Ask an Angel: Early Exit Options

ARI Team, March 9, 2009

Topics: Exit Strategy

Summary:

Basil Peters recognizes opportunities for earlier exits and encourages angel groups to build strategies to capitalize on $10 to $30 million M&A exits for angel-backed companies. Corporations have money, and they are putting it to use buying young companies.

Exit opportunities have changed dramatically over the last few years. Basil Peters, fund manager for Fundamental Technologies II (an angel fund) and member of angel groups in Canada and the US, encourages angel investors to recognize that the opportunity for earlier exits exists and to build strategies to capitalize on it.

ARI: Your book, *Early Exits*, will be coming out in a few weeks. It is about angel investors and entrepreneurs creating more successful, more frequent, and more profitable exits. We take it you aren't writing about IPOs?
BP: No. I'm talking about $10 to $30 million exits for angel-backed companies that are often less than five years old when they are acquired by corporations.
ARI: On your blog (www.AngelBlog.net) and in your book, (www.Early-Exits.com) you point out several converging trends that are making these types of exits possible.
BP: We are in the midst of several big shifts in the economy. We have reached an evolution in the high technology industry where entrepreneurs can build valuable companies with almost no capital. Companies can be started on a shoestring and grow to be quite valuable in just three or four years. When I got out of graduate school, we were in an era where most technology companies were building physical products. To be in that business, companies like Hewlett Packard and Intel needed thousands of people and hundreds of millions in capital. Then in the nineties, Microsoft, Sun, and Oracle built large companies based on software and applications, and that also required thousands of people and hundreds of millions dollars.

Today you can buy a computer as big as the ones that used to run an entire university for about $300. Software that used to take 100 engineers years to build, you can download from the Internet for free. This means that a few talented entrepreneurs with almost no money can sometimes build a useful online business in a weekend.

ARI: Who is buying these early exit companies?
BP: Large corporations are big buyers. To use one of my favorite quotes: Big companies stink at innovation, and they know it. They are much better at buying technology than developing it in-house. Big companies have money, and they are putting it to use buying younger companies.
A lot of these transactions are done without announcement. In many cases, the price never gets into the public domain or may end up being a small footnote in the acquiring company's annual report.

ARI: Typically, how large are these exits?
BP: Mergerstat (www.mergerstat.com), a large merger and acquisition data base, reports that the median price of private company acquisitions is under $25 million. From my experience, I estimate it to be well under $20 million if you factor in the transactions where the price is not disclosed.
Big companies believe that their sweet spot is to acquire $10 to $30 million companies and grow them into $100 to $300 million business units. The combination of all these trends has brought us to a

wonderful point in the technology industry where angels and entrepreneurs are making excellent returns in very short times.

Up near where I am in Canada, a company called Club Penguin was started by three software guys to address the children's online game business. They had no outside investors and sold it in just two years to Disney for $750 million. They were brilliant bootstrappers and cash flow managers.

ARI: Do you think that the reality of an active mergers and acquisition market for under $30 million companies has worked its way into the angel and entrepreneur mindset?
BP: Angels are starting to get it. Entrepreneurs, not yet. The typical thing I see in investor presentations is some enthusiastic entrepreneur who says, "I'd like to raise money from angels today, then in two or three years raise a venture capital round and have completed an exit by five to seven years from now." That almost guarantees that I won't invest.
ARI: You object to investing with VCs?
BP: It isn't that I have something against VCs. I don't. I've been a VC. I just believe that it is more that the fundamental DNA of entrepreneurs and angels is compatible, but its much less so with VCs. The big trends are also not moving to favor the traditional VC model.
Why? Because venture capitalists usually enter later in the company's life cycle and need to invest at least $5 million. If the company is doing well, traditional VCs wont let the company be sold unless they are making at least a 10X return on their investment.
That means that the minimum price you can usually sell for is over $100 million. While big companies can afford to buy companies for over $100 million, they don't do it very often. These are very rare events - especially today.

When a VC invests, it resets the exit clock for the entrepreneurs and angels. It is hard to make a 10X return in less than 10 years - especially in the later stages when VCs invest. That means the entrepreneur is often in the company for more than 15 years and the angels for 10 to 12 years. I'm seeing fewer and fewer angels who want to lock up their money for that long. Today more investors are interested in opportunities where entrepreneurs say they are going to drive to a liquidity event in three or four years. Entrepreneurs have a much higher probability of success if they target $10 to 30 million exits. The M&A market in this value range is still surprisingly strong. This is a perfect fit for angel investors.

ARI: That would make it very important for entrepreneurs in these businesses to be aware of angel groups.
BP: Absolutely. The finance team in these companies has to know how to find angels and keep them informed about how the company is progressing. They should also be aware that angels are more comfortable co-investing these days. I have seen several angel financings for over $5 million.
ARI: It sounds like one smart option for angels is to work entrepreneurs to create an early exit, for the entrepreneur to start another company, and for the angels to re-invest their capital.
BP: Yes, exactly. When there is a convergence of major trends like this, it can get very exciting. I believe the next several years will turn out to be very good times for entrepreneurs and angel investors.

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