

Selling a Business

A Guide for Angel Investors
and Entrepreneurs

Keynote Speech at the
National Angel Capital Organization Summit

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Basil Peters

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 these meetings 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 – 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 talk 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 half the time for typical VC funds

Building a “5 Year” VC Fund

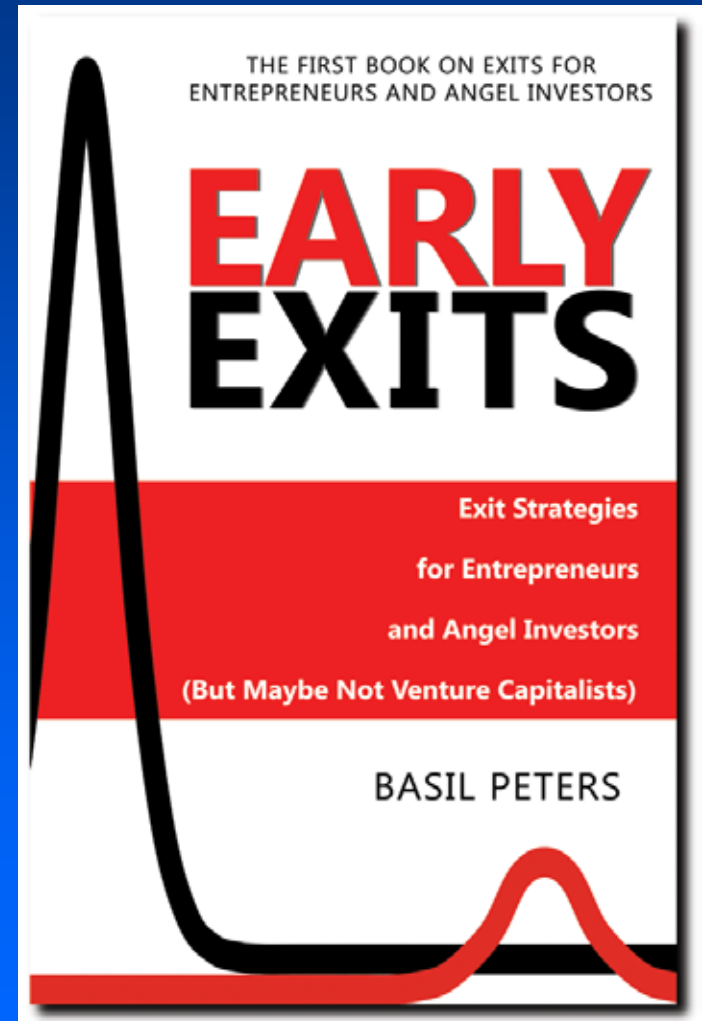
- As a fund manager, I knew I would need to focus intently on exits
- To provide liquidity in just 5 years
- I managed the BC Tech Fund for 3 years
- During that period, I made 9 investments
- Had three exits – 2 acquisitions and an IPO
- #1 Canadian VC tech fund of that vintage

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 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 cover or ebook formats at: www.Early-Exits.com



Earlier Talks on Exit Strategy

- Online videos of my recent talks on exits:
- [www.angelblog.net/
Exit_Strategies_for_Angel_Investors_Video.html](http://www.angelblog.net/Exit_Strategies_for_Angel_Investors_Video.html)
- [www.angelblog.net/
Start_at_the_End_Your_Exit_Strategy.html](http://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](http://www.angelblog.net/Dont_Blow_the_Biggest_Deal_of_Your_Life.html)

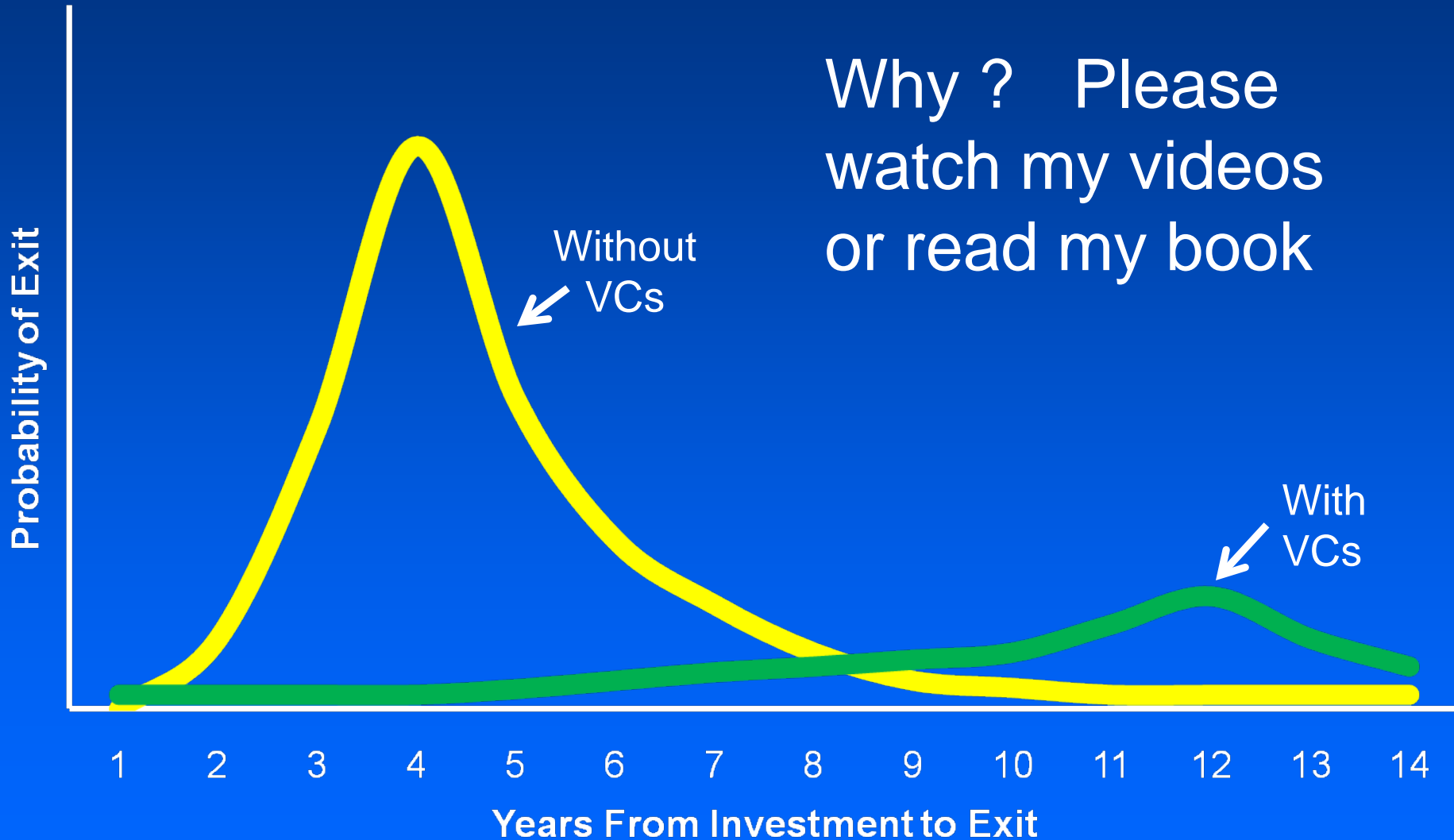
From Strategy to Execution

- Recently, I've had a number of requests to 'go to the next level' and talk about exit execution
- This presentation is a practical guide on "How to Sell a Business"
- For Angel investors and entrepreneurs (but maybe not traditional Venture Capitalists)

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
- Really understanding VC follow-ons

Exits Without and With VCs



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 |

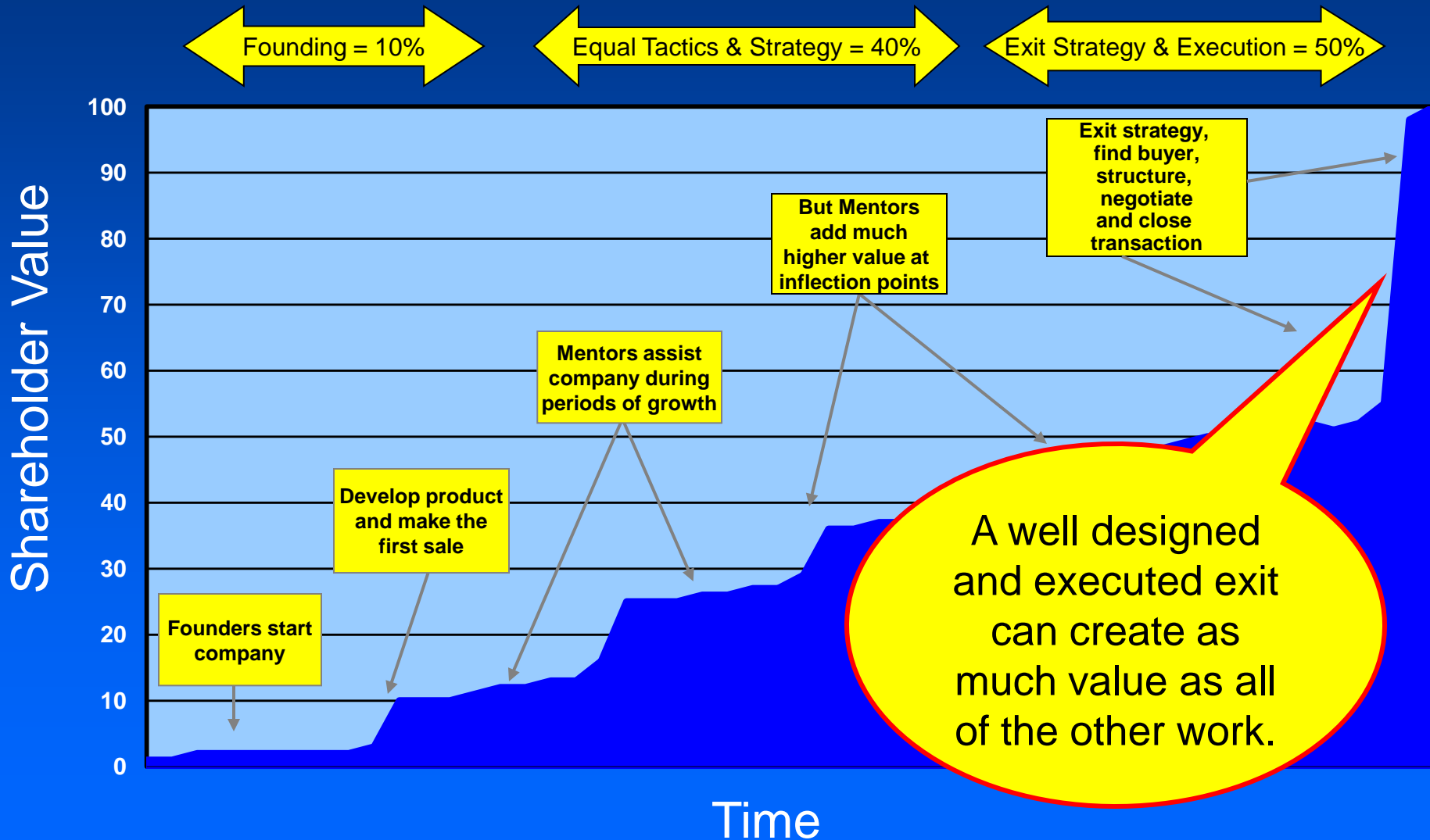
Focusing on Exits is Healthy

- 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

Building Shareholder Value



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 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

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 help 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 all 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

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 who are too young to retire

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 group 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

- 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 exclusive
- 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 Advisory 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

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
- Considered almost impossible a decade ago
- Today, secondary are much easier to do

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
- 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 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

Benefits of Multiple Bidders

- An unsolicited offer is almost always a lost opportunity
- Every business sale should have multiple bidders to:
 - Increase the final selling price
 - Increase the probability of completion
 - Close the transaction sooner
 - Demonstrate good governance

Selling and Negotiating Skill

- There is no question that some sales people are just better – often much better
- Selling a company is just like any other sale – but bigger and more complex
- A really outstanding M&A advisor can help to increase the final price by 50% or more

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 video of this and some of my previous talks

Good Luck With
All of Your Exits!