Planning and Executing Early Exits

New Strategies and Practical Suggestions

Dinner Keynote at the Alberta Deal Generator
TEC Edmonton

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Qualifiers on This Presentation

- I was a technology entrepreneur
- And now I am a technology investor
- My comments are from that perspective
- Some aspects of financing and exit strategies are different for life science and clean tech companies
- I am not including ‘public market’ strategies (until those markets recover)

Angel Investing is Still New

- Organized angel investing is still quite new
- The early angel groups started around 1997
- Angel investing today is where traditional Venture Capital was in the early 1980s
- We are still discovering the best practices
- The financial world is also changing – a lot
- That’s why meetings like this are so valuable

Perspective On My Comments

- I am 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

My Tech Investment Funds

- When we sold Nexus, it was the first time I had money to invest
- Been an enthusiastic tech investor since
- Founded and managed a:
- Hedge fund – 1996 to 2000
- Venture Capital Seed fund – 2002 to 2006
- Angel fund – 2005 to present

What I've Learned About Investing

- I've learned (expensively) that successful investing requires two things:
- Buying right – investing in the right opportunities using the right structures, and
- Exiting well – getting my money back at a good price and in a reasonable time frame
- This presentation is about M&A exits

How I Got Started on Early Exits

- I became fascinated by early exits in 2002
- When starting a Venture Capital seed fund
- The B.C. government provides a 30% tax credit to investors in qualified VC funds
- But under that legislation, the investors can get their money back in just five years
- Less than <u>half the time</u> for typical VC funds

Building a “5 Year” VC Fund

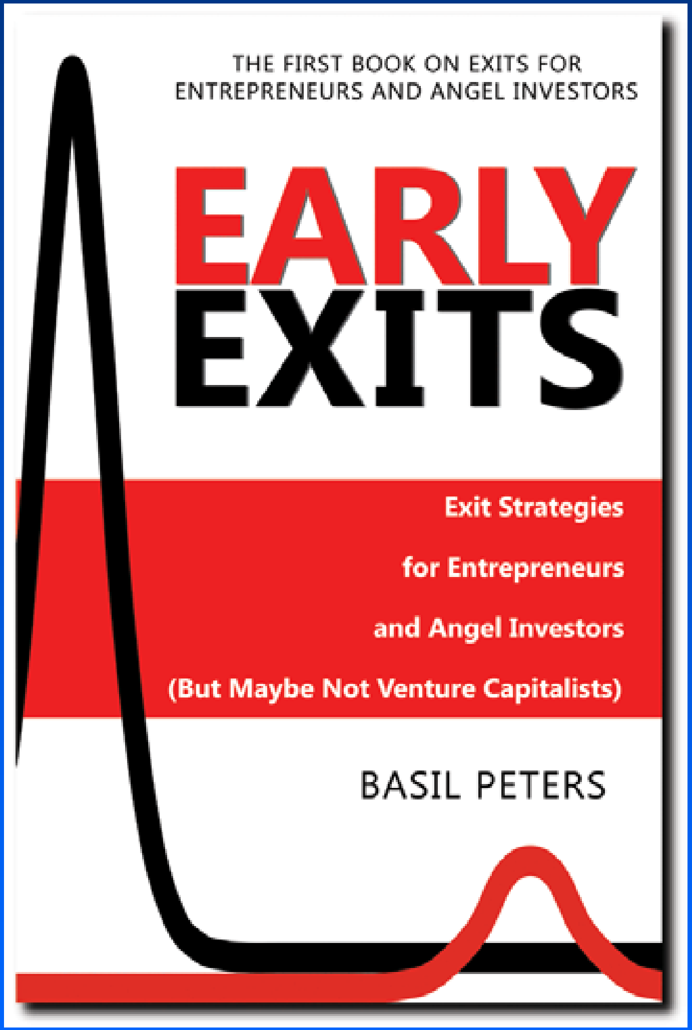
- As a fund manager, I knew I would need to focus intently on exits
- To provide liquidity in just 5 years
- I managed the BC Tech Fund for 3 years
- During that period, I made 9 investments
- Had three exits – 2 acquisitions and an IPO
- #1 Canadian VC tech fund of that vintage

Early Exits Increase Returns

- The success of the BC Tech Fund taught me that:
  - Early exits can be designed into the corporate DNA and investment term sheet
  - Early exits increase investment returns
  - Early exits work for entrepreneurs and angel investors (but maybe not VCs)
  - Early exits are more fun

Early Exits – The Book

- Started to share some of what I had learned about exits on my blog: www.AngelBlog.net
- That grew to be an entire book
- Available in hard copy or ebook formats at: www.Early-Exits.com



Free copy for tonight's attendees

From Strategy to Execution

- Recently, I’ve had a number of requests to ‘go to the next level’ and talk about execution
- This presentation also includes practical suggestions on how to sell an angel backed business
- I hope that you will view the online videos of my earlier talks to angel audiences for some background information to this presentation

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

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

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, in Kelowna BC, is a game website for 6 to 14 year olds
- It was sold to Disney for $350 million cash just two years from startup
- YouTube was also 2 years old when it sold

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

Corporate Buyers vs. VCs

- This has created a new, very interesting environment where corporate buyers have become competitors to traditional VCs
- Companies have lots of cash
- And don’t see VCs as adding much value
- So they are buying promising companies at just about the time the VCs want to invest

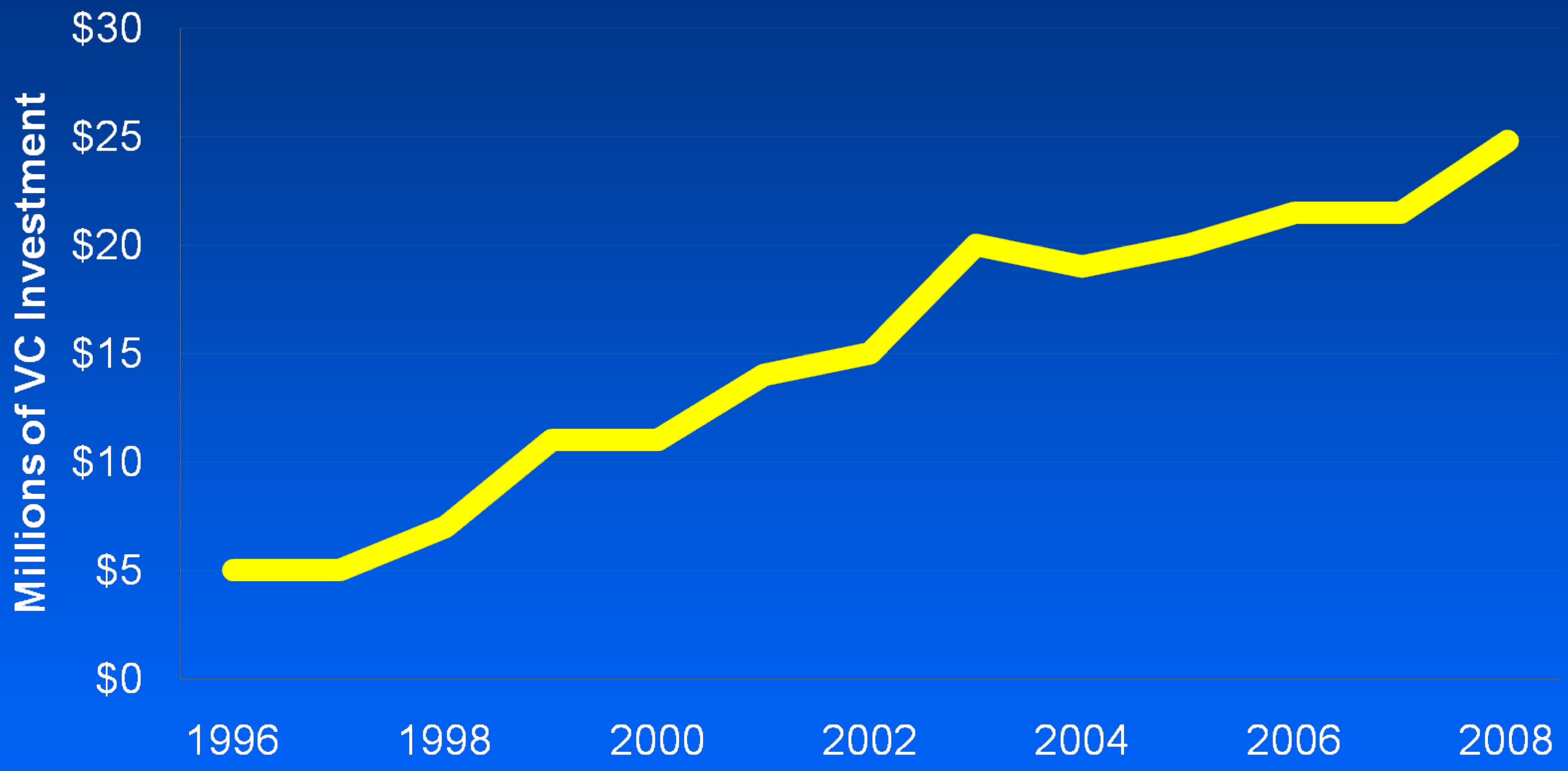
Venture Capital in Crisis

- The press is full of stories about traditional Venture Capital being in crisis
- Big VC funds clearly aren’t working anymore
- Many believe the industry will shrink to less than half its current size – possibly a quarter
- I think this is just a healthy correction
- What does that mean for angels and entrepreneurs?

Angels and VCs - More Different

- This new environment is creating a much 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

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

Exits Without and With VCs

Why ? Please watch my videos or read my book

Angel or VC Checklist

	Angels	VCs
Amount of capital required to prove the business model	Under $5 – 10 million	Over $5 – 10 million
Years before being able to exit	2 to 5 years	Over 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

Increasing The Number of Exits

- We can all increase our successful exits by:
- Focusing on exits before we invest
- Helping entrepreneurs build alignment on the exit strategy (also before we invest)
- Designing our term sheets to facilitate the exit transaction - especially vesting
- <u>Really</u> understanding VC follow-ons

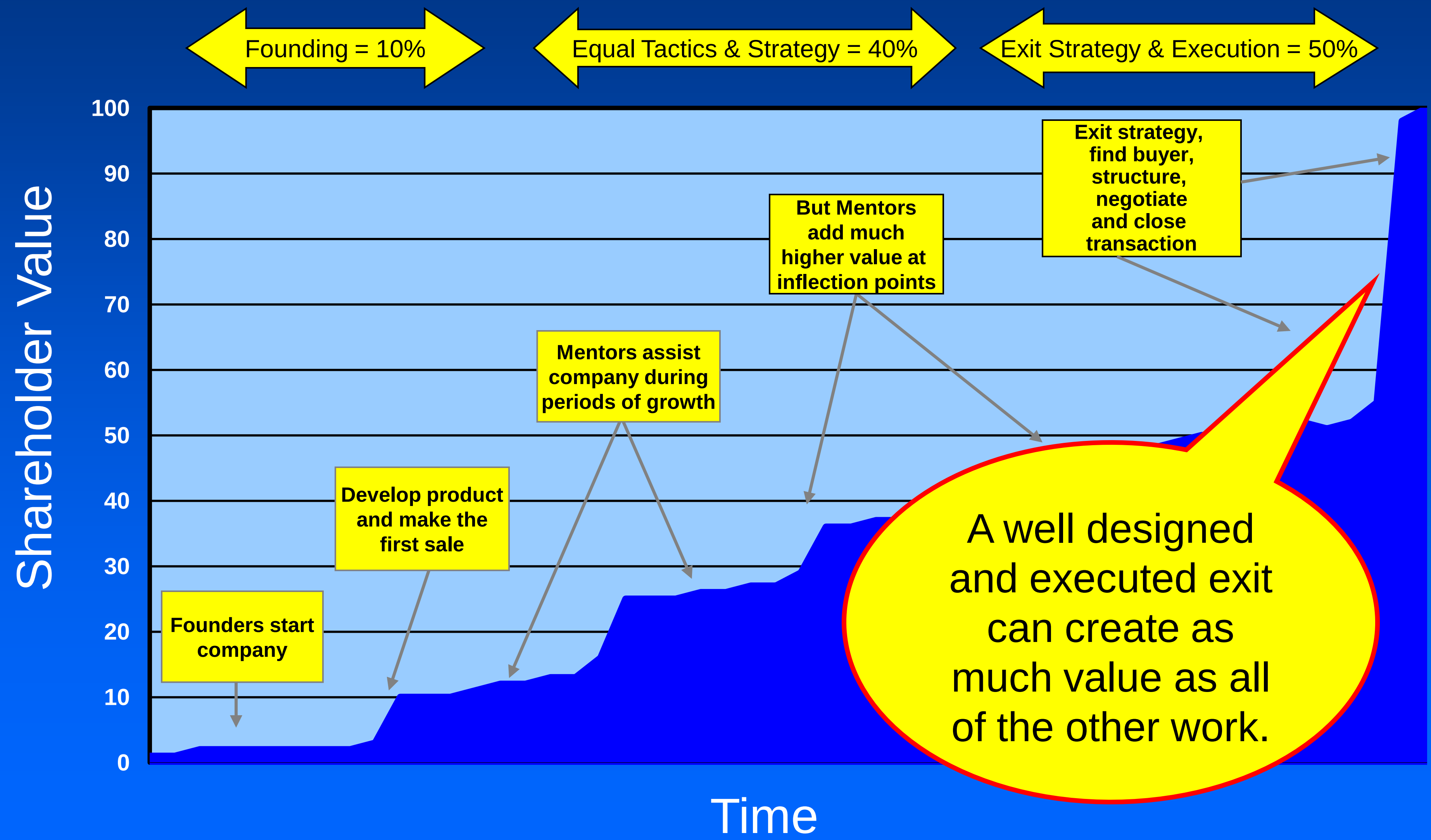
Focusing on Exits is Healthy

- Companies can be pre-selected for exit suitability – depending on your criteria
- It is surprising how often entrepreneurs will ask for investment in ‘life style’ or ‘no exit’ companies
- A focus on exits is healthy - and in my strong opinion, does not detract the team from their primary function of maximizing shareholder value (a popular myth)

Companies Are Sold, Not Bought

- I often hear ‘companies are bought, not sold’
- People think that when ‘it’s time’, someone will knock on their door to buy their company
- While that has happened, it’s almost never a good thing for the shareholders
- It’s not just that the price will be much lower
- More importantly, the probability of success decreases because there is only one bidder

Maximizing Shareholder Value



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)
- Every company needs an exit strategy

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. Build the sales funnel
  7. Manage the auction (multiple bidders)
  8. Negotiate and close

The Exit Strategy

- An Exit Strategy can 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]_.”
- The optimum exit strategy depends on the type of company
- Entrepreneurs need advice on this

Term Sheets to Facilitate Exits

- There are several elements of the term sheet that confirm the ‘exit intention’ and
- Reduce ‘exit friction’
- The Articles should specify that a 51% vote of <u>all</u> shares can effect a sale (a drag along)
- Vesting is the most powerful term
- “Puts” and redemptions are popular in VC term sheets but are rarely effective

Vesting to Maintain Exit Alignment

- All stock options, and all nominally priced previously issued shares, should vest on the following basis:
- 50% of the shares vest daily and linearly over a three year period; and
- The other 50% vest on a sale of the business
- All vesting accelerates on a sale

Start Right After The Financing

- Big companies are spending more on M&A than R&D –it's the best way for them to grow
- Big companies are VCs fiercest competitors
- Tech companies are now regularly acquired just two or three years from start up
- Which means that management should start to work on the exit right after the last angel round closes

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 or Angel
- 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)

Why The CEO Should Not Lead

- There are several reasons the CEO should not lead the exit process, they:
  - Rarely have the exit experience
  - Need to maximize the financial results
  - Should be held in reserve for the final negotiation of price and terms
  - Are often conflicted
  - Need a good relationship with the new owners (cannot be the ‘bad guy’)

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 committee of the board

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

Selecting The M&A Advisor

- There is almost nothing written about selecting M&A advisors
- The majority make sub-optimum choices
- Relationships are always <u>exclusive</u>
- The most important criteria are:
  - Transaction completion rate
  - Track record of maximizing price
  - Proximity, knowledge and compatibility

The M&A Advisors Function

- The M&A advisor is really ‘the sales guy’
- Their important functions are to:
  - Plan and coordinate the process
  - Reduce the time to closing
  - Improve the probability of success
  - Protect the CEO (for as long as possible)
  - Maximize the price and terms
  - Do the selling and be the ‘bad guy’

M&A Advisor's Fees

- Fees for selling companies are not published but are surprisingly uniform
- Work fees usually $50,000 regardless of the company size (less if learning or not busy)
- Success fee, including the work fee, from:
  - 7 to 10% for sales under $5 million
  - 4 to 6% for sales from $10 to 30 million
  - 2 to 3% in the $100 million range

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, secondary are much easier to do
- Buyers are usually Angels and small funds

The Exit Timeline

- Once an M&A advisor has been engaged
- The exit usually takes 6 to 18 months
- Depends mostly on the company
- Most of the time is spent preparing the due diligence and sales collateral
- The next biggest time sink is scheduling
- Then waiting for lawyers

Before Contacting Buyers

- A common, and expensive, mistake is engaging with prospective buyers before the company is ready
- Then realizing that there is a lot to be done before due diligence can complete
- At worst, the buyer loses interest
- At best, it costs the company hundreds of thousands in professional fees

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
- Some are built into the corporate structure
- Others are contracts with unforeseen consequences during an exit
- Fix these before contacting buyers

Employment and IP Agreements

- Do the deep patent work early
- Every buyer will want senior and technical employees to have signed a good, modern employment agreement
- Many companies miss the contractors
- Both are essential for IP ownership
- Don’t get held for ransom at the closing by an employee who doesn’t want to sign

Corporate Records and Taxes

- Have a very experienced M&A lawyer review all of the corporate records early
- Shareholder and board meeting minutes are critical
- Taxes are different in each state and can be almost impossible to get certainty on
- Don't overpay your law firm to build the corporate record history at the last minute

The Shares and Share Register

- About half of the companies I’ve seen start an exit don’t have their shares properly issued or properly recorded
- Far too often the sale proceeds will be in the lawyers trust account before shareholders start to dispute the records
- And print out years old emails from the CEO
- Get everyone to sign confirmations early

Review or Audited Financials

- Most companies have notice to reader financial statements
- Post Enron, audit costs have skyrocketed
- Some buyers will accept review engagements, but others need audits
- Consider reporting in US currency & GAAP
- Don’t pay your outside accountants double at the end to do the review or audit

The Sales Collateral

- Should all be complete before contacting the first prospects:
  - Complete due diligence online
  - Teaser document (2 pages)
  - Selling document (20 pages)
  - Financial history and projections (Excel)
  - PowerPoint for online and boardroom presentations

The Sales Funnel

- For most companies, the suspect list can be 50 to 100 buyers
- 10 to 20 might sign the NDA and get the selling document and financials
- 5 to 7 might visit and start due diligence
- Optimum short list is 3
- And is probably a practical maximum

Maximizing The Price

- There are many 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
- Articles on each on AngelBlog

The Reps and Warranties

- A very experienced M&A lawyer friend says that in his experience,
- More M&A transactions fall apart on the Reps and Warranties than price and terms
- CEOs, and Directors, should be afraid to sign personal guarantees about things that are literally unknowable
- But they have to – so introduce it early

Closing and The Party

- Once everything is completely agreed to
- It still takes forever to close (4 to 8 weeks)
- There are hundreds of small sticking points
- And fate will have it that their lawyer is working on three closings simultaneously
- M&A closing parties are always the best parties (that I am allowed to go to)

Exits and Recycling

- I think exits are the best part of being an entrepreneur and investor
- It’s when we get paid for all of our hard work and risk capital
- It’s also when entrepreneurs and angels have the option of doing it all again,
- Or doing something else with our money
- Think of it as recycling.

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!