Only 25% of Saleable Companies Successfully Exit

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Improving Investment Returns

- Successful investing requires two things:

1. <u>Investing Right:</u>
    - In the right companies
    - At the right valuation
    - With the right terms

We are getting better at these

2. <u>Exiting Well</u>
    - In a reasonable time
    - At a good price
    - With a reasonable probability of success

Our biggest opportunities

My Most Important Message

- I believe only 25% 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 most likely result is that it will fail.
- This is my observation – we don’t have data yet.

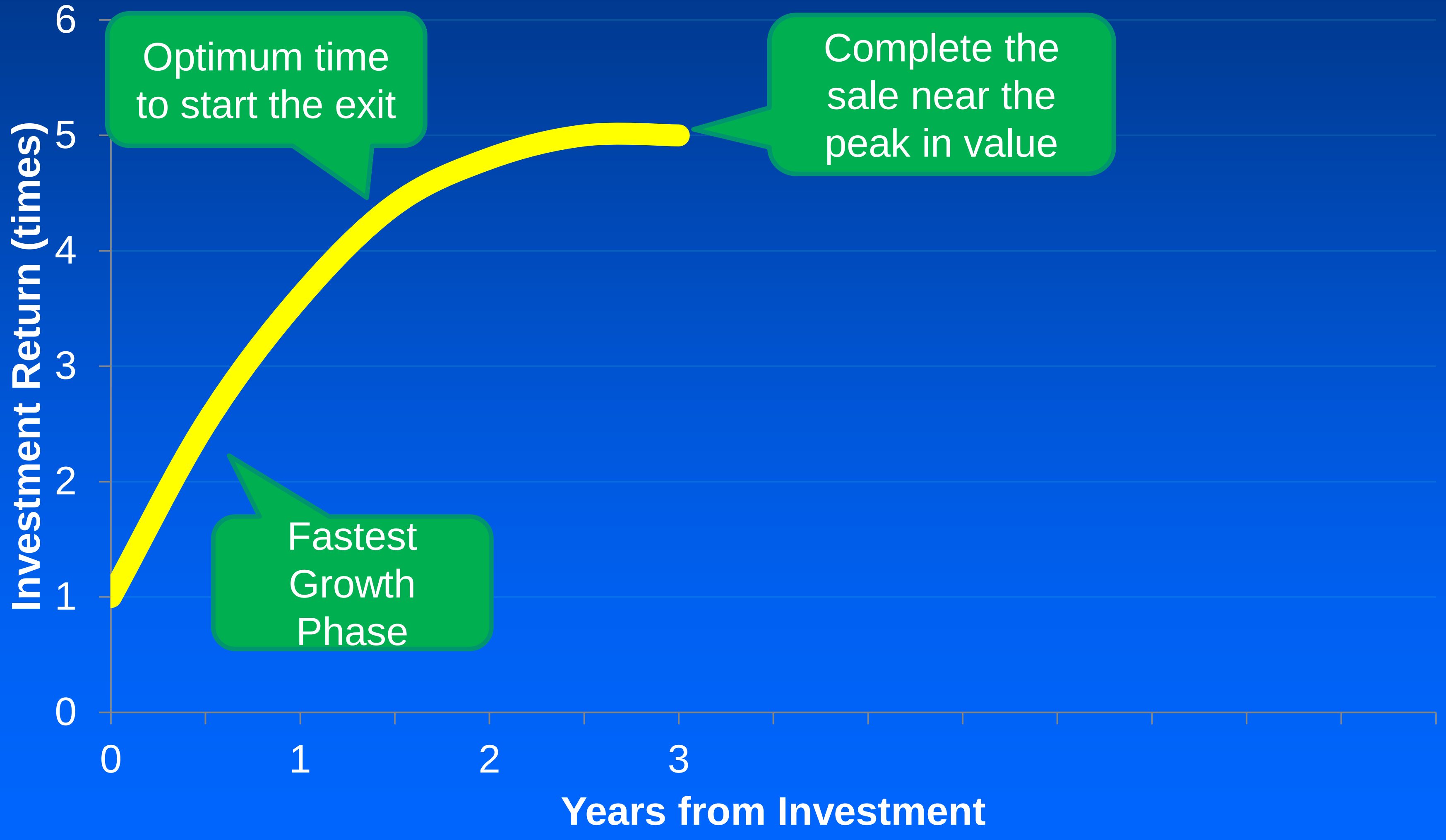
How Long It Takes to Exit

- 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 longer if the company isn't ready, or if the structure needs to be cleaned up, or if the financials need improvement

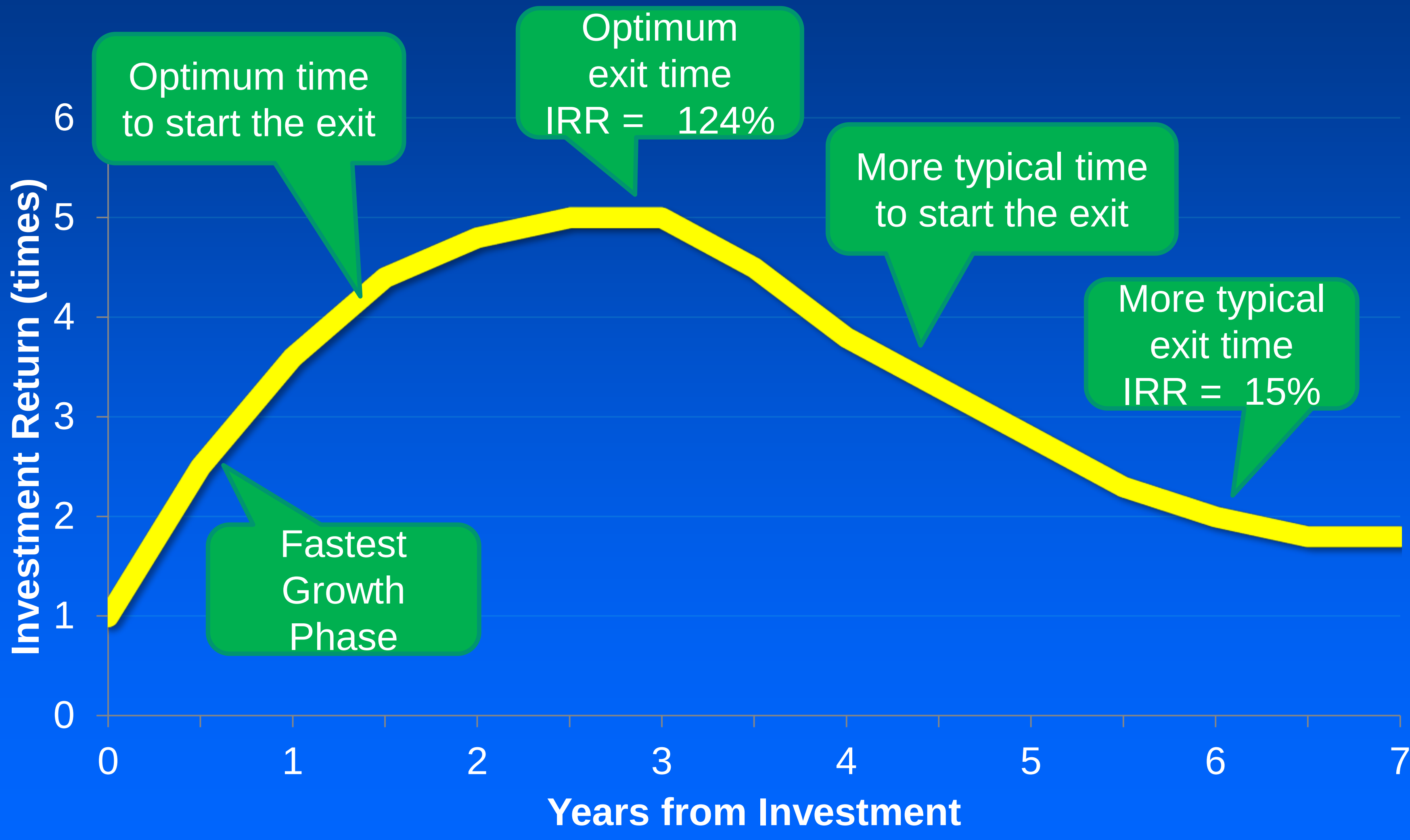
Ideal Exit Timing

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

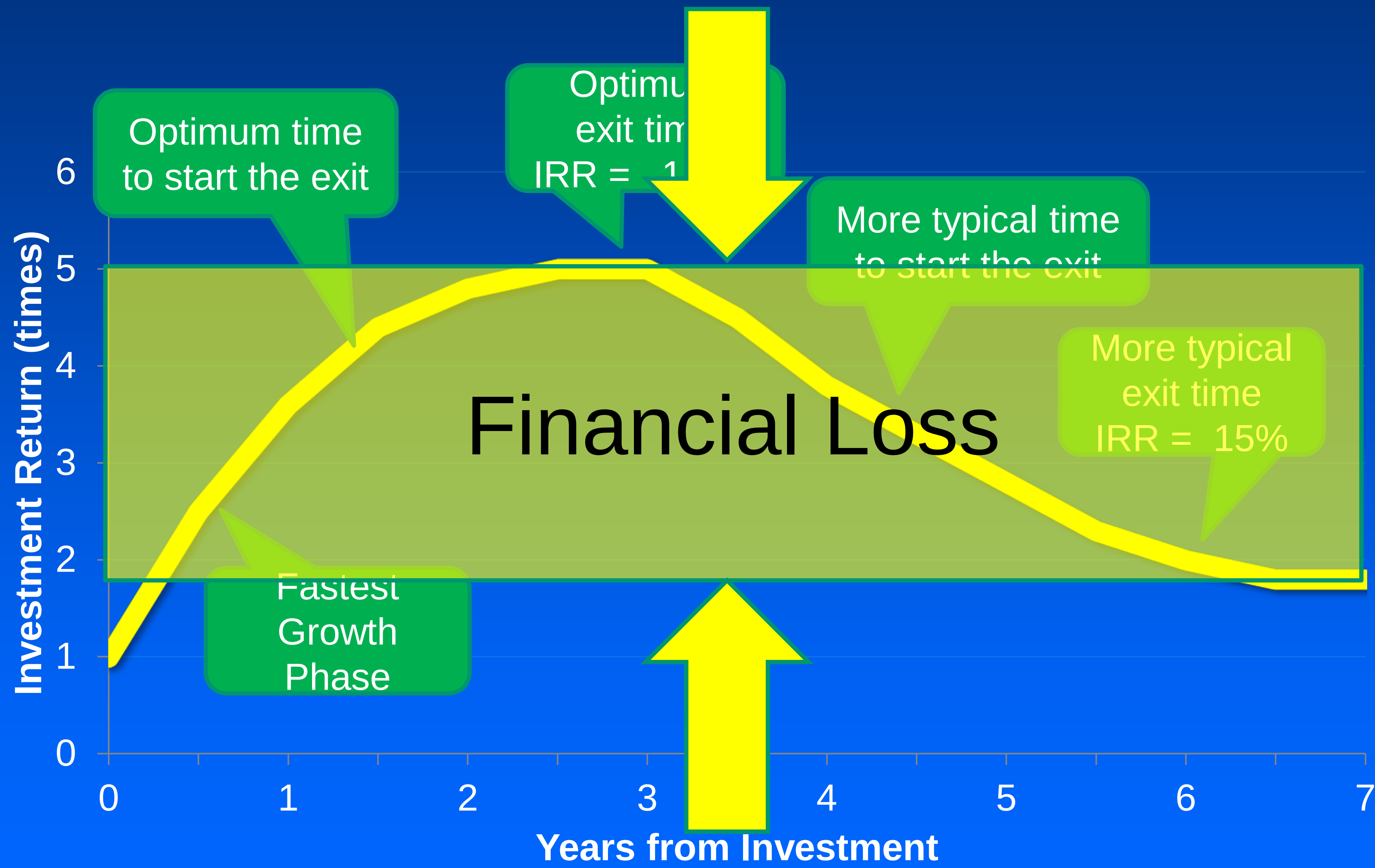
Ideal Exit Timing



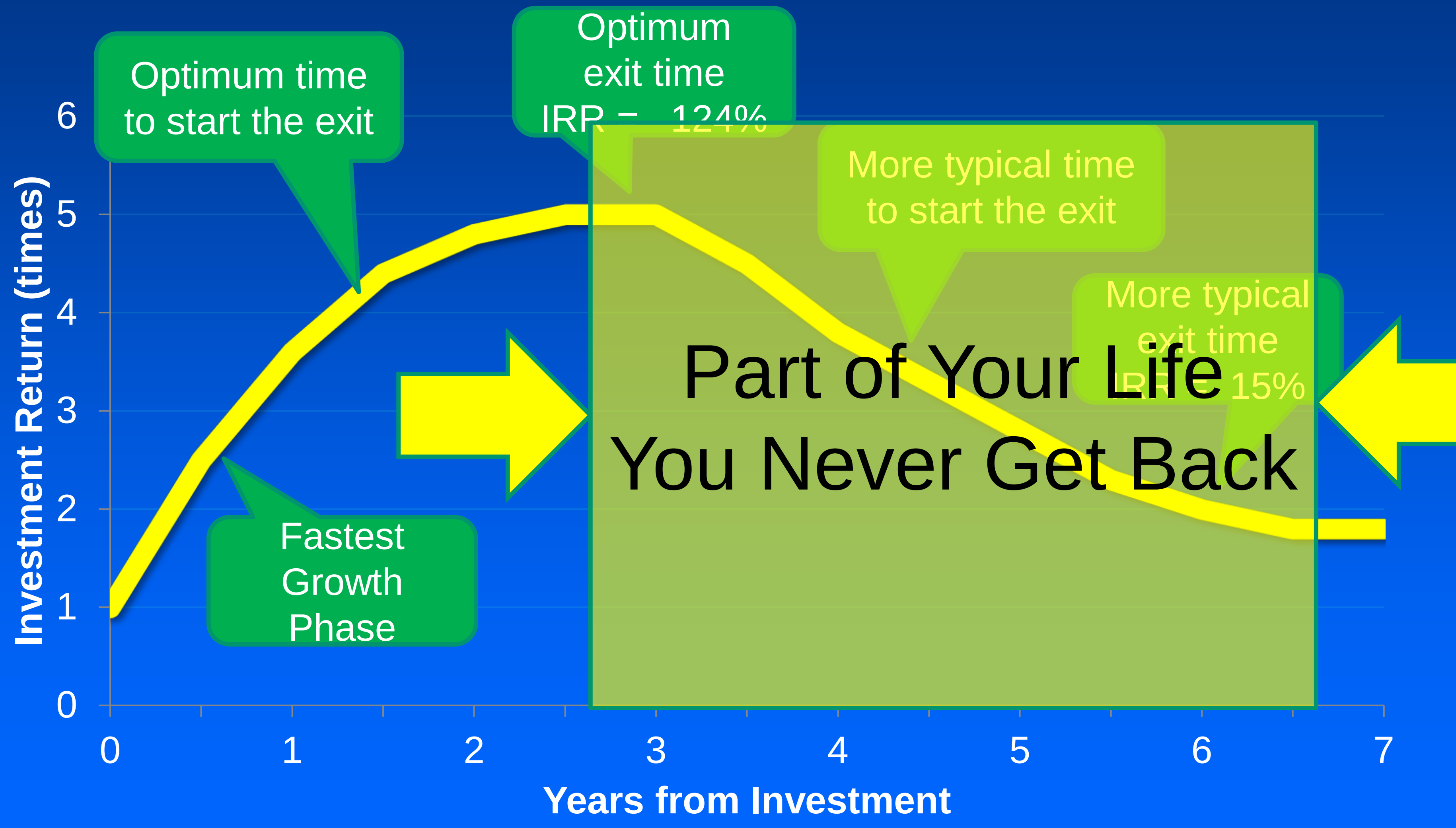
“Riding It Over the Top”



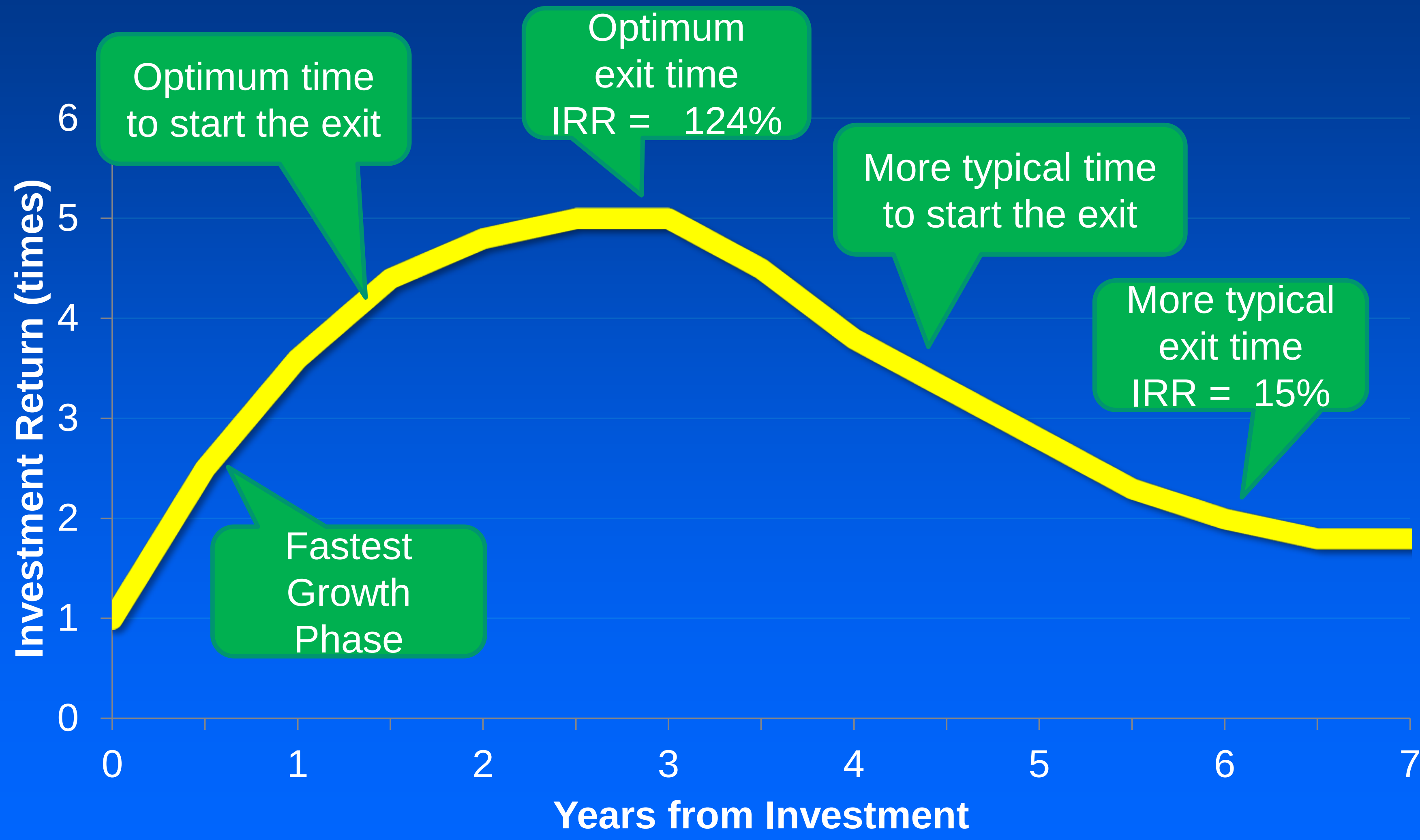
The Financial Loss



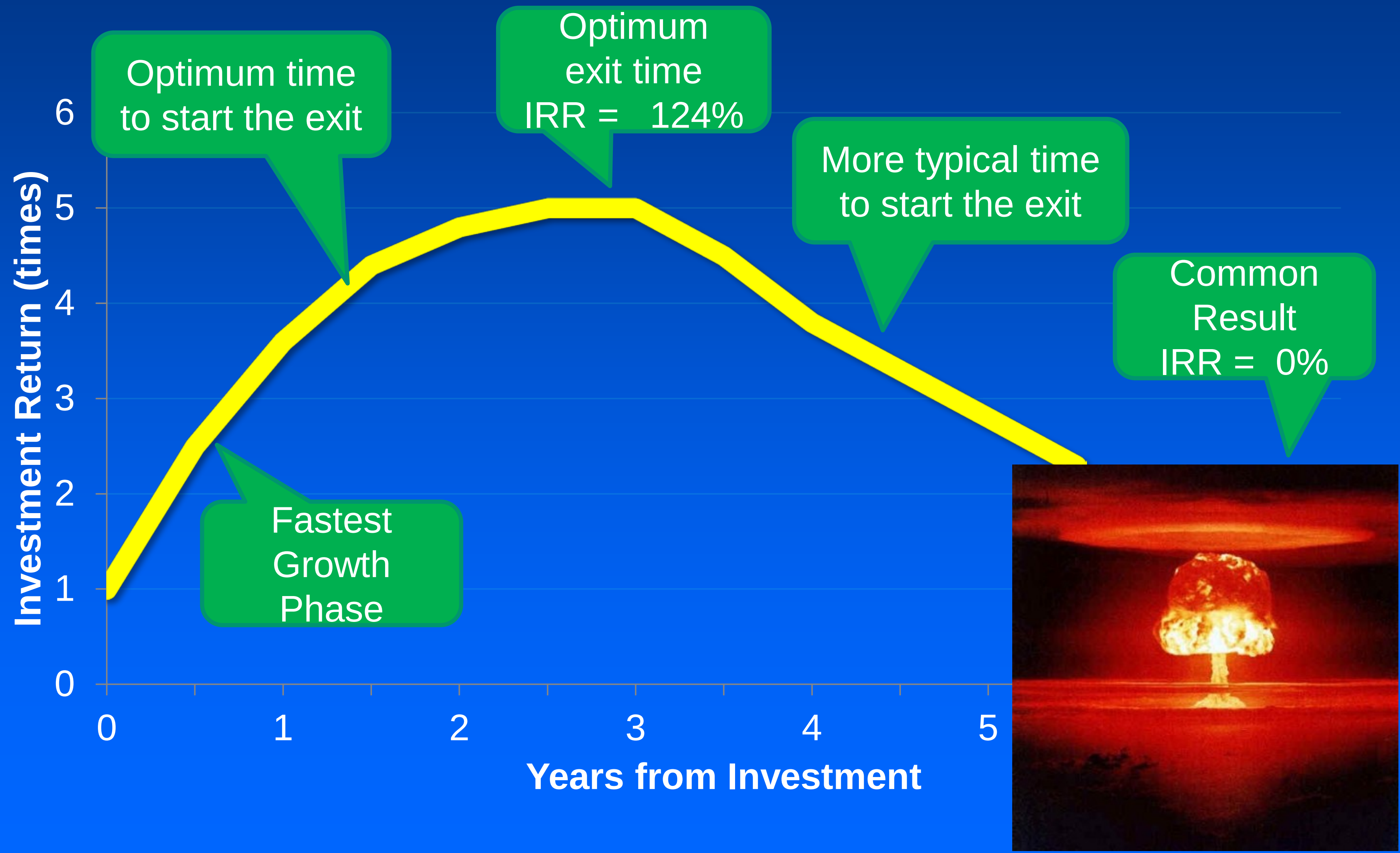
Part of Your Life You Never Get Back



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

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

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

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

The Pacinian Case Study

- Pacinian was an angel backed, thin keyboard company in Cour d’Alene, Idaho
- Many of you saw the company present
- Raised about $6 million from angels
- We helped to sell last year for $30 million
- Pre-revenue – all because of the patents
- http://www.exits.com/blog/pacinian-pre-revenue-30-million-exit/

Patents – a Double Edged Sword

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

Big Company Attitudes

- One of the difficulties of 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 good 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
- Which ever is sooner
- The risks of not selling just aren’t a good business, or investment, decision

Negative Momentum

- It’s not easy to see the stock price graph in a private company
- But the team can sense if the value has peaked and the companies value is declining
- 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

Vesting Can Reduce this Risk

- It’s devastating to watch a company doing through a negative momentum spiral
- One thing we can do to reduce the probabilities of attrition lead negative momentum
- Is to build a better vesting formula into our term sheets and corporate structures
- 50% of shares and options should vest at the exit
- http://www.angelblog.net/Share_Vesting.html

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 early exits and internet acceleration
- Unlike the earlier threats, missing this effect is
- Virtually impossible to fix after the fact, and
- Almost always fatal – even if it takes years

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
- And make similar decisions at almost the same times

Large Company Growth

- Medium and large companies grow primarily through acquisition
- Many have more cash than they can deploy
- And are under pressure to acquire companies
- Partly to grow but also to keep new innovations from being acquired by their competitors
- And because the buyers are all connected
- They often make decisions at the same time

Hypothetical Example

- For simplicity, let’s imagine an industry where there are three large competitors
- All run by smart executives
- And all with lots of cash
- When technology or markets create a new opportunity to grow their businesses
- They usually all see it at about the same time
- Sometimes triggered by an external event

They All Decide to Acquire

- Often they all decide <u>at the same time</u>
- to acquire a company in a specific space
- In many situations, the impetus is external
- For example, created by an M&A advisor
- Who shows a specific company to all of the potential acquirers in the world
- And describes the strategic opportunity

They All Get Interested

- The 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 all hope they can get several buyers interested
- And a competitive bidding situation will develop
- 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
- 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 some unsolicited interest

The Wave

- Which creates the beginning of the wave
- Buyer interest brings in more buyers
- And more M&A advisors
- 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 niche or 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 usually too late to react

What Happens After the Wave

- The wave results in most companies who want to buy finding a company to acquire
- 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
- Usually $10 – 20 million
- Most of the buyers will plan to invest a similar amount in growing their new acquisition
- And competing for market share against their traditional 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

Missing the Wave

- Missing the Wave of Consolidation is a particularly heart-breaking error
- Many of the companies that missed were very valuable and often extremely profitable
- The wave destroys both
- For CEOs that <u>have built</u> valuable businesses,
- <u>Not missing the wave might be their most important job</u>

The Right Side of the Wave

- Most CEOs are so busy operating the business it’s almost impossible to watch closely enough
- And the early signs are not easy to see even if you are looking
- The best way to get an early indication is to watch the trends that start the wave process
- Almost all CEOs need some help from M&A professionals to do this well

Summary on Exit Timing

- Like many parts of life, and business, “timing is everything” with exits
- Planning and timing exits better will significantly reduce the probability of shareholders blowing the biggest deal of their lives
- Recommendations:
- Have a professional watching your M&A market
- Drive your exit process – don’t wait for an offer