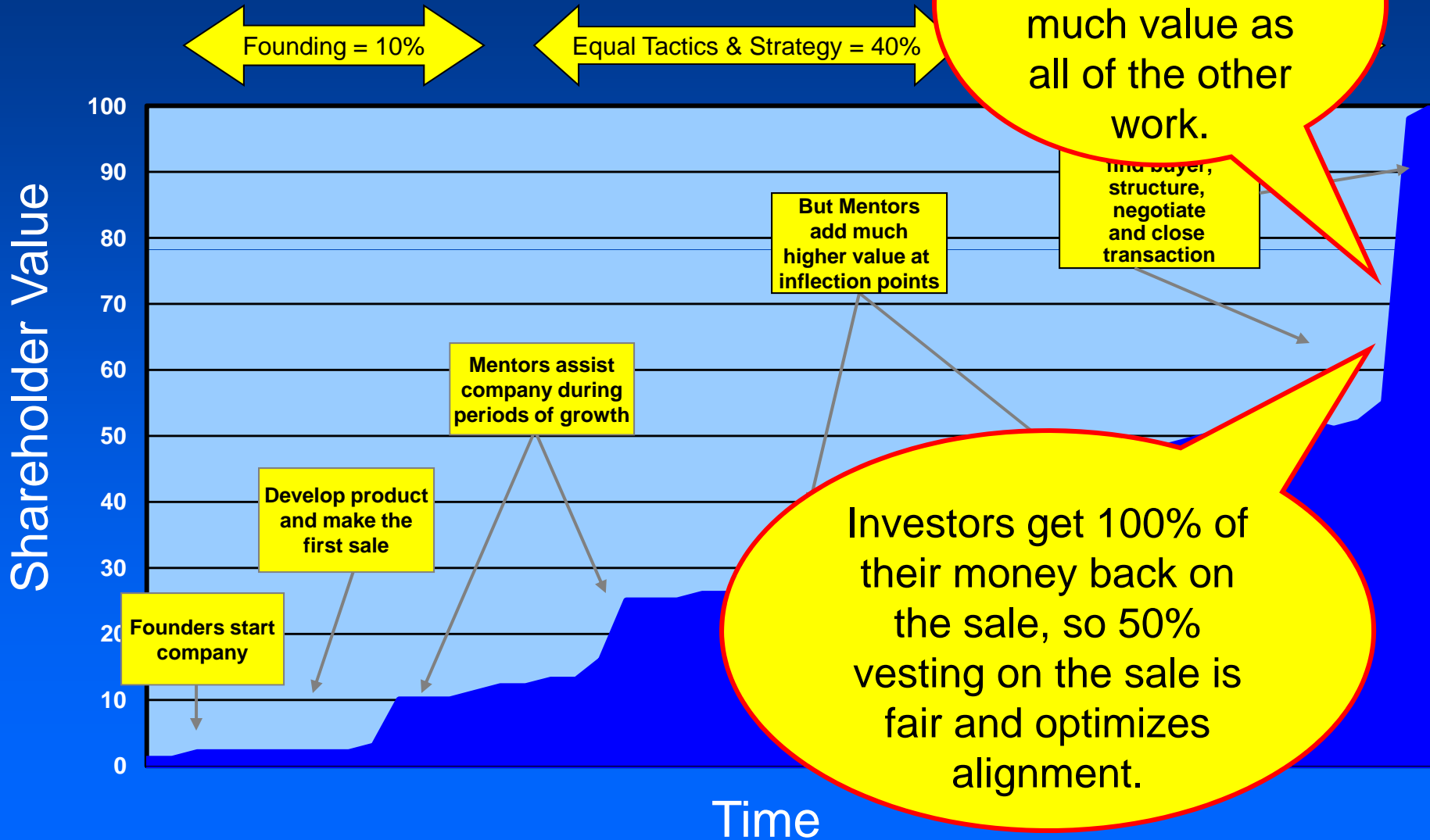
- It's surprising how often there is a misalignment between key stakeholders on the exit strategy
- The only way to check is to get a 'signoff' on a written exit strategy
- Usually takes at least one offsite planning retreat to build full alignment
- Even after, check alignment annually

The Agreement With Entrepreneurs

Today, many believe that the fundamental agreement between investors and entrepreneurs is:

1. The investors invest their money as equity
2. The entrepreneurs all work together to increase the value of the equity, and
3. Provide the investors, and themselves, liquidity.

Building Shareholder Value



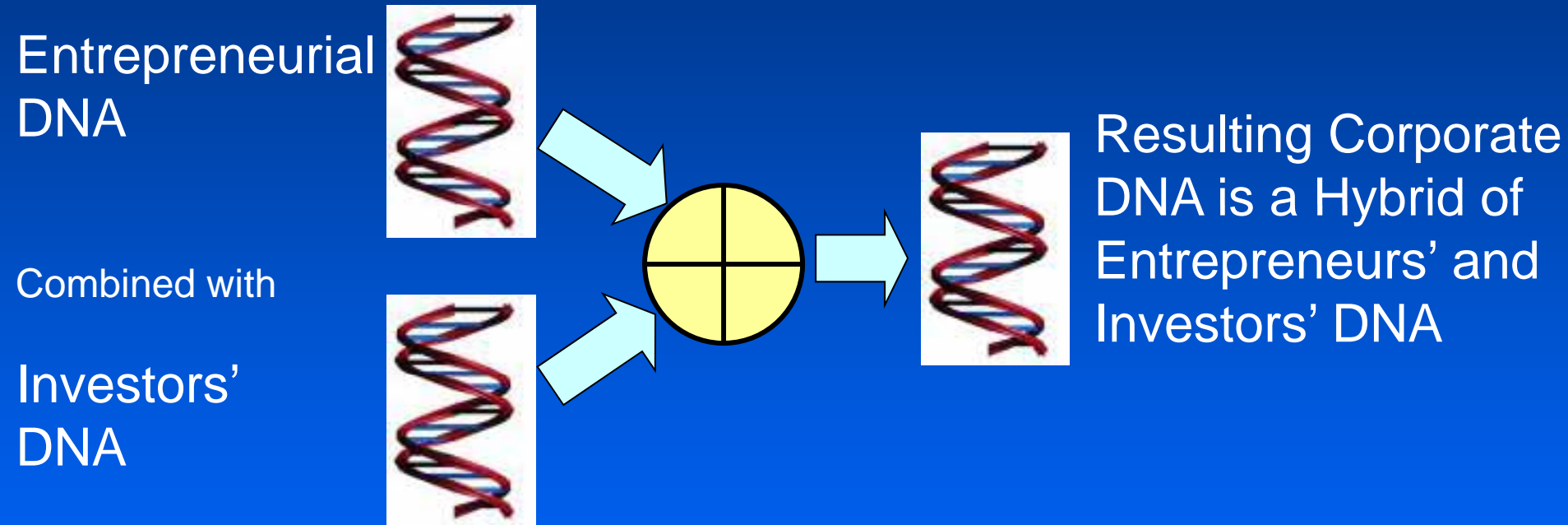
Most Fair Vesting Formula

- Assuming that was the fundamental agreement,
- and that 50% of the value is often created at the exit,
- Then reverse vest:
 - 50% of the shares daily over a three year period, and
 - The other 50% when there is a 'sale' of the company.
 - All vesting for senior employees accelerates on a sale of the company.

First Exit Strategy, Then Finance

- This doesn't happen most of the time
- But the right way to build a company is
- Determine the type of business
- Build alignment on the exit strategy
- THEN develop the financing plan
- And then start to contact investors

Check Financial DNA Before



Check the compatibility first

Engage 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

The CEO Should Not Lead

- There are several reasons the CEO should not lead the exit:
 - CEO is needed to maximize the numbers
 - CEO rarely has the depth of experience
 - And is often conflicted
 - Usually cares too much
 - Should not 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)

Failure is Quite Common

- One of the secrets of the M&A business is that M&A professionals often fail to complete a transaction
- There are no statistics on this and the professionals never talk about it
- I have been asking companies for years
- The fault often lies with the company but the cause is the same - communication

Professionals Should Be Local

- Executing an exit is an intimate process
- Done right, often requires weekly meetings with the CEO for many months - or a year
- Companies often engage professionals who are thousands of miles away
- In my opinion, that rarely makes sense for under \$100 million transactions
- And often results in a failure to complete

M&A Advisory Fees

- It's surprisingly difficult to get accurate information on what professionals charge
- High quality M&A advisory fees are usually:
- Work fee of about \$50,000 plus a
- Success fee of approximately:
 1. 6 to 10% for under \$10 million transactions
 2. 4 to 6% for \$10 to 30 million sales
 3. 2 to 4% for \$30 to \$100 million

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

Clean Up the Structure
and Prepare for
Due Diligence

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
- Many are built into the default corporate structure by statute
- Well intentioned minority shareholder rights can cause big problems
- Fix these before contacting buyers

Pre-Exit Structural Elements

- 51% shareholder vote required to sell the company
- Not the standard statutory terms!
- Clear and well understood share allocation
- Employment agreements
- Protection of corporate interest agreements
- IP 'cleanly' owned by the company

Prepare for Due Diligence Early

- Exits require a lot of manpower from the company and the professionals
- The worst thing is to lose momentum during the latter stages on a due diligence issue
- Strongly recommend the due diligence be complete and online early in the process

Secondary Sales

Do 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
- Usually considered impossible a decade ago
- Today, secondary are much easier to do

Successful Secondary Sales

- But secondaries can be done, if:
 - The price is reasonable, and
 - There is a clear exit strategy, and a
 - Good team in place to execute the exit
- For example, the ParaSun case study in the workshop
- In that case, the buyers were angels and other accredited investors (about a dozen)

Deliver the Best
Numbers

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

The Exit Timeline and Telling the Team

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 that it will create 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 early

Timing is important

- Most common mistake is to ride it over the top – it's human nature
- 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

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

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

Summary

- Angels can provide enough capital for most modern companies
- The rules on exits have changed
- Most exits are under \$20 million
- Small M&A activity is still doing well
- Angels and entrepreneurs will usually have better returns with an early exit

For More on Exits

- www.Early-Exits.com in hardcover or eBook
- www.AngelBlog.net for new articles and updates
- www.BasilPeters.com for PowerPoints and videos