THE FIRST BOOK ON EXITS FOR ENTREPRENEURS AND ANGEL INVESTORS

EARLY EXITS

Exit Strategies for Entrepreneurs and Angel Investors (But Maybe Not Venture Capitalists)

BASIL PETERS

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"I wish I had your book years ago; my life would be different today. Early and smaller is the way to go!"
Robert Paddock

"Peters tells a coherent story. It resonates with what I read and hear from investors. It is consistent with other trends in the VC market. It should be essential reading not just for all angels but also those involved in policy and practice (e.g. university technology transfer offices, economic development officers)."
Colin Mason, Hunter Centre for Entrepreneurship, University of Strathclyde, Glasgow, Scotland

"Basil lays out a compelling case for early exits. We all know that taking VC is no guarantee of success. In fact, Basil has shown that VC-backed companies have considerably longer time to exit and lower rates of success. There is no question, that his message is anti-VC. And since this comes from a former VC, we should take note."
Mark MacLeod, StartupCFO

"I find *Early Exits* to be a useful, practical and comprehensive exit guide for both angels and entrepreneurs…I am grateful that you took the time to write the book to share your wisdom and experience. I know others have said it before, but it IS really hard to put your book down. I read it cover to cover in one sitting…"
Elaine Kong, Washington Technology Center - Program Manager, Business Consulting and Angel Network

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"*Early Exits* is a work that draws the broad lines of not only what startup financing conventions are but also why they exist. It's the way he brings out the "ah hah" that best captures the value of his work. It's factual. It's specific. But it also draws the reader in with real case examples providing personal insight."
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"*Early Exits* is a 'must-read' book for serious entrepreneurs and individual investors. It is the only book that I have seen in 12 years that focuses exclusively on Exit Strategies. An invaluable resource with a detailed contents section, it is easy to read with plain language, not too much jargon and good case study examples. READ IT."
Bob Chaworth-Musters, founder of the Angel Forum, Vancouver

"*Early Exits* is a must-read for all entrepreneurs wishing to attract angel investors. Peters nails it when he says that 'exits are the best part of being an entrepreneur or investor'. This book will get entrepreneurs and investors to plan for earlier exits rather than waiting until it's too late!"
Mike Volker, Co-founder Vantec Angels and CEO of the WUTIF Fund

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Early Exits

Exit Strategies for Entrepreneurs and Angel Investors (But Maybe Not Venture Capitalists)

Basil Peters

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Dr. Basil Peters is the principal of Strategic Exits Corp., and the Fund Manager for Fundamental Technologies II—an angel investment fund (seed stage venture fund).

Basil is an active, early-stage, technology investor and writes a blog on best practices for entrepreneurs and angel investors at www.AngelBlog.net.

He has a Ph.D. from the University of BC in Electrical and Computer Engineering, and has received the Entrepreneur of the Year Award, Entrepreneurship Silver Award, BC Science and Engineering Gold Medal, and Business Leader of the Year Award.

For more on Dr. Peters please visit www.BasilPeters.com.

For more on this book please visit www.Early-Exits.com.

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The 21st century economy needs entrepreneurs
—those magic few among us who can conceive and
create new high-growth, knowledge-based companies.

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All you do is stare at a blank sheet of paper
until drops of blood form on your forehead."
-Gene Fowler

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1

Introduction

Exits are the least understood part of investing—as often by the investors themselves as by the entrepreneurs. This book is about the large number of other exits—the ones that are not driven by the VCs.

1.1 The End of the 'Swing For The Fences' Era

As I prepare this book in late 2008 the world's financial systems are in turmoil. Huge investment banks have become extinct, governments have rushed in with bailouts, initial public offerings (IPOs) have all but disappeared, the venture capital industry is in crisis and investors are holding on to their cash more tightly than they have in decades.

This chaos is, in part, a result of the 'swing for the fences' thinking that has taken over much of the financial world in recent years. Everyone's been looking for the 'big score,' the billion-dollar payout—the moon shot that would vault them into the ranks of big money.

That era is over. Sober thinking is now the rule of the day. The turmoil and this new way of thinking presents a new, and possibly even more exciting, opportunity for entrepreneurs and angel investors. The news may not be as good for traditional venture capitalists or the companies in which they invest.

This new reality extends trends that have been emerging for some time, but which have gone unnoticed amid all the noise about the big venture capital and private equity deals that were awash throughout North America.

A different financing landscape for entrepreneurs has been emerging over the past few years and will continue to evolve in this new financial climate. This new reality favors investments in promising young companies by angel investors, who will often achieve an exit within a few years instead of following the riskier, and much longer, funding patterns of the traditional venture capital industry.

As far as I can tell, this is the first book on exits written for entrepreneurs and angel investors.

The payoffs for this strategy are not as large as some of the earlier moon shots in the last few years of the 20th century, like Google, Skype or PayPal, but they come far more often—and with much less risk. Cumulatively, these early exits provide a very attractive investment return for both angel investors and entrepreneurs.

It's similar to a baseball team concentrating on hitting consistent singles and doubles rather than hoping for the big grand slam home run to put them in the win category. It's old time ball playing—and investing—and it's the complete opposite of the swing for the fences mentality that emerged over the past couple of decades. In that scenario, a company started up, raised big venture capital funding, and after a decade or more of hard work, and a great deal of luck, eventually completed a multi-hundred million dollar initial public offering (IPO).

My premise is that startups and emerging companies should adopt a new, simple approach—start small, stay lean, raise only the funding you really need, grow the business judiciously and then execute an early exit.

As far as I can tell, this is the first book on exits written for entrepreneurs and angel investors.

1.2 The First Book About Exits For Angels and Entrepreneurs Instead of Venture Capitalists

Exits are the least understood part of investing—as often by the investors themselves as by the entrepreneurs. That's because there has been very little said, or written, about them. The emphasis was always on starting, scaling and growing.

Most of the early books on exit strategies were written for business owners who wanted to retire. More recently, there have been a number of books written about exit transactions for venture capitalists. This is not surprising considering that most venture capital (VC) agreements give the VCs most, if not all, of the control in deciding when and how all shareholders will benefit from an exit transaction.

Most of the strategies and exits described in this book don't work for traditional VCs.

This book is about the large number of other exits—the ones that are not driven by the VCs.

Exit opportunities have changed dramatically in the past few years. Today, it's more likely that a company will be sold without ever having an investment from a venture capitalist.

Exits are also happening much earlier than before. The largest number of exit transactions today are in the under $30 million valuation range. These exits are often completed when companies are only two or three years from startup.

The second quarter of 2008 was the first time in history that there were no IPOs of venture-backed companies in the US. At the same time, the market for merger and acquisition (M&A) transactions of technology companies was extremely active.

These trends created a terrible time for VCs but a great one for entrepreneurs and angels.

Most of the strategies and exits described in this book don't work for traditional VCs. In fact, I expect many VCs to react quite negatively to many of the observations and ideas presented. This is not surprising, as this is not good news for the traditional venture capital investment model.

In this era, the choices entrepreneurs and boards make between angel and VC investment will have profound effects on exit opportunities and probabilities of success.

This new exit reality has new rules and new opportunities—some of which include:

- Exits occurring in only two or three years.
- Most transactions under $30 million.
- Small M&A markets are much less efficient (often a very good thing).

The goal of this book is to help entrepreneurs and angel investors have more successful, more frequent and more enjoyable exits.

2

Exits are the Most Fun

Exits are the best part of being an entrepreneur or investor. It's when we get financially rewarded for all of the creativity, hard work, investment and risk we put into our companies.

2.1 Why Exits Are Fun

There are many reasons we work. One of the obvious ones is to earn money, but money is not the most important reason. Money is often well down the list depending on the scale on which you measure. Most of us work to feel successful, to know we are useful, to have a sense of purpose and to have fun.

All work becomes boring eventually. After you've performed any business process well a few dozen times it can become numbing and routine. Your hundredth subordinate review, or sale of the same product to the same customer, can be worse than dental work.

After about my tenth exit, I figured out why I like working on them so much—exits are the most fun. Exits are the best part of being an entrepreneur or investor. It's when we get financially rewarded for all of the creativity, hard work, investment and risk we put into our companies.

2.1.1 There Is Always a Great Party

One of the other benefits is the big closing party.

It's not so much that I need more rich food or expensive beverages, it's just great to look around the table and bask in that feeling of excitement, accomplishment and celebration.

Exits are also exciting. The numbers are big—often really big. It's always more exciting to be strategizing and negotiating when the differences are millions of dollars instead of tens or hundreds of thousands.

2.1.2 The People Are Interesting

The people involved in exits are also the most interesting. When you work on exits you always work with founders, directors and

C-level executives, sometimes from the biggest companies in the world. These people are always smart, challenging and interesting. This contributes to the challenge, and the fun.

2.1.3 It's Psychologically Rewarding

Leading up to an exit, founders and CEOs have a lot of anxiety about whether they really want to sell their 'baby' and what will happen afterward. There are usually several sleepless nights devoted to fretting about when and if the transaction will be completed.

Fortunately, after being involved in a few dozen transactions, you begin to realize how normal these emotional and psychological effects are. It's gotten to the point where I can almost predict the emotional implications of the next phase of the process. The good news is these are all just a normal part of the exit experience. It's rewarding to have the perspective to be able to help the participants through these challenging phases of the exit process.

Possibly the best thing about exits is that they almost always make everyone happier and more excited about the future—and that's contagious.

Some of the most heartfelt thank you emails I have ever received were after exit transactions. A few of these are included in the case studies in the appendix.

3

The Current Environment for Exits

Nobody can predict the future. We may be near the peak of the tech M&A market or the trend may last several more years. If you have been thinking about selling your business, now looks like a very good time.

3.1 It's a Great Time To Sell a Technology Business

The years preceding the publication of this book, in the later part of 2008, have been a very good time to sell a technology business.

There is an interesting article in the April 7, 2008 issue of *Business Week* titled "Ravenous for Small Tech." The article reports that while the change in value of mergers and acquisitions (M&A) in all sectors is down 51% in 2008, the value of high technology M&A is actually up 132% compared to the previous year.

In a May 2008 article in *Mergers & Acquisitions*, Tom Stein looks back and says, "2007 will be hailed as the biggest year for acquisitions of venture-backed technology since the dot.com days."

Why is this happening now and how should it affect your exit strategy?

3.2 Big Companies Are Growing By Acquisition

Acquiring smaller companies is now the best way for large companies to grow, which is the main reason the M&A market is so active. This is summed up nicely in a quote from Vivek Mehra, general partner at the venture capital fund August Capital in Silicon Valley: "Big companies stink at innovation, and they know it."

Acquisition works so well that many big companies are now spending more on company acquisitions than research and development (R&D). Take Microsoft for example. According to Tom Stein, "Microsoft is seeking 20 companies, worth $50 million to $1 billion, and will spend more on acquisitions in fiscal 2008 than on R&D for the first time in its history."

Cisco also prefers to 'buy rather than build.' The company has acquired 125 businesses since 1993. These big companies have large internal divisions completely devoted to buying companies.

It's also a great time to sell a business because large companies are sitting on loads of cash. This situation presents a problem for company management because shareholders want them to either invest the capital to create growth or distribute it to the shareholders as dividends. Distributing cash is considered an admission of defeat for tech company management because it shows they don't have any ideas about how to invest cash to increase shareholder value.

Big companies are also trying desperately to re-energize the entrepreneurial cultures that got them started in the first place. This phenomenon is well articulated in a December 2005 article in *Business 2.0*, "The Flickrization of Yahoo!" The story describes how Bradley Horowitz, the head of Yahoo's developer network, decided to offer the founders of the photo sharing website, Flickr, $30 million for their startup. Horowitz invited Stewart Butterfield and Caterina Fake to Silicon Valley in late 2004. They had lunch in the Yahoo cafeteria and immediately hit it off. "I met Stewart and Caterina and fell in love," Horowitz recalls. "It was beyond Flickr. I saw them as kindred spirits, entrepreneurs who could infect Yahoo with that small-company focus."

Nobody can predict the future. We may be near the peak of the tech M&A market or the trend may last several more years. If you have been thinking about selling your business, now looks like a very good time.

3.3 Most Exits Are Under $30 Million

These days, the really interesting story about tech exits is not the small number of really big company acquisitions—it's the big number of smaller exits. For the typical entrepreneur and angel investor, these smaller transactions are an excellent way to make several million dollars in capital gains and should be part of every company's exit strategy.

The financial media and most bloggers write about the really big startup exits like Club Penguin, YouTube, Skype and MySpace. Those are certainly exciting company acquisitions and great startup stories.

But for the other 99.9% of entrepreneurs and investors, the really exciting news is the large number of tech company acquisitions for under $30 million. Many of these acquisitions are so small they aren't even press released. In my own funds, where I have been generating some regular early exits, recent transactions have been in the range of $15 to 30 million.

Several smart venture capital bloggers have also been writing about this trend over the past few years. The best reference I found was an article by Om Malik titled "The New Road to Riches," which was in *Business 2.0* a couple of years ago. He reports that the Mergerstat database, which includes about 5,000 tech company acquisitions per year, showed an average selling price of $12 million.

3.4 Examples of Early Exits Under $30 Million

I spent some time on Google searching for recent tech company acquisitions and quickly pasted this list together (while the sales can be confirmed, some of the prices cannot be verified). Most of these companies are big success stories and millions of us use their services every day. They are also great companies acquired for $30 million or less:

- 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).

3.5 Who Is Buying?

3.5.1 Fortune 500s Are Buying

One of my friends from a Fortune 500 company explained it to me this way: “We know we aren’t good at new ideas or startups. 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. It’s a different skill set than starting things. If we see a company acquisition priced at $100 million, we regard it as already out of our sweet spot for adding value. But at $20 million, it’s really easy for me to get an acquisition approved.”

3.5.2 Medium-Sized Companies Are Also Buying

It's not just big companies that are growing through acquisition. For every big company, there are probably tens of medium-sized companies that are also potential acquirers for any company looking for an early exit. In some situations, companies with strong management teams will acquire other businesses that are larger than the one they are operating. A good example is Parasun, which was acquired by a public company with larger revenues but a lower enterprise value. (You can read about this exit in the case studies section.)

These medium-sized companies are also active purchasers of companies valued under $30 million.

3.5.3 Private Equity Funds Are Also Strong Buyers

There has also been a remarkable growth in private equity buyout funds in the past several years. These funds are similar to what used to be called 'merchant banks' 20 years ago. These funds often buy companies for cash, operate them for a few years and then resell them, hopefully for a significant gain.

Private equity funds will often purchase a number of companies in an industry and increase their value by consolidating and realizing operating synergies and efficiencies.

These funds are very active acquirers of companies in the under $30 million range.

3.5.4 Even Individuals Can Be Buyers

Another increasingly common type of buyer for companies under $30 million is previously successful entrepreneurs or executives. These individuals, having been successful in an earlier business, have exited with a substantial amount of money, but not enough to retire. Even if they did make enough to retire, they often just aren't ready to. They will often use some of their own capital, augmented by capital from private equity funds and subordinated debt, to purchase a company. Often this practice enables them to acquire a business that is worth several times the amount of money they can invest themselves.

This type of transaction also works most often when the purchase price is under $30 million.

3.6 Optimum Exit Strategies For Entrepreneurs and Angel Investors

It seems pretty clear that the optimum strategy for tech startups today is to design the company, and its corporate DNA, so everyone is aligned around the idea of a company acquisition in the under $30 million range. The good news is that these exits can often be completed in just a few years from startup. They also have a much higher probability of success than swinging for the fences and hoping for a big NASDAQ initial public offering.

This exit strategy is nicely summarized in "The New Homerun" by Tom Stein in *Mergers & Acquisitions*, May 2008. He said, "Startups must be content with hitting singles or doubles, that is, a buyout of $50 million."

4

The Evolution of Venture Capital

As VCs invest more and more money
in each company, they have to wait
longer and longer before they can exit.

From an exit perspective, the two most important characteristics of venture capital investors, or VCs, are that they:

- Invest large amounts of money.
- Can wait ten years for an exit.

4.1 VC Funds Have Grown Larger and Larger

In the 20th century, technology companies often required tens or hundreds of millions of dollars to build out and prove. Companies like Intel, Microsoft, Amazon and Google required hundreds of millions of dollars to scale up to the size where they were proven winners. This was one of the factors that led to ever larger venture capital funds.

Being a VC fund manager was also a great job for the fund principals, once the fund was large enough. Most VC funds are structured so the fund managers charge a management fee of about 2.5% of the value of the fund each year. The management fee pays the salaries of the fund managers and their support staff. A small VC firm usually has four partners and some support staff. This means that the annual operating budget for even a small fund quickly grows to more than $2 million per year. Most VC managers believe a fund under $100 million isn't economical. The goal of most VC managers is to grow the fund to several hundred million—in part because they can then start to pull down some very attractive compensations.

The graph in Figure 3.1 shows how these trends have led to the phenomenal growth of VC firms over the past 30 years.

Average Size of VC Firms

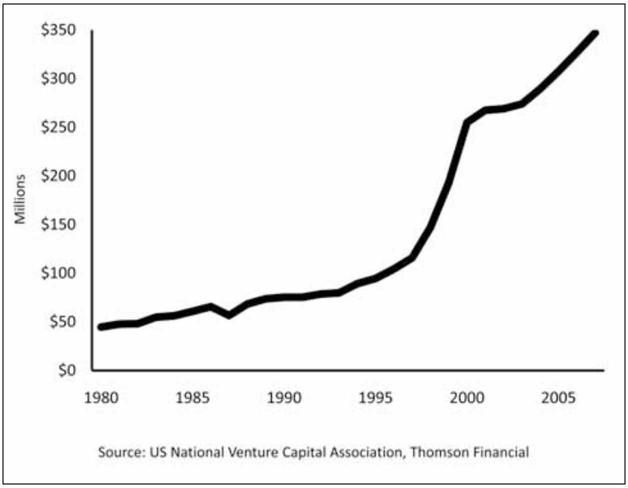

Figure 3.1. VC Firms have grown larger and larger

4.2 Each VC Partner Is Managing More and More Money

As VC funds have grown larger, the amount of money that each VC principal has to invest has grown even faster.

Average Capital per VC Principal

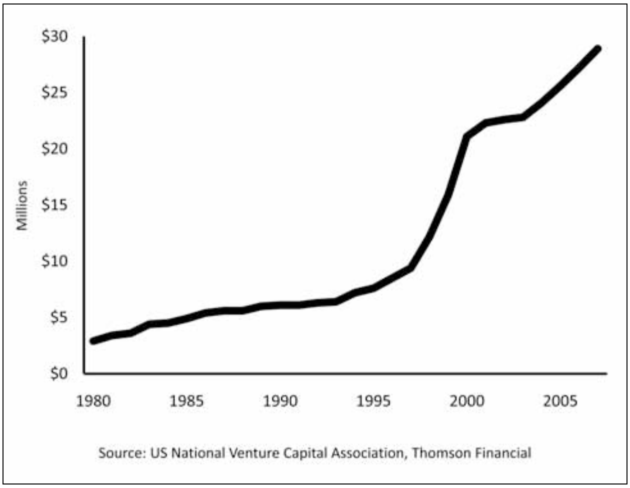

Figure 3.2. The amount of capital each VC has to invest has also grown

Figure 3.2 shows that a typical VC fund principal was responsible for investing less than $3 million in the 1980s. Today, the typical fund principal has to invest almost ten times that much.

4.2.1 VCs Are Investing More In Each Company

The amount of work a fund manager has to perform is directly related to the number of investments, not the size of investments. It takes almost as much time to manage a $1 million investment as it does a $10 million investment.

As the amount of capital each venture partner has to invest has grown, their natural tendency has been to make larger and larger investments.

Figure 3.3 shows how the amount of money in an average US VC-backed company has increased over the past ten years. The amounts shown are for companies that exited through merger and acquisition (M&A) transactions. As recently as 1996, the median equity raised before an M&A exit was only $5 million. Today, that has increased to $25 million.

VC Investment Prior to M&A Exit

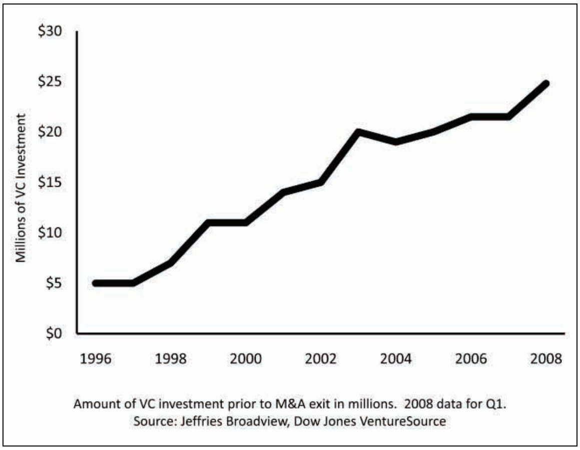

Figure 3.3. The amount of VC investment prior to an M&A exit

4.3 An Outline of the VC Math

Peter Rip of Leapfrog Ventures describes the math behind VC funds in a fascinating post titled "Traditional Venture Capital Sure Seems Broken—It's About Time." This article is a high level summary of how the math works for a VC fund.

In a typical VC portfolio, all the returns are from 20% of the investments. These are the two out of ten investments that are winners. A minimum respectable return for a VC fund is a 20% compound return.

For a ten-year VC fund, the fund needs to pay investors 6x their investment to generate a 20% compound return. So those two winners each have to make a 30x return on average to provide investors with the 20% compound return—and that's just to generate a minimum respectable return.

This math is simplified but it's more than accurate enough to illustrate this important point. If you are not familiar with the math behind an investment portfolio, I hope you will spend a few minutes with a spreadsheet so you feel comfortable with these numbers.

Even more interesting is that a traditional venture fund is usually a limited partnership. This means that the fund managers only get to invest the money once. So if they make an investment and exit for a 3–4x return, they give the principal and gains back to their institutional investors. They don't get a chance to invest it again. From the VC partners' perspective, this effectively guarantees they have failed.

Of course, a successful VC fund is not likely to have two 30x exits. It's much more likely they will have one 10x exit and one 100x exit. What is important here is how the VC fund managers think and act.

4.4 Time Required To Generate 10x to 30x Returns

If the successful investments need to return 30x on average to generate a minimum VC return of 20% per year, how long will the VC fund have to hold the investment before an exit?

The chart in Figure 3.4 shows on average how many years it would take to generate a minimally acceptable VC fund return from the winning investments.

Additional Years to VC Exit

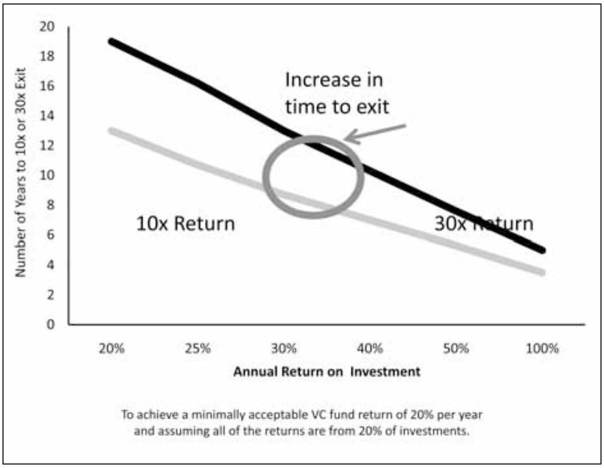

Figure 3.4. Additional years to exit for a VC to achieve a minimally acceptable return

Some companies will create increases in shareholder value faster than 30 or 40% per year, but these are extremely rare. Everyone who has run a company knows that generating consistent 30 to 40% annual increases in value requires a great deal of hard work and some luck.

4.5 VCs Have To Wait Longer To Exit

As VCs invest more and more money in each company, they have to wait longer and longer before they can realize an exit.

The fascinating graph in Figure 3.5 shows what has happened to exit times for US VCs. The median time from when a VC initially invested to an M&A transaction had been pretty stable in the late 1990s at around three years. The time to exit dipped to about two years in 2000. This was at the peak of the tech equity bubble when the velocity of transactions was incredibly high.

Time From VC Financing to M&A Exit

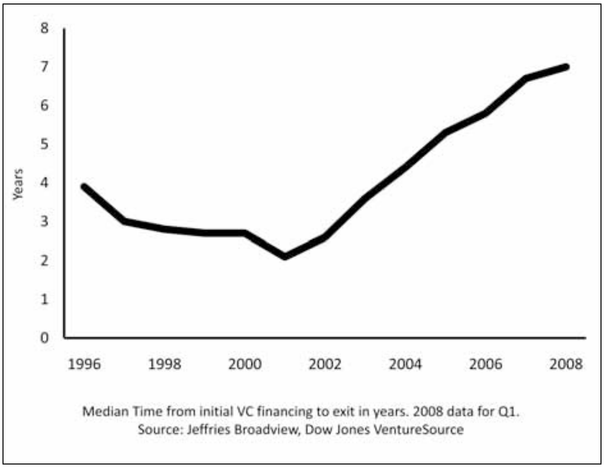

Figure 3.5. Median time from initial VC financing to exit

In the years since the tech bubble burst, times to M&A exit have steadily climbed to where they are now at seven years.

The practical implication of Figure 3.5 is more complicated than it appears on the surface. Section 5.4.1 describes a model to illustrate what this data means for the exit times for entrepreneurs and angel investors.

4.6 Venture Capital Fund Lifetimes

Venture Capital funds get most of their money from either financial institutions or individual investors. Institutions are extremely patient investors. They are usually managers of pension or life insurance funds and they often hold their capital for decades. When individual investors in Canada invest in 'public' VC funds they receive a 30% tax credit, but are usually required to leave their money in the fund for eight years. Some newer types of 'VCC' (Venture Capital Corporation) funds have reduced this requirement to about six years.

Most VC funds are designed for a lifetime of 10 years. But in practice, as shown in Figure 3.6, the actual lifetime of technology (IT) VC funds averages closer to 13–14 years.

Lifetime of IT VC Funds

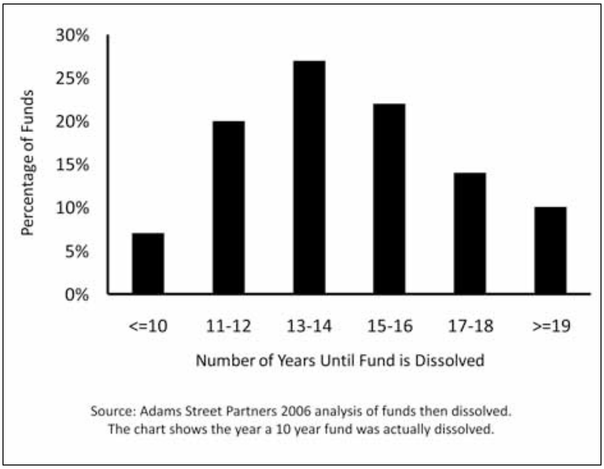

Figure 3.6. Lifetime of IT VC funds

This extension of the lifetime of venture funds is often a surprise to angel investors. Many of them remember VC fund lifetimes that were under ten years, and specific examples of VCs who started to encourage companies to exit after only 5 or 7 years because the VC funds were close to expiring. Even the VCs themselves have been surprised by how fund lifetimes have extended.

To me it looks like a natural but unexpected consequence of much larger funds—and the current exit environment.

In an article in the October 1, 2008 issue of the *Venture Capital Journal* titled "High Anxiety or Great Expectations?" Bart Schachter and George Hoyem of Blueprint Ventures say that part of the current anxiety around VC funds exists because "the minimum average duration of a venture fund has been creeping to the mid teens. Put another way, those 10-year funds with a two year extension are turning into 10-year funds with a five year extension—and counting."

So, even the times shown above in Figure 3.6 are probably shorter than today's reality.

What these longer fund lifetimes mean to entrepreneurs and angel investors is critically important. When a VC makes an investment, they can often be quite happy to leave their money in the company for a decade. This is especially likely when it is a Series A investment made near the start of the fund's lifetime.

4.7 Unwritten Contracts With Investors

Just in the last few years, in part due to blogging and angel investor conferences, there has been an increasing understanding that there are unwritten contracts between entrepreneurs and investors.

There has always been an implicit understanding between entrepreneurs and investors that if the investors advanced their money, then the entrepreneurs would do everything possible to maximize the value of the company's shares. More recently, bloggers and speakers at conferences have been talking about the other unwritten agreements between the investors and the entrepreneurs.

One unwritten agreement that is increasingly well understood is that the entrepreneurs agree to not only work to increase the value of the shares, but they also commit to working toward achieving liquidity for their investors. This element of the unwritten contract has evolved from a growing appreciation that in some situations entrepreneurs have increased the value of the shares, but never did achieve a liquidity event—even though it would have been easy to do so.

It's important for entrepreneurs to remember that a liquidity event doesn't mean that the company will end when it's sold; it just means that part of the entrepreneur's job is to ensure that those who have been shareholders for a number of years have an opportunity to sell their shares. These days the common way to achieve this is through an M&A transaction, but the most popular way over the last decade or two has been through a public offering.

4.8 Unwritten Agreements With VCs

Over the past few years there have been several fascinating blog posts about the unwritten terms in VC term sheets.

Josh Kopelman, in an excellent post titled "When the music stops…" said:

> "Entrepreneurs should understand the 'unwritten term in the term sheet': few VCs will willingly part with a 'winning company' (i.e., a company that is executing/performing well) for less than a 10x return."

In another post titled "Unintentional Moonshot," Kopelman said:

"They need to pay attention to the unwritten term on the term sheet. Specifically, they should make sure they are comfortable with the exit multiple that would generate the returns needed to satisfy their VC. While every situation is unique, here's a simple rule of thumb:

This unwritten term in the VC term sheet can have devastating effects on entrepreneurs and angel investors.

- Series A - 10x
- Series B - 4–7x
- Series C - 2–4x

So, once you sign a Series B term sheet valuing your company at $50 million premoney, you've basically signed up for at least a $200 million exit target. With the data showing that there are fewer exits—and those that do exit happen at lower prices—I think it's worth considering whether you want to eliminate the head-end of the M&A curve."

Kopelman goes on to add:

"As an investor in StumbleUpon and del.icio.us, I can pretty confidently say that had either company elected to raise a Series B round—it would have been very difficult (if not impossible) for the founders to choose to sell their companies when they did."

This unwritten term in the VC term sheet can have devastating effects on entrepreneurs and angel investors. It means that VCs will often block an exit that would have been fabulous for the entrepreneurs and the angels.

4.9 Why VCs Will Block Good Exits

A friend of mine founded a tech startup about five years ago. The company was backed by several local VCs.

The company had an opportunity to be purchased by a much larger company at a price that would have produced a return for the VCs of about 3x (a 'triple'). The management team was eager to sell because much bigger players were moving into their space and they had concluded that it would be much harder to win new contracts in the future. They also believed that because the big players were now excited about their space, they would probably get the best valuation now.

But the VCs were blocking the sale.

My friend couldn't understand it and he asked me why the VCs on his board couldn't see the situation they were in, and didn't appreciate the opportunity for a great exit that was right in front of them.

I explained that it wasn't the VCs who were missing something; it was my founder friend who didn't get it.

This is not an isolated event. It happens all the time. I didn't understand this until I had been a VC for a few years. VCs will almost always block a sale where they will only make a 3–4x return on their investment.

The sale of my friend's company could easily have been a 10x return for the angels and a 100x return for the entrepreneurs.

This example illustrates how VC funds have to 'swing for the fences.' The winners have to produce at least a 10–30x return for the fund to perform respectably. (See Section 4.3 for "An Outline of the VC Math.")

4.10 How VCs Block Exits

Most entrepreneurs don't even know that a VC is likely to block a potential exit with a great return when they accept the VC's money. I didn't in my first company—and my friend didn't either. For me, it wasn't until the final extraordinary general meeting when the shareholders were voting to approve the exit transaction that I actually realized how aggressively a VC will try to block an exit.

VCs design their investment agreements in part to give them the power to block exits. This is something they plan for in advance. VCs worry that after they invest, the entrepreneurs will want to sell the company for something that might give the entrepreneurs a 100x return and the angels a 10x return but only a 3x return for the VCs. This was one of the reasons that VCs wouldn't invest in Brightside (one of the case studies at the end of the book).

The most effective way VCs block exits is through the terms in their preferred shares. Most first-time entrepreneurs have no idea how this works. (I didn't either when I was an entrepreneur.)

VCs can also effectively block exits by dominating the boards of the companies in which they invest. They will also have terms and conditions in their investment agreements that allow them to make the decision when a company can exit and for how much.

4.11 Many VCs Have Never Had an Exit

This returns us to the concept of VCs having to swing for the fences. The kinds of exits that work for VCs are extremely rare—I'd guess they are less than 5% of all exit opportunities and probably fewer than one in a thousand startups.

In an interview titled "Paul Kedrosky warns that VC is swamping tech startups," Stacey Higginbotham talks with Kedrosky who posits one of the reasons VCs are leaving the industry is because many of them are "IT investors who have yet to have their first major exit. They've been in this business for six to eight years with no exit."

In my conversations with VCs, many say that there are lots of VCs who haven't had an exit in eight or even ten years.

This is a new phenomenon. In earlier times, VCs were involved with more exits, at lower values and in shorter timeframes. But things have changed. VC fund structures now force VCs to hold on for moon shot exits—which are extremely rare.

Unfortunately for traditional VCs, the new economic environment is making the best chances for exits earlier, and at lower valuations. This new reality just doesn't work for these large VC funds.

4.12 And It's Going to Get Even Longer

You might think that with the dominant trend of the large number of early exit transactions at valuations under $30 million, the VC funds would recognize this trend and adapt.

You might be surprised to learn VCs are actually moving in the opposite direction—in Canada especially.

At the Canadian Venture Capital Association Annual Conference in May 2008, the association presented "The Drivers of Venture Capital Performance, 2008 Update Monitoring Progress - An industry facing a financial crisis."

This presentation summarizes the current VC environment in Canada. The fundamental problem is that VC funds in Canada have been an underperforming asset class for over a decade. As a result, institutions have been investing less and less money into VC funds. The report describes the industry as being in crisis.

The conclusions and recommendations to reverse this trend?

- "We still have to fund larger rounds."
- "Hold on longer, go for larger exits."

5

Angel Investors

Angels also often want to contribute more than money to a young company. Angels have the experience, and inclination, to be great mentors and valuable directors.

From an exit perspective, the two important characteristics of angel investors are that they:

- Invest much less money than venture capitalists (VCs).
- They are happy to exit in a few years with a 3–5x return.

5.1 Angels and VCs Are Very Different

Angel investors are quite different from VC investors—more so than most angels and VCs realize. Very few entrepreneurs fully appreciate the differences, and the profound effect these distinct types of investors can have on their exit options.

Most angels are in their 50s or 60s—right in the middle of the baby boomer demographic. Unlike VCs, angels are investing their own money, which means they have become wealthy enough to become 'accredited investors' under the legal definition. Many angels earned their capital by being successful entrepreneurs or senior executives.

Angel investors usually have most of their capital invested in traditional financial assets, like large equity and debt funds. They typically allocate something under 5-10% of their portfolio to their angel investments. A reasonably well diversified angel portfolio should have at least six to ten investments. These factors result in individual angels typically investing $10,000 to $250,000 in a company.

Angels also often want to contribute more than money to a young company. Angels have the experience, and inclination, to be great mentors and valuable directors.

These characteristics mean that angel investors are much more likely than VCs to invest in startups. The amount of capital that angels invest is also a perfect match to the capital requirements of today's capital-efficient startups.

5.2 Angel Investment Timelines

In the 20th century, the average person planned for retirement by contributing to their company's pension plan. It was also common to think of life insurance as an investment. If people had additional investable capital, they probably had an account with a stock broker or financial planner. People couldn't do anything with their pension plans or life insurance policies for three to four decades. With a human broker, every time you picked up your phone (they had cords back then), you paid the broker about 3% of the value of the transaction. If the transaction was completed, the broker would mail the details. People didn't make investment decisions very often.

Nobody I know even has a company pension plan, but everyone has at least one '$9.95 per trade' internet brokerage account. Everyone is making investment decisions much faster and expecting returns in far shorter timeframes. We check the value of our portfolios hourly instead of at quarterly meetings with our financial advisors.

The Internet has dramatically shortened investors' time horizons and preference for liquidity. Most of the hundreds of millions of dollars I have helped raise so far have either gone into angel investments or tech VC funds. All have had at least five year hold periods. I've probably been face-to-face with a thousand investors who are making a decision about an investment. Almost every investor I've met is more and more reluctant to make an investment with a long hold period (the time from investment to when you can get your money back).

In the public markets, the regulators used to impose a one year hold on most new financings to encourage investment and reduce speculation. Today, investors just won't buy one-year hold stock. Modern exchanges now have four month hold periods—and brokers will tell you it's getting more and more difficult to sell four month holds.

The current state of the financial markets has also made investors more aware of how fast things can change in the macroscopic economy. Accordingly, investors today are extremely reluctant to invest capital in anything that doesn't have a clear path to liquidity—and are extremely reluctant to invest in something where they might not get their money back for three to five years or more.

Imagine how a typical investment pitch to angels conveys the hold period. These days, when most entrepreneurs pitch their investment opportunities, they don't talk much about initial public offerings (IPOs). Instead, they usually say they plan to follow their angel financing with a venture capital Series A round and then hope to be acquired. Here's what the angel investor is thinking: "Oh, great. These guys want me to invest now. Then, in two or three years, they are going to let VCs into the company. The VCs will determine when and how the company gets sold. VCs usually hold their Series A investments for around ten years. So, if I'm lucky I might get my money back in 12 to 14 years. I think I'll pass."

5.3 The First Data On How VC Investment Affects Angel Investors

In the last year or so, for the first time, we are starting to get some statistically valid information on angel investing. This research was funded by the Kauffman foundation and conducted by Rob Wiltbank of Willamette University. More on this study is available on AngelBlog[1].

One of the fascinating aspects of this research was about how VC investment affects the exits of angel-backed companies. When I first saw this data, it leapt off the page at me.

<u>What Happens When VCs Invest</u>

New Insights from Wiltbank Data

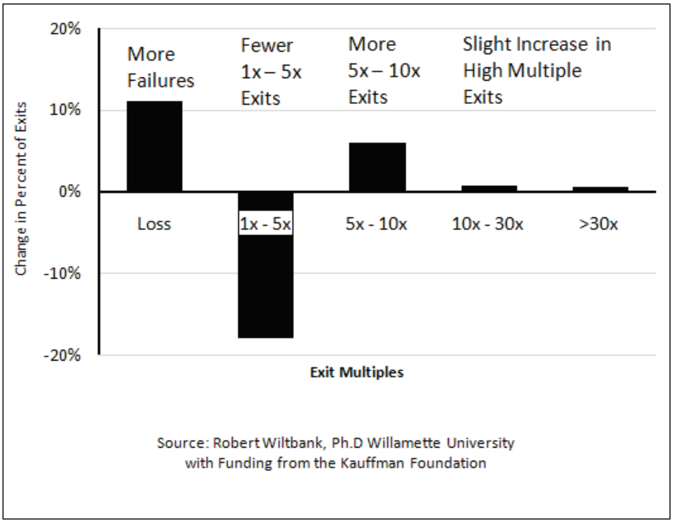

Figure 4.1. What happens to angel investors if a VC invests

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[1] www.AngelBlog.net/Angel_Returns.html

The graph in Figure 4.1 shows what the greybeard VCs have known for a while. If your company has VC money in it, the VCs will reduce the chances of an exit that would produce a 1–5x return for the angels, and possibly a 100x return for the entrepreneurs (because they paid much less than the angels for their shares).

Having a VC invest does increase the probabilities of exits above a 5x return. But there is no free lunch. After a VC invests, your chances of losing money also increase significantly.

This is exactly what happened in the example of my friend's company described in Section 4.9. You'll recall that his VCs were blocking a sale that would have produced a 3x return for the VCs. The VCs chose to hold their investment in hopes they'd realize a much higher return at a later date. The entrepreneurs in that company instinctively knew that delaying their exit would also increase the chances that everyone would lose money, especially because bigger players were moving into their market.

5.4 What This Means For Entrepreneurs and Angels

The decision to let a VC invest in a company has a dramatic effect on the time to exit and the probabilities of overall success. Swinging for the fences always takes much longer and is much riskier.

To better understand how the decision to accept VC money will affect the founders, friends and family investors and angels, take another look at the graph in Figure 3.5. That graph shows that today the median time from a VC making an investment to a merger and acquisition (M&A) exit is seven years. Figure 3.3 shows that the median amount invested by the VCs prior to exit is now about $25 million.

When you look quickly at the data, it might be tempting to think that the decision to add VC investors would add seven years to the time to exit, on average. A closer look at the data shows that the real implications are quite different.

5.4.1 A Simple Model

The table in Figure 4.2 is a simple model that illustrates what is really happening.

(millions of dollars)

Years From Startup	0	2	4	6	8	10	12	16	Years Invested
	Friends & Family	Angel Investors	VC Series A		VC Series B	VC Series C		M&A Exit	
Friends & Family 1	$0.1								16
Friends & Family 2	$0.1								16
Angel 1		$0.1							14
Angel 2		$0.1							14
Angel 3		$0.1							14
Angel 4		$0.1							14
Angel 5		$0.1							14
VC 1			$2		$2				12
VC 2			$2		$2	$1			12
VC 3					$2	$2			8
VC 4					$2	$2			8
VC 5						$2			6
VC 6						$2			6
VC 7						$2			6
VC 8						$2			6
Total $	$0.2	$0.5	$4		$8	$13			
Median Number of Years VCs Were Invested									7
Average Number of Years VCs Were Invested									8
Average Number of Years Angels Were Invested									14
Average Number of Years Friends and Family Were Invested									16
Average Number of Years Founders Were Invested									16

Figure 4.2. Model to show what happens after VCs invest

Most VC financings involve multiple VCs. As rounds progress from Series A to B to C and the rounds get larger, the number of VC investors in each round tends to increase. There is a strong tendency for VCs in an earlier round to participate in the next round.

<u>Let's review this example:</u>

First, when does each investor type enter the picture?

The friends and family investors invest at startup, in year zero. The angels invest at year two. The company progresses and decides to accept a VC Series A round in year four. Things go well and the company accepts subsequent Series B and Series C rounds in years eight and ten. Things continue to go well and the VCs approve an exit that will give each of the VC investors the return they need in year sixteen.

Now, what was the average hold period for each investor type?

The first VC investment was in year four. So, the Series A VCs were invested for twelve years, the Series B VCs for eight years and the Series C VCs for six years.

And what amount did VCs invest?

There were two VCs in the Series A round, two new VCs in the Series B round and four new VCs in the Series C round. In this hypothetical example, the combination of VC investments totaled $25 million.

This is the actual median amount invested by VCs prior to an M&A exit, shown in Figure 3.3. The example in Figure 4.2 also works out to the actual median time from investment to exit of seven years, as shown in Figure 3.5.

But let's look a little closer.

5.4.2 What's Happening To The Angels and Entrepreneurs

What this example shows is that the decision to accept VC investment increases the time to exit by approximately 12 years, not the median time of 7 years.

Figure 4.3 illustrates what happens to the time to exit, and the probabilities of exit, for the angel investors. If the company decided to exit before accepting VC investment, it might have been sold around year six, four years after the angels invested. But when VC investment was added to the corporate DNA, the time to exit increased to somewhere around year sixteen, twelve years after the angels invested.

Angel Exits Without and With VCs

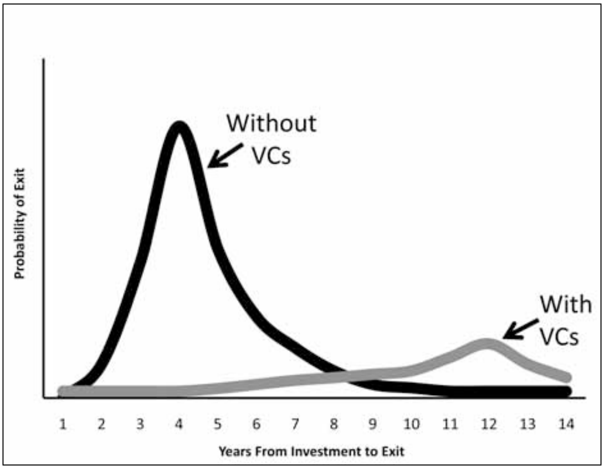

Figure 4.3. What happens to the angel investors without and with VC investors

This is a simple model and I don't know of any statistically valid data on this yet, but the trends and implications are clear. If a company accepts VC investment, then the minimum exit valuation per share has to be 10–30x above the price the VCs paid. This dramatically reduces the chances of success and statistically extends the exit timeline for the angels and entrepreneurs by as much as a decade.

This data does not come from my friend's business described in Section 4.9, but it represents exactly what happened to him. He'd have been perfectly happy to sell the shares in his startup and pay the capital gains on several million dollars. His dream was to launch another startup. Unfortunately, that isn't going to happen for possibly another five to seven years and the chances are good that the value of his company will be lower at that time.

If you think your company might be a candidate for an exit in three or four years, in the most common valuation range of under $30 million, you just can't let a VC invest.

5.4.3 The Bottom Line

Angels are usually happy to make 3–5x returns on their investments within a three to five year timeframe. This typically translates to an exit for the entrepreneurs of about four to seven years with a multi-million dollar capital gain.

What this means for angels and entrepreneurs is that if you think your company might be a candidate for an exit in three or four years, in the most common valuation range of under $30 million, you just can't let a traditional VC invest.

6

The Shift Toward Early Exits

'Built to flip' should not be a dirty phrase or unnatural act. I believe that to succeed today, entrepreneurs must not only aspire to early exits, but design that objective into their corporate structures and corporate DNA.

Over the past several years there has been a dramatic shift toward earlier exits. Companies are being acquired only two or three years from startup. Several factors are driving this change.

- Web 2.0.
- Google transforming advertising.
- Huge amounts of cash on the balance sheets of large corporations.
- Growth in private equity and buyout funds.
- Large numbers of medium-sized companies and individuals buying companies.
- Preference of larger corporations to grow by acquisition instead of internal research and development (R&D).
- Reduction of the costs and time required to build new companies via the Internet.

The trend toward early exits is creating exciting and lucrative opportunities for entrepreneurs and angel investors.

6.1 Early Exits Are Good For (Almost) Everyone

Whenever I hear entrepreneurs or angel investors say 'early exit,' they have big smiles on their faces. Even some of my VC friends beam when they talk about the jump in their returns if they've been lucky with some early exits.

But when I first blogged about early exits, many of the comments were negative. Even though the phrase is used often in the tech world, searching on Google produces surprisingly few hits. The more commonly used keyword phrase is 'built to flip.' Most of the articles are quite negative. So why are most writers so against early exits? In my opinion, it's partly just a by-product of our human resistance to change—to progress.

In my experience, almost everyone wins in an early exit. Certainly entrepreneurs, employee shareholders, option holders and angel investors win. I do acknowledge that early exits don't usually work well for VC investors.

6.2 Early Exits Increase Investment Returns

Recent research from the University of British Columbia (UBC) Sauder School of Business shows that in British Columbia and Alberta we are very good at early exits. This conclusion comes from an excellent study led by Thomas Hellmann and others at the Sauder School of Business. Professor Hellmann is also the Director of the W. Maurice Young Entrepreneurship and Venture Capital Research Center.

In a large scale research project conducted to high academic standards, Hellmann and his colleagues analyzed 509 exits of Canadian VC-backed companies that generated a total exit value of $30 billion and compared them to 3047 exits generating $381 billion in the US over the period 1997 to 2004. The study, "Value creation in venture capital: A comparison of exit values across Canadian provinces and US states" by Thomas F. Hellmann, Edward J. Egan and James A. Brander is available online[2].

Their methodology is described in the executive summary:

> "The primary objective of this study is to calculate the amount of value that is created by venture-capital-backed companies,

[2] http://www.llbc.leg.bc.ca/public/PubDocs/bcdocs/379236/ValueCreationVC.pdf

and to compare these valuations across jurisdictions. Our measure of value creation is the value of companies at the time of an initial public offering, or at the time of an acquisition. Since venture capitalists and other early investors have an opportunity to liquidate their investments at this time, this is commonly referred to as the 'exit value.'

By focusing on exit values we are looking at 'output' measures of venture capital performance rather than 'input' measures, like total investment. Exit values are a fundamental measure of venture capital activity. They quantify what is arguably the most important outcome of venture capital investments, namely the value of the companies they finance. As such, exit values allow us to compare the performance of venture capital markets across different jurisdictions (i.e., Canadian provinces and US states)."

This way of analyzing returns makes a great deal of sense to me as an investor and fund manager. That's exactly how we should measure the performance of a fund or fund manager—by how much they make—not how much they invest.

So, if we sell companies in BC and Alberta sooner than anywhere else, is that a good thing? The study shows that it is a very good thing. Hellmann states, "If we compare total exit values against GDP, we find that Canada outperforms the US by 3%. When compared against the amount of venture capital investment, Canada outperforms the US by 15%."

The study continues:

"Comparing the performance of the two countries' venture capital markets against the amount of R&D spending, Canada generates more exit value for every dollar spent on R&D. Canada generates 79% more exit value per dollar spent on R&D. This figure increases to 125% for private sector R&D. [And specifically] British Columbia and Alberta are the two most profitable jurisdictions across all of Canada and the US when evaluated against R&D spending.”

6.3 Early Exits Also Work For Entrepreneurs

Investors are easy to understand. They simply want to maximize returns and lower risk. The motivations of entrepreneurs are more complex.

It’s not just about the money for entrepreneurs. Entrepreneurs are also motivated by learning, success and ego. The next few sections explore why early exits are also the most desirable exit strategy for most entrepreneurs.

6.3.1 The First $10 to $20 Million Are the Easiest

One factor driving the trend toward early exits is the realization by entrepreneurs that the first $10 to 20 million of shareholder value is the easiest to create.

Young companies, like young children, want to grow quickly. When companies are young it’s easy to maintain year-on-year compound annual growth rates of 100%—or even 200%. At these growth rates it’s also pretty easy to grow revenues to a few million. Depending on the type of company, its profitability and the value of its customers, sometimes just a million or two of revenue is all you need to create the first $10 to $20 million of shareholder value. In Brightside’s case, their revenue was well below $1 million (see the case study in the appendix).

Companies don’t grow linearly, but instead go through periods of relatively smooth incremental growth interspersed with spurts of revolutionary change. The seminal article on this phenomenon is "Evolution and Revolution as Organizations Grow" by Larry Greiner from the Harvard Business School. One of the effects of this natural law is that the CEO skills required to successfully start a company and grow it through its first few growth phases are quite different than those required to grow a company through the next several stages of organizational development. This is one of the reasons VCs are so likely to replace the founding CEO, as described in Section 6.3.3.

Even for those of us who are slow to learn, the second CEO experience is usually enough to cure just about anybody.

Given this reality, the best thing for most founding teams is to recognize that they're going to feel most comfortable, and be most successful, growing from zero to a few million in revenue. Growing from there to $20 or 50 million in revenue requires a significantly different skill set. While some entrepreneurs manage the transition, the odds are not in their favor. Most of the time, an early exit is the optimum choice for the founders.

6.3.2 Entrepreneurial Recycling

There aren't many true entrepreneurs in the world—and even fewer serial entrepreneurs. Veteran investors always lament that there are so few experienced CEOs in whom they can invest.

I think the reason for this is obvious. After being a CEO, you appreciate what an enormous amount of work it is. Much of it—especially some of the management challenges—isn't any fun at all.

After being a successful CEO, the most likely outcome is that you'll end up selling your company. In situations with happy outcomes, this results in a great deal of money finding its way into your bank account. The appreciation of how much work it is to be a CEO combined with a large amount of cash in the bank is usually sufficient to dissuade anyone from taking on the job again. Even for those of us who are slow to learn, the second CEO experience is usually enough to cure just about anybody.

It's still a theory, but I think successful early exits are more likely to create serial entrepreneurs. Here are some of my anecdotal observations:

- An early exit means that the CEO will have spent less time in the job and may not have become tired of doing it.
- Early exits can also often mean that a successful founder puts some real money in the bank, but not usually enough to permanently retire. This cash in the bank is often enough to provide a lot of the startup financing for a next venture.
- Exiting also feels better than being replaced by the VCs.

6.3.3 It's More Fun Than Being Replaced By The VCs

VCs replace founders in a surprisingly large number of their investments. The best statistical reference I could find was from Douglas Gray & Brian Nattrass, co-authors of "Raising money: the Canadian guide to successful business financing." They state: "It is an amazing fact, yet little known outside the venture capital industry, that many venture capital firms force the replacement of the chief executive officer in more than 75% of the companies in which they invest. This usually occurs within eighteen months of their initial investment!"

Being replaced by VC investors is a uniquely terrible version of purgatory for most founding CEOs. Obviously, it means they no longer lead the company they founded. That's tough enough, but when the entrepreneurs also realize that their shares are trapped in an illiquid private company that may not see an exit transaction for another five or ten years, this purgatory becomes particularly torturous.

CEO replacement by VCs is always controversial. But as a former VC, I agree that the CEO position does require change in a very large percentage of situations. It's a very rare startup CEO who can learn fast enough and grow quickly enough to deserve to retain the CEO job as the company grows to a medium or large-sized organization. Still, it can seem particularly harsh when you're the one who is deemed inadequate.

6.3.4 The Equity Effect

The 'equity effect' also makes building the first $10-$20 million of shareholder value much easier. In the first two or three years of the company's lifetime, there is usually ample equity available to allocate not just to the founders, but also to most of the early employees.

Employees' and founders' equity should always have vesting provisions that strongly encourage employees to stay with the company for three to five years or, even better, until the exit. During the time employees are working to vest their equity, personal motivations are extremely high and shareholder value growth is commensurately high.

Once most of this initial equity is allocated, the only thing a CEO or board can do is to grant options. The number of options is usually limited to 10-20% of the number of new shares issued every year. This makes it harder to incent and motivate employees with equity, which means it's also more difficult to achieve supercharged growth in shareholder value.

In the middle of the 20th century, people often worked for the same company for decades. In the mid-1980s, when I researched vesting for my first startup, the typical vesting period was ten years.

A decade later, when I was a CEO in Silicon Valley, the longest vesting period that anyone would agree to was three years. Today, most people appreciate that even with a three year vesting period, the effective, or psychological, vesting period is only about two thirds of that.

This means that founders and directors should start worrying that their employees are 'recruitable' in about two years (assuming three-year vesting). Most companies can't just go out and hire new employees because they have already allocated all of the founders' shares.

In the past, companies could significantly extend the 'equity effect' period with an option plan. Unfortunately, this does not work nearly as well as it used to because the attractiveness of options has plummeted over the past five years. The biggest change is the new financial reporting standards that make it prohibitively expensive for companies to grant options. Many large companies, including Microsoft and Time Warner, have stopped issuing options to most employees.

If a company isn't looking at an imminent liquidity event, or if the vesting hasn't been properly structured, or if all the shares have been allocated from the founders trust, the company's only alternative is to pay employees with more and more cash to recruit and retain. This is usually not a viable option for a company that's just a couple of years old.

6.4 Some Real Life Early Exits

All of these trends have been converging to make it easier to execute early exits. This section includes some examples.

6.4.1 Early Exits in the BC Tech Fund

In my early-stage VC fund, the BC Tech Fund, I invested in nine companies. Three years after the first investment, three of the nine had achieved early exits—one went public and two were acquired.

- Brightside was acquired in February 2007.
- Parasun was acquired in May 2007.
- MetroBridge went public in July 2007.

These are much faster exits than in typical VC portfolios. At a recent investor conference, someone asked if I thought it was a fluke. My answer was, “No, that was our plan.”

The BC Tech Fund and the other BC Advantage Funds are (VCC) funds—retail venture capital funds created under the Venture Capital Corporation legislation in British Columbia. These Canadian funds provide investors with a 30% tax credit, but investors cannot redeem their shares for at least five years without losing the credit.

Five years is a relatively short timeframe for a VC fund. Most traditional funds are designed for at least ten year lifetimes. When we started BC Advantage, the legislation enabling the tax credit was brand new and nobody had any idea what redemptions would be like. As a fund manager, I wanted to be sure I would have enough cash to redeem the investors. My portfolio strategy was based on maximizing returns, early exits and diversification. These early exits helped make the BC Tech Fund among the best performing technology retail venture funds of its vintage in Canada.

There were two primary ways I worked toward early exits: selection and structuring. The first thing I did when looking at any investment was to ask how I could achieve an early exit. If I couldn't see an obvious, direct route to an early exit or if the entrepreneurs and the board were not enthusiastic about an early exit, I passed.

Structuring was the second way I facilitated early exits. In the investments I led, I employed structures and vesting agreements that aligned everyone toward the goal of achieving an early exit.

In the early days of BC Advantage Funds, some of our directors were concerned that our enthusiasm for early exits might somehow be inappropriate or a negative aspect for entrepreneurs. But after deploying the strategy for five years, it is clear to me that it improved returns and was a positive for the investee companies.

Over the years, I've found that about 90% of entrepreneurs are even more excited about an early exit than investors. The reason is simple: investors have other capital, so selling one investment won't change their lifestyle. But for entrepreneurs, selling their stake in a company is almost always an enormously positive life-changing event. And their preference is to achieve that as soon as possible.

Results from my early VC fund show how early exits can maximize returns. Early exits have also boosted the returns in my new angel fund and provided our early investors a 100% return of their capital in just over two years.

6.4.2 Other Early Exits In Local Startups

These are a few other examples of recent early exits in British Columbia:

Club Penguin—created an online world for 6 to 14 year-olds. The company was founded in October 2005 and was sold to Disney in August 2007—less than two years later—for $700 million ($350 million up front and another $350 million if they hit their projections). The three founders were the only shareholders; there were no investors in the company.

Brightside—is a University of British Columbia spin-off that builds technology for brighter, higher contrast, liquid crystal displays. I invested in this company three times. It was incorporated in 2002 and sold to Dolby Labs in February of 2007 for $28 million cash. This was about five years later, but the company was still pre-revenue and working on its first real production prototype. The Brightside story is an interesting case study. You can read about what happened behind the scenes in the Cases Studies section at the end of the book.

OctigaBay—was a Vancouver company, founded in 2001, that developed an innovative, high-performance computing system based on Linux and AMD processors. It was acquired by Cray in February 2004 for $115 million—three years after founding.

Flickr—was started in a Vancouver loft sometime after June 2003. I know the date because I still have the email from Stewart Butterfield who was trying hard to raise angel money for his multiplayer online game called 'The Game Neverending.' I first met Butterfield at a talk I gave on building better boards. Shortly after, he pitched at the Vantec Angel Forum. I really liked him and wanted to invest, but I'm not a gamer and just never understood the fundamentals of that industry. Less than two years later another friend mentioned he was helping Butterfield finish the legal work on selling Flickr to Yahoo for $30 million. Another friend of Butterfield's told me that no other investor understood his game either. In a fit of despondency one weekend, he decided to build a photo-sharing application instead.

6.5 The Built To Flip Controversy

A lot has been written about the negatives of startups being 'built to flip.' The term has a negative connotation—as if something improper is being done.

The seminal article on this topic, titled "Built to Flip," was written by Jim Collins and published in *Fast Company*. Collins co-authored a book called *Built to Last* in 1994, which profiles 20th century icons, including Disney, General Electric, HP, IBM and Wal-Mart. Collins also wrote *Good to Great* in 2001. He was previously a lecturer at the Stanford School of Business and now operates a management research lab in Boulder.

In my opinion, these are great books—about history. But they are not very applicable to the current generation of technology companies. The companies he profiles are "so 20th century" (I use that term here as my teenage daughters do—as a pejorative.)

Don't get me wrong, the companies Collins writes about were great in an earlier time. But they are not the type of companies that are likely to be started, thrive or prosper in the 21st century. As an interesting footnote to this premise, Paul Kedrosky wrote an interesting follow up in a post on November 7, 2008 titled "Good to Gone: Disappearing 'Great' Companies?" His post looks at the current share prices of these 'greats.' Some have not fared at all well through the first few years of the 21st century.

Think about it. If you were launching a startup today, would you prefer it be:

- Disney or Blizzard (the makers of WoW)?
- IBM or Yahoo?
- HP or Google?
- Wal-Mart or Amazon or eBay?

'Built to flip' should not be a dirty phrase or unnatural act. I believe that to succeed today, entrepreneurs must not only aspire to early exits, but design that objective into their corporate structures and corporate DNA. This does not in any way suggest that entrepreneurs should build companies with less quality or lasting value—in fact it encourages the opposite. It is the excellent companies that have lasting value that are the best candidates to be acquired in an early exit. The only difference is that today it can, and should, happen much faster.

The Internet has accelerated everything. It's just not possible any more to take decades to build a company. Entrepreneurs, employees and investors just don't have the patience. Even if they did, their competitors don't.

6.6 Early Exits Are a Natural Consequence of The Internet

I know it's an overused statement, but the Internet really has changed everything. Today, in the Web 2.0 era, everyone is starting to experience the 'network effect,' as it was termed by Bob Metcalfe. Everybody is connected to everyone—globally. The majority of mankind's knowledge has been indexed and is available instantly to everyone, regardless of where they are and how much money they have.

One of the most dramatic effects of the Internet is that everything pertaining to starting, funding and growing a company is happening faster than ever before. Your exit strategy, as founder or angel investor, needs to take these changes into account.

6.7 Companies Are Being Built Faster

In the previous century, it might have taken ten or twenty years to grow a company to a point where it made sense to take it public or sell it. In my first startup, during the 1980s, we built hardware—equipment that bolted into racks. We beat our Fortune 500 competitors because we were really good at rapid product development. We could conceive of a new product line, do the R&D, and introduce it to the market in only three quarters to one year. It took our competition two or three years.

My contemporaries, who were building enterprise software companies, were also trying to reduce their product development lifecycles—from years to quarters. (It still takes Microsoft about five years to fully develop a major new product.)

Today, in the first decade of the 21st century, entrepreneurs are having fun with 'weekenders.' These weekenders come in a variety of forms, but they are all about getting a group of entrepreneurs together to conceive new startups. Participants think up a new company concept, build the product, launch it, market it and watch the first customers use the product—all in one weekend! It's true. New rapid-development software technologies allow talented developers to do 'mashups' where they can build entirely new web apps in only part of a weekend.

Blogs, Google, Facebook and the rest of the web enables them to launch, market and make the first sales all in that first weekend. By Monday, they can have an idea of whether the new company is a success.

6.8 And It's Just Going To Get Faster

Internet acceleration is far from complete. I recently spoke with a university Dean of Engineering who was deeply concerned that his undergraduate students did not have the patience to read even a few chapters of a book or sit through a 50 minute lecture. He said his faculty had no idea how to educate people with such incredibly short attention spans. I really depressed him by describing what was coming next.

Anyone with a teenager has seen how that generation uses instant messaging, SMS, Twitter, micro-blogging and Facebook to conduct simultaneous micro-conversations while at the same time professing to do their homework. They make fun of us because we still use email as our primary communications channel.

These kids have a tenth the attention span that I do but ten times the ability to multi-task. The teenagers of today will be the new class of entrepreneurs in just a few years and the most important investors in just a few decades.

They'll probably define an early exit as selling the company before the end of the weekender.

7

21st Century Exit Strategy

VC bias toward swinging for the fences means companies that could have exited easily in the $20 to 30 million range will end up being 'ridden over the top' and eventually worth much less—or possibly nothing at all.

Entrepreneurs today have an unprecedented opportunity to start and exit startups earlier than ever before. It's another step in mankind's development brought on by the Internet. I believe that instead of fighting this change, founders and angel investors should focus on ways to design and execute even better early exits.

7.1 Shareholder Alignment

Alignment is critically important to entrepreneurial and investor success.

By alignment, I mean consensus among the stakeholders—among the investors, founders and board of a company—on a set of key strategic issues. Creating an optimum alignment among the stakeholders can dramatically improve organizational success. Failure to create shareholder alignment often leads directly to the entire company failing.

Alignment is still a relatively underappreciated concept in business management. Alignment is the intersection of human behavior and group psychology. It's often very difficult to describe to young entrepreneurs. In fact, it's quite rare for an entrepreneur in their 30s or even in their early 40s to fully *get* just how critical alignment really is.

Most angel investors agree that until you have been closely involved with one or two dozen early-stage companies, the full impact of alignment is underappreciated. The experience of sitting on at least a dozen boards helps the patterns sink in. The light usually goes on when you're sitting around a boardroom table, watching something negative happen, and you suddenly realize, "This is just like what happened to ABC Co in the early 1990s and XYZ Corp back in 1998."

7.2 Alignment and Exit Strategy

Alignment on exit strategy is an element of structure that most entrepreneurs rarely think about until it's too late. It can be the single biggest factor in determining whether entrepreneurs can actually realize on the value in their founders' shares.

> *It's critically important for the company founders to be aligned on their exit strategy.*

Even though the exit comes last, the exit strategy should be built into the structure of the company from its earliest days.

It's critically important that the company founders and board be aligned on the exit strategy early because the exit strategy is a prerequisite to determining the best way to finance the company.

7.2.1 Founder Alignment

Company founders should discuss and reconfirm their alignment on all important corporate issues regularly during the company's formative years. Offsite strategic planning retreats are especially valuable for these alignment checks.

7.2.2 Investor Alignment

Most of the time, friends and family investors are happy to do whatever the founders want. This is primarily due to the inherent trust involved in the relationship. Furthermore, friends and family investors usually make relatively small investments so the exit timeline isn't generally a major concern for them.

By the time the company is ready for angel investment there must be a clearly articulated exit strategy and plan. The most common problems arise when entrepreneurs who haven't clearly articulated their exit strategy obtain financing from venture capital (VC) investors. The most heartbreaking examples are when entrepreneurs receive venture capital financing and then realize that their company is an excellent candidate for an early exit.

Our goal is to be fair, and be seen to be fair, both today and for years into the future.

Early exit strategies and exits under $30 million are almost always incompatible with VC investors. In virtually every VC investment there will be legal mechanisms that allow the VC shareholders to block an early exit or any other exit that doesn't meet their criteria.

In many cases the strong VC bias toward swinging for the fences means that companies that could have exited easily in the $20 to 30 million range will end up being 'ridden over the top' and eventually worth much less or possibly nothing at all. This is a particularly heartbreaking decade-long lesson for a young entrepreneur.

7.3 Being Fair and Equitable

Being fair and equitable is much more than a philosophical or ethical principle—it is an essential part of your company's DNA. This can be summed up in a statement I have used a thousand times:

> "Our goal is to be fair, and be seen to be fair, both today and for years into the future."

Be Fair—if you were to ask 100 experienced angel investors, knowledgeable mentors or directors there would be a reasonably tight consensus on what would be fair and equitable in a given corporate situation.

Be Seen to Be Fair—is more challenging because often the people evaluating the degree of fairness are young entrepreneurs, or inexperienced investors, who don't yet have enough experience to really know what is fair. This step often requires a considerable amount of time, energy and persuasion to have everyone 'see' that an agreement is fair and equitable.

Today—is also relatively easy. At the beginning (for most companies) there is boundless optimism and enormous team spirit. This makes it much easier to build consensus on what is fair.

Years into the Future—is absolutely the most challenging. As years pass, the reality of everyone's contributions becomes clear to all. A team member who everyone expected would contribute significantly might have discovered a new interest in a completely different area. One of the founders who swore they would contribute as many hours as everyone else may elect to train for the ultra marathon (taking up 40 hours a week of 'spare time').

Building fair and equitable structures, equity ownership and compensation plans is an essential component of a successful company, and an angel investor portfolio. If people do not believe that they, or fellow stakeholders, are being treated fairly the impact on morale and performance can easily be so detrimental it is fatal to a nascent enterprise.

Being fair and equitable must be part of the corporate DNA—and is a necessary element for a company to be able to hire and retain new staff.

7.4 Vesting

Share and option vesting is one of the most important elements of corporate structure. Young entrepreneurs often create vesting formulas that introduce fatal, genetic flaws in their newborn companies.

The failure mechanism for a flawed vesting formula usually follows this scenario:

1. An entrepreneurial team forms and pledges eternal loyalty to the new venture.
2. They work shoulder to shoulder for long hours at low pay, building the value of their equity.
3. One day, one of the founders gets an offer to join 'ReallyNewCo' with the promise of new equity and a cool, new idea to become obsessed with.
4. He, or she, leaves the original team to join the new enterprise—and it's everything they dreamed it would be. The long hours and low pay are no worse, but the idea and the people are new.
5. The rest of the first team continues to grind it out doing all the hard stuff young companies need to do.
6. Then the members of the original team get together with their old colleague who regales them with stories about how much fun it is at ReallyNewCo.
7. Then a second member of the team starts to think: "These hours are arduous and the pay really sucks. This isn't as exciting anymore. My partners are doing a good job of building the value of my equity. They don't really need my help that much. My old partner sure is having fun at ReallyNewCo."
8. And he, or she, gets seduced by the next new thing.

9. At this stage, the other members of the team realize they are chumps for working punishingly long hours for low pay and the same equity that their old partners have.
10. And an exodus begins, leaving almost nobody who has the critically important experience, and who is willing to work the long hours for low pay that the original company requires at this early stage.
11. And the value of everyone's equity plummets.

Unfortunately, this happens all the time.

An exodus like this can usually be prevented by a fundamentally fair and equitable equity allocation and vesting formula. That will usually prevent this type of scenario from reaching critical mass. People inevitably come and go. What's important is treating both the people that leave and the people that stay fairly and equitably.

There is now a broad consensus on the range of equity that is reasonable for a new CEO, or other senior employee, to expect when joining a company.

Widespread employee ownership is still a relatively new concept. Even as recently as the 1980s, there was still debate on the degree to which employee equity ownership affected share value. Today, it is widely accepted in North America that companies with broad employee ownership create larger and more rapid increases in shareholder value.

After a couple of decades of experience and a few good analytical studies, there is now a broad consensus on the range of equity that is reasonable for a new CEO, or other senior employee, to expect when joining a company.

Even though there is reasonable agreement on the optimum magnitudes of equity ownership, there is still discussion on the optimum vesting formula.

In the mid-1980s, ten-year share vesting was common. As the tech equity mania gathered momentum in the 1990s it became more difficult to hire, and vesting periods got shorter and shorter. In Silicon Valley, in the latter half of the 1990s, vesting periods were often as short as 18 months.

Anyone who has built a few companies knows this doesn't make sense. It takes much longer than 18 months to build a company. Many employees do not even reach their maximum level of productivity in a new job for the better part of a year.

Interestingly, even though those short vesting periods did not make fundamental sense, they were widespread because the market for talent was relatively efficient. Companies soon realized that if they did not offer short vesting periods, they would not be successful in recruiting new employees.

Along with the equity markets, the pendulum has started to swing back. Today, common vesting periods are four to six years.

One of the challenges in discovering the optimum vesting formula is something called 'psychological vesting.' Veteran serial entrepreneurs believe that when someone is two-thirds vested, they reach a psychological turning point where the vesting of the balance of their equity is much less meaningful to them.

Experienced early-stage investors have also come to strongly believe in the 'unwritten agreement' between the company founders and the investors. This agreement says the founders will both increase the value of the investors' shares, and ensure that (at some point) they will also have a liquidity event.

Investors in companies with large founders' positions have often found themselves in situations where the founders have successfully increased the value of the shares, but have no motivation to create a liquidity event. Sometimes these founders leave the company to pursue some new venture, leaving whoever comes next with the responsibility to create a liquidity event. Investors in these situations often describe themselves as 'stuckholders.'

There is also increasing agreement that up to half the value that an investor realizes on an investment is often created during the last few months of an investment's lifecycle—during the exit. As a result, many experienced serial entrepreneurs and investors believe the fairest and most equitable vesting formula is one that makes explicit this implicit contract to create liquidity, and a value increase upon exit.

This means that the fairest and most equitable structure, and the one that maximizes the alignment between the founders and the investors, is to vest:

- 50% of the shares daily over a three year period.
- The remaining 50% when there is a sale of the company.
- All vesting for senior employees accelerates on the sale of the company.

The sale of the company is an event in which everyone in the company has an opportunity to exchange their shares for cash, or shares with effectively immediate liquidity. In this context, an initial public offering (IPO) is not a sale of the company, neither is a conversion into restricted stock. In these situations, the board should develop a new formula that recognizes the incremental or delayed liquidity created by this type of transaction.

7.5 Corporate DNA

Companies certainly have cultures. Companies also seem to have DNA. Corporate DNA, like all other DNA, determines the characteristics and success of the organism to a large extent.

Corporate DNA is formed early in a corporation's lifecycle by what the founders do and how they do it. Flaws in the DNA can lead to infant mortality or failure modes that might not be apparent for many years. But unlike most living creatures, a company's DNA can change later in life.

When investors or other new partners join a company, their DNA—their way of seeing the business, the market and acting and reacting to it—is effectively combined with the original entrepreneurial DNA. The result is a new hybrid organization.

It's absolutely essential to the health of the organization to think carefully about whether this new DNA is complimentary to, or even compatible with, the original organizational DNA. Figure 6.1 is a graphical representation of this concept.

Adding Financial DNA

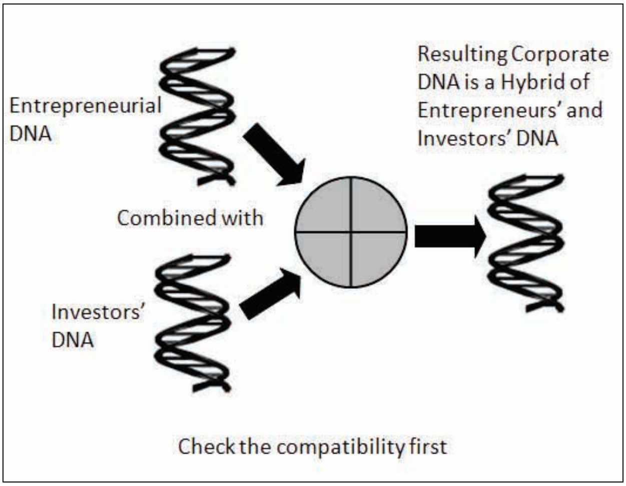

Figure 6.1. Corporate DNA

It's often not obvious that a company contains incompatible DNA until it's time to exit.

7.6 When Exits Can Reduce Value

A well-designed and executed exit transaction can substantially increase the final value of a company—often by 50% or more. Unfortunately, it's also quite common for a poorly designed and executed exit to dramatically reduce the final value shareholders receive.

I've been through these latter situations and they're not pretty. I am not going to name names here—it would be too painful for the people who were involved—but I can pass on some of the lessons I've paid so dearly to learn.

There are two common ways an exit transaction can reduce value:

1. An exit without competitive bids.
2. A poorly conceived or executed early public transaction, such as an IPO.

There are also several other situations that can reduce the final shareholder value.

7.6.1 Exits Without Competitive Bids

A lot of entrepreneurs still think that when it is time for their company to be acquired, someone will come knocking on the door. This does happen, but only about as often as someone knocking on the door of your house asking to buy it.

If you do receive an unsolicited offer to sell your company, and you think it's a good time to sell, the best strategy is to move as quickly as possible to develop competitive bidders. Unfortunately, in the majority of situations with an unsolicited offer, the board is so excited by the prospect of being acquired that they often accept the first offer.

Experienced buyers know that they can make a lower offer if there is only one bidder. I don't believe it's possible for one side of the table to convince the other side that there are competitive bids if there are really aren't. So while it might not result in a catastrophe, accepting an uncompetitive offer will often leave about 50% more than the original offer 'on the table.'

7.6.2 Going Public Too Early

A depressingly common, value-reducing exit scenario is one in which a company decides to go public too early. This is often done through a reverse takeover (RTO)—an acquisition by a public company. This has the effect of making the acquired company public. A decade ago this was a fairly common occurrence on both the OTCBB exchange in the US and the TSX-V exchange in Canada.

I estimate that in over 95% of the cases involving an OTCBB company, the long-term results did not work out well for the company. In these situations the people involved with the public company, or the 'shell,' usually retained a large number of free trading shares after the RTO transaction. Most of these shareholders were not long-term investors, and they often sold their stock over the months immediately following the transaction.

This scenario left the company management in a situation where there was much more supply of stock in the market than there was natural demand. The stock almost always fell—usually catastrophically. These companies became orphans, unable to finance again. Often they were slowly bled to death by the new public company compliance and investor relations costs. Fortunately this type of OTCBB transaction has been widely written about and is quite rare these days.

There are newer versions of the RTO model that are becoming quite popular. On the Toronto Stock Exchange-Venture Exchange (TSX-V) in Canada, over 70% of new listings are now RTOs. The TSX-V has developed a very good program called the Capital Pool Company (CPC). The TSX-V has solved all of the regulatory and structural problems with this method of going public and now has a very sensible program with a fair and reasonable degree of regulation.

Nevertheless, not all companies that elect to use a CPC are good candidates for being public. Only a small fraction of technology companies make good public companies. Entrepreneurs and boards must objectively evaluate whether their company is a good candidate for an early public listing. RTOs on either side of the border usually go bad when either the company management or board doesn't have the experience a public company requires.

Poorly conceived and executed early public transactions often occur when the board is seduced by the ease with which companies can raise the initial public financing. Unfortunately, that's the easy part.

The much bigger challenge is learning how to do all the things that are required to be a successful public company over the medium and long term. These involve setting up effective compliance and investor relations programs. If these programs aren't in place by the time the company goes public, the almost inevitable result is a dramatic reduction in the price of the stock and a corresponding reduction in the value that the shareholders receive for their equity.

7.6.3 Mergers

Another way boards and CEOs can dramatically reduce the value of their companies are poorly conceived and/or executed mergers.

In almost every situation where a merger is contemplated, the synergies look great on paper. Unfortunately, an objective historic evaluation of mergers shows that the majority of these transactions do not actually increase shareholder value.

A good large scale example was the $19 billion merger in 2002 of Compaq and Hewlett-Packard. It's always difficult to prove how much of the post-merger results can be attributed to the merger, but one telling fact is that the board, probably with the best insight, fired the CEO in 2005.

The reason value decreases is that the post-merger synergies are often not realized. Management teams need to master different skills to be good at merging companies, and the first few mergers are usually disasters for any management team or CEO.

7.6.4 Waiting Too Long

Another common mistake that reduces shareholder value is waiting too long or 'riding it over the top.' Many boards and CEOs wait until they can clearly see that their company's value has peaked before starting to execute an exit. This is a natural psychological flaw. When things are going very well, nobody thinks about selling. As soon as it's clear that the company's best days are behind it, and the future looks bleak, everyone's immediate reaction is to sell.

Unfortunately, buyers are smart and transactions always take a number of months. The acquiring team will almost always see that the company has peaked and will clearly understand the psychology of the shareholders who are now eager to sell. The buyers inevitably reduce their offers accordingly.

The best time to sell a company is when the future has never looked brighter. The additional value that can be realized on an upward trend is usually more than the ultimate increase realized if the current shareholders hang on until the peak in value is obvious.

7.7 When Things Look Really Bad—Sell

As discussed above, the best time to sell a company is when everything is going perfectly well—that is when you can get the best value for the shareholders. Unfortunately, human psychology, and the uncertainty of the future, prevents us from knowing with any certainty when that peak will occur.

Another time our psychology impairs our ability to maximize shareholder value is when things are going badly. Very often when the prospects for a company look particularly bleak, the board and CEO won't think about an exit transaction. This is because our human nature and fundamental psychology makes us think that if things look this bad nobody would want to buy.

It's surprising how often an exit transaction can take a situation that's looking particularly bleak and turn it into one where there is a modest, or sometimes even surprising, gain. A good example of this situation is the PCS Wireless transaction described in the case studies at the back of the book.

In the PCS Wireless transaction, a surprise decision about which multiple access technology was to be adopted by the large US telephone companies for their wireless telephone networks decimated the value of the company. The management team had put all of their resources behind a single strategy that looked like a sure bet. But as often happens in business, 'stuff happens.' In this situation, at a pretty low point in their vision of the future value of the company, I was engaged to look for a buyer.

The shareholders were very happy when I was able to find a buyer who saw strategic value in an entirely different application of the core technology; and we managed to execute a very good exit transaction. Even more surprising, in this situation the combined companies went on to have a multi-billion dollar market cap. The interesting aspect of this story was that the lawyer on the transaction, who agreed to be a board member, made over $5 million personally on his options. That story is included in the PCS Wireless section of the case studies.

7.8 Timing Is Everything and Luck Is Certainly a Factor

The value of a business goes up and down all the time. Often the factors that have the biggest impact on a company's short-term value fluctuation will be completely out of management's control. They will often be entirely unforeseeable. It is very disconcerting when this happens just before an exit transaction. Whether they do is most often a matter of luck.

In one exit that I was involved with recently, everything went exactly according to plan through all of the expected phases of the exit process. The management team had consistently delivered slightly ahead of plan. The bidding process had evolved in almost a textbook manner. Near the end of the transaction, the process bogged down because the buyer was involved in another acquisition. My job in that situation was to do everything possible to keep the transaction moving forward and to maintain the momentum. I pushed hard.

At the closing dinner, the lead member of the other team spent a good ten minutes roasting me for some of the tactics I had used to keep the transaction moving forward to finally get it closed. There were probably 15 people around the room and there was no question that I provided the bulk of the entertainment after the first case of wine had been consumed. The lead member of the other team was a funny guy and I have to admit my face was pretty red on a couple of occasions because he did an excellent job of making me the brunt of his ‘pushy’ jokes. This was all in good fun, typical of a successful closing dinner, and just fine with me.

None of us knew as we were celebrating that my instinct to push as hard as I did was enormously beneficial to the company shareholders. A couple of months after the transaction closed there was an enormous drop in the value of the US dollar. The company we had sold had 100% of its expenses in Canadian currency, and about 85% of its revenues in US currency. It was almost perfectly unhedged against a US dollar value change. In these couple of months after the close, the US dollar had its biggest valuation change in our lifetimes.

That exchange rate change had a devastating effect on the profitability of that business. I wasn’t privy to the financial performance of the business post-transaction, but I knew the company well enough to be able to run the numbers in my head. The change in the value of the business had probably been halved in just a couple of months. This was nobody’s fault and it was entirely unforeseeable. Nobody knew the currency was going to shift like that.

In this situation, the purchaser had actually been much smarter than the previous shareholders and had built a considerable hedge into the business post-transaction. Nevertheless, the change in the value of the business from the seller’s perspective was sobering. The previous shareholders had dodged a bullet. In many other situations where I’ve been a shareholder, luck moved against us instead of in our favor as it did in this case.

The important moral to this story is that ‘stuff happens.’ If the sellers are happy with a selling price the best strategy is to push as hard as you can to get the transaction closed and the cash in the bank. You never know what kind of stuff is about to happen.

8

Exit Planning

Every company needs an exit strategy and an exit plan. Ideally, the exit strategy should be agreed upon by the founders before the first dollar of investment goes into the company.

Successful exits require careful planning, well thought out strategies and excellent execution. This chapter describes the elements of a good exit plan.

"Know when to fold 'em"

8.1 Start at the End

Every company needs an exit strategy and an exit plan. Ideally, the exit strategy should be agreed upon by the founders before the first dollar of investment goes into the company. This is especially true today in an environment in which early exits are such an attractive option for many technology companies.

Om Malik, in a great article titled "The New Road to Riches" published in *Business 2.0* in October 2004, describes the following as one of his 'Rules of the New Road':

> "KNOW WHEN TO FOLD 'EM
>
> Establish a business plan with a two-year maximum. Develop technology in the first 12 months, and spend no more than the next 12 developing partnerships, building sales, and finding a buyer. If you don't have decent prospects in 24 months, think about finding another startup niche to pursue."

These days companies are often sold only two or three years after they are founded. With exit transactions taking anywhere from as little as four to five months, to as much as eighteen months, it's easy to see that there can't be much of a delay from securing the financing to starting to work on the exit.

Of course, in many cases it will take longer than two or three years to optimally exit. But this doesn't reduce the need for an exit strategy before the first dollar is invested, and continuous work on the exit plan until the day the company is sold.

8.2 It's Just Another Business Process

Selling a company is just another business process. Designing and executing the exit well can easily make half again as much money as all the hard work that goes into every other business activity, so it is often the most lucrative of all business processes. It can also be the longest and the most complex.

Managers know that every other business process needs a plan and regular monitoring. The exit transaction is no exception. It requires an organization's very best strategy development, planning and execution.

8.3 The Entire Purpose

Looking at it in the simplest terms (or as an investor would) Figure 7.1 shows a company as simply a black box with inputs being the entrepreneurs' effort and the investors' cash. The only output is the purchase price paid by the ultimate buyer.

Simple Model of a Company

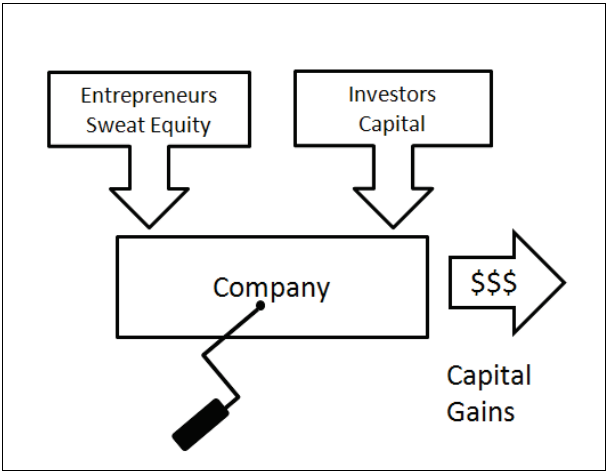

Figure 7.1. Simple model of a company

Everything happening inside the black box are simply the details driving toward the single output—a successful exit. While this is an enormous simplification, it is clearly the purpose of most externally financed technology companies.

8.4 Build It and They Will Come—Not

The classic joke for entrepreneurs and managers involved in product development is 'build it and they will come.' In the 1980s, there were several well-known management gurus who wrote books and made good livings on the lecture circuit advising entrepreneurs and managers to listen to their customers before starting to build new products or services. Today, almost everyone agrees that a strategy of 'building it and hoping they will come' is laughably ill-advised.

Yet the same entrepreneurs and managers will quite happily build a company hoping that one day a 'buyer will come.' It's an equally bad idea. To succeed in any business process, you have to start at the end. Clearly articulate the desired outcome, then plan and execute accordingly.

For almost all externally financed technology companies the ultimate goal is to sell the company. To achieve this most important goal, and do it well, the exit strategy and the exit plan have to become part of the corporate DNA. The exit strategy must be clearly articulated, recorded and reviewed regularly. The exit plan is arguably the most important business process in the company. With these processes clearly established, and with good attention to the process, your company will exit earlier and for a better price.

8.5 The Three Big Questions

Inevitably when a board decides to sell a company—or even as soon as they decide to think about selling the company—three questions arise.

1. How much can we sell for?
2. How long will it take to sell?
3. Who should execute the exit?

The following chapters shed some light on each of these questions for typical M&A exits.

9

Valuation

Agreeing on valuation requires the buyer and seller to have a common view about what the profit margins are likely to be in the future and how fast they will grow.

It's not a simple matter to provide a general formula about pricing companies. It's much easier to say something like "a well-designed and executed exit transaction can easily add 50% to the selling price." A statement like that can apply across a wide range of companies and still have some validity.

It's difficult to give general guidelines about company valuation because there are so many different types of companies and so many different metrics that can be used. There are dozens of excellent books devoted just to the topic of company valuation.

9.1 Market Conditions

Valuation is also a difficult topic because values vary depending on market conditions. Changes in value can occur because certain types of companies are in greater demand or because some sectors are perceived to be more attractive by acquiring companies.

In the past few years Web 2.0 companies have been in high demand. Companies like Yahoo, Google, Cisco and eBay bid up the prices for these types of companies because they wanted to buy them faster than entrepreneurs could add to the supply. As a result, it's been both relatively easy, and relatively lucrative, to sell some types of Web 2.0 companies recently. In earlier times, online storage, software-as-a-service, online advertising and blogging platform companies have all had valuation peaks as demand grew faster than supply, or as those sectors were perceived to be 'hot.'

9.2 Valuation Principles

That said, the basic mechanics of valuation are straightforward. In financial terms, the value of any business is the present value of the future income stream the company will generate. The present value calculation factors in the discount that someone would pay today for a stream of income in the future.

For example, let's imagine a company that generates $1 million in profit every year. A $1 million profit next year is worth pretty close to $1 million today because you'd only have to wait a year to get it. If you could get an 'interest rate' of 10% per year, then you'd value $1,000,000 in a year at around $900,000 today (i.e., its present value).

But $1 million of income ten years from now is worth considerably less. If it's almost certain that the $1 million would actually be there in ten years, then the discount is pretty close to the interest rate that you could earn on the money over the ten year period. For example, Figure 8.1 shows the present value if the interest, or discount, rate was 10% and the company generated $1 million in profit for the next ten years and then shut down.

	Profit in the Year	**Present Value of this Year's Profit**
End of this year	$1,000,000	$900,000
End of next year	$1,000,000	$810,000
Three years from now	$1,000,000	$729,000
Four years from now	$1,000,000	$656,100
Five years from now	$1,000,000	$590,490
Six years from now	$1,000,000	$531,441
Seven years from now	$1,000,000	$478,297
Eight years from now	$1,000,000	$430,467
Nine years from now	$1,000,000	$387,420
Ten years from now	$1,000,000	$348,678
Total Present Value		**$5,861,894**

Figure 8.1. Simple valuation model with zero growth

Unfortunately, in real world situations, it's never that simple.

The first complication is that companies are either growing or contracting. So if the income from the company was $1 million last year, the only thing you can be sure of is that it's not going to be $1 million again next year. Companies with high growth rates are worth much more than companies that are growing more slowly. If the discount rate is still 10%, but the company's profits are growing at 25% per year for ten years, the numbers would look like those in Figure 8.2.

Save yourself the aggravation and find someone with experience to give you an accurate number.

	Profit in the Year	**Present Value of this Year's Profit**
This year	$1,000,000	$1,000,000
Next year	$1,250,000	$1,125,000
Three years from now	$1,562,500	$1,265,625
Four years from now	$1,953,125	$1,423,828
Five years from now	$2,441,406	$1,601,807
Six years from now	$3,051,758	$1,802,032
Seven years from now	$3,814,697	$2,027,287
Eight years from now	$4,768,372	$2,280,697
Nine years from now	$5,960,464	$2,565,785
Ten years from now	$7,450,581	$2,886,508
Total Present Value		**$17,978,568**

Figure 8.2. Simple valuation model with 25% growth

In this case, the present value of a company with $1 million in profit this year, but a 25% growth rate, is actually worth almost $18 million, or three times as much as the example with no growth. In this case, the price earnings multiple, or P/E ratio, is about 18x.

Note to Math Purists: These present value calculations here are simplified to make them easier to follow. If you use the Net Present Value (NPV) formula in Excel, the numbers will be slightly different.

There are numerous complicating factors that go into the valuation of a company. It's not something you can just read up on or learn on your own. Save yourself the aggravation and find someone with experience to give you an accurate number.

9.3 Predictability

Another significant and difficult to quantify factor in company valuation is predictability. Even if a company has been growing at 25% per year for the past several years, there is no way to be sure that growth rate will continue. The management team may be confident that the growth rate will be even higher in the future—and may say so enthusiastically to potential acquirers. The buyers, however, will be skeptical. And one can't blame them for being concerned that the growth rate might decline in the future.

This uncertainty in the future projections creates another type of discount factor on the valuation. The predictability discount becomes very subjective and everyone involved in a transaction will have a different perception of what the fair predictability discount should be. For mature stable companies, it might not be a very significant part of the valuation calculation. In valuations of technology companies, especially young ones, this factor can create an enormous divergence in the perception of the fair value.

9.4 Profitability

Valuation gets even more interesting when the company and its business model have yet to be proven in the market long enough to establish profitability margins. A large percentage of the companies that are sold in the technology area have yet to reach profitability, or are growing too quickly to generate any significant profit. Agreeing on valuation requires the buyer and seller to have a common view about what the profit margins are likely to be in the future and how fast they will grow. It's easy to see how the difficulty in predicting these future financials can lead to wide variations in what different people think is the fair value.

9.5 Pre-Revenue Companies

At the very earliest stages, companies may not even have revenue. In these cases they are being sold entirely for the perceived future value of their intellectual property (IP). A good case study for this type of exit transaction is Brightside, a Vancouver company that developed technology to increase the brightness of large liquid crystal displays. In this case, the company had effectively zero revenues, but was nevertheless sold to Dolby Labs for $28 million in cash. This was entirely based on Dolby's belief that the company's patents and IP would enable them to build a future stream of licensing revenues that would more than justify the $28 million purchase price. Brightside is one of the case studies in the Appendix.

There are a couple of models to value pre-revenue companies but they really aren't very useful. Pre-revenue valuation is much more of an art than a science. The best way to determine a current, fair value is to find someone with the experience, and current knowledge of your market, to give you a number.

9.6 Comparables

In practice, the challenges of developing even limited consensus around a company's future growth rate, profit margins and predictability often make the whole financial model exercise too challenging to be useful. As a result, most of the time, both buyers and sellers resort to much simpler math.

The easiest way is to use comparables. Comparables are used every day by professional analysts who work for stock brokerage firms. The analysts' job is to examine individual companies and then put their current valuation in perspective by comparing them to similar companies. Through analyses like these, it's possible to generate broadly applicable rules of thumb, or multiples, to value similar companies. The most common multiples for tech companies are price to earnings ratios (P/E) and price to sales ratios (PSR).

For example, it's easy to say that on average, in low interest rate environments, mature companies could be fairly valued at P/E multiples of five to six or a PSR of one (depending on their growth rate and profitability).

For younger companies, earnings are often non-existent or extremely volatile. In these situations, most valuations are based, at least in part, on multiples of revenue. For example, these days software-as-a-service companies are regularly valued in the three to four times revenue range (PSR = 3-4). This relatively high revenue multiple is thought to be reasonable because these companies have a high percentage of recurring revenue and good margins. It is also believed that market growth will enable these companies to grow faster than other tech companies.

On the other end of the spectrum are service companies that are essentially 'body shops.' These companies can only grow as fast as new employees can become productive. Typical examples are web design firms, management consultants and human resource companies. These types of companies are often valued at PSRs of 0.5

or P/E multiples as low as three or four. This is also partly because the revenue predictability of these types of companies is low and because they usually have small percentages of recurring revenue.

9.7 Other Multiples and Factors

Every industry, and every type of company, also has its unique multiples based on key performance indicators (KPIs) applicable to that industry. For example, with Web 2.0 companies, some analysts reference the company price to the number of unique visitors per month, and multiples based on Alexa rank. Almost any metric can be used to build a valuation model.

The easiest and fastest way to get an idea of what your company might be worth is to find someone who has been doing exit transactions for similar companies. You will need to share with them enough of your numbers so they can apply the applicable multiples to give you a first pass estimate of your company's value.

The only other alternative is to do some research yourself. This is often not very satisfying because many of today's smaller transactions are not even announced, and the ones that are rarely disclose enough information to be a useful comparable.

As a final note, the price achieved on the sale of a company can be significantly skewed by the quality of the exit design and execution. This is especially true in transactions under $20 million because these are often young companies with little history. These companies can also have a much broader range of potential strategic values for different acquirers. With these smaller transactions, the skill of the business broker, or merger and acquisition (M&A) advisor, has a much larger effect than it would in the sale of a large established company with predictable profit margins and growth rates.

10

The Exit Timeline

From the time that all of the sales collateral is complete until the cash is in the bank, the exit process can take as little as 4 to 5 months and as long as 18 to 24 months.

An exit transaction will often change the lives of many of the individuals involved. For a founder, it's often the transition from being a starving entrepreneur to having large amounts of cash in the bank. For some shareholders, the exit may be the event that starts to make them think seriously about retirement. For almost everyone it's a significant milestone. This often makes the question of how long the exit will take a more interesting question than how much the company will be sold for. Fortunately, it's often easier to estimate how long an exit transaction will take than the company's selling price.

Exit transactions are classic 'complex sales' as defined by the famous Miller Heiman books. They are also often the largest of all types of sales.

The biggest difference between the sale of a company and sales in general is obvious—with the sale of a company there is only one item to sell. The flipside, of course, is you only need one buyer. This creates the opportunity for a bidding process that can often generate a significant increase in value.

10.1 Preparing To Sell

There are several steps that need to be completed before the M&A advisor (or business broker) and sales team can actually start selling the company. These steps include the preparation of:

1. An excellent selling document.
2. An executive summary or teaser document to introduce the company.
3. Current and historic financial statements (preferably audited).

4. A solid PowerPoint presentation, and ideally a video.
5. Complete due diligence materials preferably available online.

At the earliest stages of the prospect identification and qualification process, potential buyers might ask for a two-page executive summary, online PowerPoint or video, or even the full selling document. These requests are usually the outcome of a successful initial email or phone contact. To avoid losing momentum in the sales process the executive summary, PowerPoint or video and selling document should all be ready to send before starting to contact prospective purchasers. The set of due diligence materials can usually be completed over the next few weeks.

10.2 Building The Sales Funnel

Once the sales collateral is polished, serious work can begin on building the sales funnel—the sourcing of prospects and qualification of the most likely buyers.

Today, the job of building a list of prospects is much easier and faster than it was in the pre-Google era. A decade ago, large stock brokerage or investment banking firms had a distinct advantage in doing exit transactions because they had proprietary databases of companies that might be interested in acquisitions. Now, with so much information being available online, this is no longer a significant competitive advantage. Even in the largest organizations, the individual M&A advisors will probably start with a Google search to build the sales funnel. Building the initial list of possible purchasers should only take a few weeks.

10.3 Initial Contact

Once the top of the sales funnel is populated with prospects, the much harder work of making the initial contacts can begin. In earlier times, exit transactions often required a warm introduction or some other high-level connection into the prospective acquirer. This has changed a lot in the last decade or two. Potential acquirers now often have entire departments focused on M&A transactions. These will include some relatively junior members whose job includes being easy to contact. After the first call with the junior member, assuming there is a possible fit, it's a fairly straightforward process to earn a conversation with a more senior decision maker.

Here again we see the effects of the Internet—faster timing and reduced costs.

In the pre-Google era, reputation, like all other forms of information, propagated much more slowly and with much higher resistance. If you weren't known to one of the senior decision makers, you could spend a month or more just getting the first call. You often had to find someone who knew you and get them to make an introduction before you could even get past the gatekeeper. It was like using LinkedIn by snail mail.

In my first exit transaction, when we sold Nexus Engineering to Scientific Atlanta, we actually paid a considerable amount of cash to someone who had creditability with Scientific Atlanta to let them know that we were 'in play.' Back then, it was not easy to get to speak to a decision maker at a Fortune 500 company, so my board and I agreed it was a good use of our company's capital to spend quite a few thousands of dollars just to convey a few dozen words to the right recipient. Today I can't imagine any board agreeing that such an action would be a good use of company resources.

Here again we see the effects of the Internet—faster timing and reduced costs.

These days, it's not unusual for a busy executive to Google someone before they decide to accept the call. Sometimes you can hear them typing your name into a browser during the first few seconds of pleasantries—then they are asking whether you might have a mutual friend who was also at some company while you were there or belongs to the same organization you do. With so many of us having online profiles, blogs and personal websites, it is now fast and easy to decide whether someone who has emailed or called is worthy of the time required for a call. This is another factor that has significantly reduced the time required to complete an exit and makes it easier to execute exits under $30 million.

10.4 Where Things Always Bog Down

Up to three-quarters of the total time required for a typical exit transaction involves waiting for people to respond. Unfortunately, the Internet hasn't made this aspect of our workday much better. The people who buy companies are always busy.

As a result, even after you establish interest, it can easily take more than a week to schedule the next call. To make matters worse, these people are always involved in large, complex transactions. It's not at all uncommon for them to cancel a call that has been scheduled for a week or to be completely unavailable for weeks at a time. The result is that a lot of the hard work executing an exit is devoted to the scheduling challenges of arranging calls with multiple decision makers on each side of the transaction. This means that the qualification process can easily take several months.

This isn't all bad news. If the people executing the sale are doing a good job they might qualify 50 to 100 prospects and manage to guide 10 to 20 through the middle of the sales funnel. These 10 to 20 will reduce to a short list of two or three final bidders. The prospect of working 50 to 100 suspects down to 10 to 20 prospects can easily take two full-time people two to four months.

10.5 The Bidding Process

One of the ways that a well-designed and executed exit transaction maximizes price is by extending the bidding process just a little bit longer. Exit veterans know they have done a good job when, in the final couple of months, the price being offered increases 10-20% or more. This is done by skillfully and tactfully letting each of the prospective buyers know they are in a competitive bidding situation.

When things are going perfectly, the management team is also continuing to deliver monthly financial results that are slightly ahead of the projections that were given to potential buyers earlier in the sales process. When the management team continues to deliver results just a little bit better than projections, and the selling team has done their job in building a list of enthusiastic prospects, the bidding cycle can take anywhere from a couple of weeks to a few months.

In a recent transaction I worked on, the price went up more than 15% in the final month. Some of the board members were ready to take the first offer because it was already above the goal price that had been set in the exit plan. We convinced them that the price could be significantly higher if they would be just a little more patient. That patience paid off handsomely for all shareholders.

10.6 Due Diligence

When the materials are prepared well, and are available in an electronic data room, due diligence can often proceed in parallel with the final negotiations during the last month or two of the selling process. Unfortunately, if there are any gaps or unanswered questions, the entire sale can quickly grind to a halt while everyone waits for a satisfactory answer.

As a result, due diligence can last anywhere from a couple of weeks to several months.

10.7 When the CEO Becomes the Limiting Factor

For the first third to half of the sale process, the M&A advisor, or business broker, will do most of the prospecting and qualification work. The CEO's schedule is usually only impacted by the occasional conference call and online presentation.

In the later stages of the sales process, especially during the final bidding and due diligence process, the CEO will be required in almost every meeting. If the M&A advisor or business broker has done a good job and there are two or three active bidders, each appreciating they are in a competitive situation, the CEO will be stretched to his or her absolute limits just to schedule the meetings with the potential buyers. At the same time they will also be trying to manage the business, which was a full-time job just a few months earlier. At these later stages of the transaction, the CEO's schedule and stress level will often be the limiting factor, and tends to determine how fast the sale can move forward.

10.8 Total Elapsed Time

From the time that all of the sales collateral is complete until the cash is in the bank, the exit process can take as little as 4 to 5 months and as long as 18 months. There is a general tendency for larger transactions to take longer.

Often the biggest factor in determining whether the sale comes about in six months or eighteen months is just how busy everyone is. When M&A transactions are hot, like they were in the middle of 2008, it can easily take two or three times as long to schedule every interaction. The cumulative effect of these communication delays can make all the difference between a sale being completed in six months or a year.

11

The Exit Team

In the vast majority of exits where shareholders receive a good price for their company, there is an experienced business broker or M&A advisor.

Good exits are executed by a team of players who all have different roles in the process. One of the most important decisions is who should lead this team. The best choice is usually a professional merger and acquisitions (M&A) advisor or business broker. It can sometimes be an investor or a board member, but it should almost never be the CEO.

11.1 The CEO Should Never Lead

The slide in Figure 10.1 is from Roger Killen's *99 Milestones Seminar* and nicely summarizes the key point about the exit transaction team—you'll have a much better chance of actually making the sale if you employ a professional.

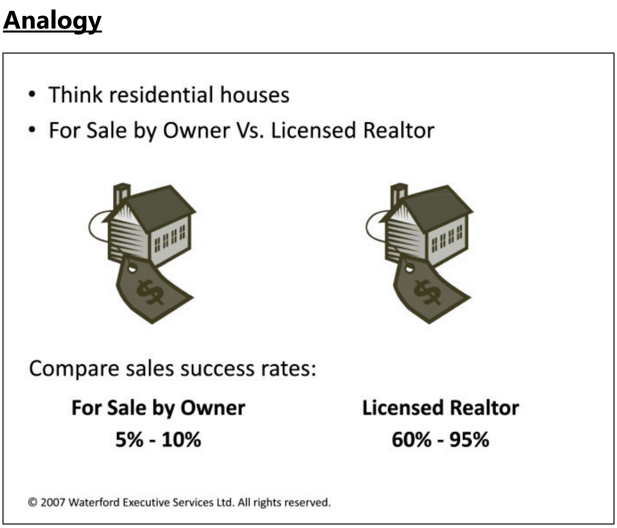

Figure 10.1. A professional will increase the probability of a sale

There are several reasons the CEO shouldn't lead the exit process.

- If there is ever a time the CEO needs to be focused on the business it is in the months leading up to the exit.

- The vast majority of CEOs don't have nearly enough exit experience to be the best lead.
- Most CEOs are just too close to their own companies to be capable of doing what it takes to maximize the price.
- There is an irreconcilable conflict of interest in many situations.

11.1.1 The CEO Must Focus on the Business

Exit transactions are an enormous amount of work. When CEOs think that they can manage the exit along with all their other responsibilities, the shareholders end up regretting it in nearly every situation. Inevitably the CEO will underestimate the amount of work required to lead the exit. And as fate almost always has it, just as the exit transaction gets going, something unexpected will happen in the business that desperately needs the CEO's focus and attention.

The financial results in the months leading up to the final pricing negotiation are the most important in the company's history. In every exit situation that I have been part of, the potential acquirers are focused more intently on the monthly numbers leading up to the final exit negotiation than the management team or board ever was.

It's also quite common to see a CEO or CFO scrambling to find an answer to an anomaly in the numbers that the potential buyer has discovered, but which has been completely overlooked by the management team. This isn't a big surprise; people who buy companies are smart and will have spent an enormous amount of time analyzing the prospective company's numbers from every possible perspective.

In the most successful exits, the team leading the transaction does everything possible not to burden the CEO unnecessarily, leaving him or her free to focus on squeezing every last bit of performance out of the organization. In these happy situations, the numbers that come in during the months leading up to the exit are always a little bit better than the projections, enabling the exit negotiating team to increase the final selling price. Even a slightly better performance in these final few quarters can easily add 10-20% to the final value of the company. This increased value occurs not so much because the overall size of the company has been increased, but because the growth rate of the company has been validated by the most recent numbers.

The opposite can also happen. I have watched situations in which the CEO became embroiled in the exit transaction and ultimately delivered numbers that were just a little below projections every month leading up to the final transaction. The prospective acquirers were disappointed every month, and the value of the exit dropped in the range of 10-25%. These situations are especially unfortunate because they're avoidable if the board and CEO adequately resource the work required on the exit transaction. It's almost always a mistake to think the CEO and CFO can handle their regular, full-time jobs, plus the additional work the exit requires.

11.1.2 CEOs Rarely Have the Experience and They're Too Close

There are only a small number of CEOs who have enough experience with exit transactions to be good at them. This is often because when someone has completed enough exits to be really good at them, they don't want to be a CEO any more.

It is also almost always the case that the CEO of a company ‘cares too much.’ It is natural for CEOs to become emotionally invested in their companies. During an exit negotiation there are always times when the potential acquirers will be less than flattering about the company as they employ a range of tactics to get a better price.

Only a small number of people excel at very large transactions. For most people, and even most CEOs, when the numbers get larger, confidence falters. Some CEOs might be completely comfortable negotiating a multi hundred thousand dollar sale of their product, but get a lump in their throat when a prospective buyer for their company starts grinding on sales prices that are in the tens of millions of dollars.

At these points in the process, the selling team needs someone with a great deal of experience and just the right amount of dispassionate disinterest. At certain points in most sales negotiations, the price can easily move up or down by 10-20% or more. It is primarily the skill of the person negotiating the exit that determines where, within that range, the final price will fall. Often it is during the final hours of price negotiations that the business broker, or M&A advisor, earns the shareholders many, many times the fees they charge.

11.1.3 The CEO Is Usually Conflicted

Today, shareholders, directors and CEOs are far more attuned to the realities of conflict in corporate situations. One of the most detrimental conflicts can arise when a CEO leads the exit negotiations for their company.

It is surprising how often good boards will overlook this fundamental—and usually irreconcilable—conflict. I am amazed by how often I see a situation in which the CEO (and others from the management team) is leading the negotiation on both the exit price and their post-acquisition contracts.

It's almost never a good idea for the CEO to lead the exit.

The reason CEOs are conflicted in an exit negotiation is because on one hand they are trying to do the very best job they can for their current shareholders, but on the other hand the people they are negotiating with are going to be their new shareholders—and likely the people who will determine their salary and equity incentives going forward. This is especially challenging because during the exit negotiation the acquirers will inevitably want to retain the CEO and other members of the C-level team—at least initially.

Experienced and dispassionate directors and shareholders know that management teams can very often end up effectively blocking a transaction they don't like. Many people think this happened recently when Microsoft offered to buy Yahoo. It even caused Carl Icahn to accuse Jerry Yang of a conflict of interest, and he tried to have Yang removed as CEO. This problem arises much more often with small- and medium-sized companies than with big ones like Yahoo. Often what is best for the shareholders is not the current CEO's first choice.

Another conflict arises in smaller exits because the economic value of the CEO's severance package, next few years of cash compensation and new option grants can be in the same range as the value of his or her equity. This clearly puts the CEO in an irreconcilable conflict of interest if he or she leads the exit. It is unrealistic to expect a CEO not to at least subconsciously prioritize the maximization of personal gain.

Even if the CEO could do a perfectly objective job of negotiating the best price for the shareholders, while only being fair with regard to their own package, there is no way to show that good governance has actually been followed. The only way to show that the shareholders have been treated fairly is to have a representative of the shareholders (or someone completely objective and motivated only by maximizing the sale price) lead the exit transaction.

In one recent exit I am familiar with, the CEO drove the buyers to the point of slamming their briefcases on elements of his personal contract. The transaction did not close and the buyers told me they gave up simply because of the CEO's compensation demands. That CEO felt he was in a very strong position and the buyers felt they were being held for ransom. The board of that company never knew why the deal blew up and the CEO never told them. Any board that lets the CEO exclusively lead the exit is, in my opinion, doing a very poor job at best and is negligent at worst.

This happens much more often than most directors realize because the stories of these inappropriate, conflict-riddled negotiations are rarely made public. It's almost never a good idea for the CEO to lead the exit.

11.2 The Job of the Business Broker or M&A Advisor

In the vast majority of exits where the shareholders received a very good price for their company, there was an experienced M&A advisor involved. The two terms are, for most practical purposes, interchangeable. The truly excellent exit professionals will:

- Shorten the time to exit.
- Save a transaction that otherwise would have not closed.
- Regularly increase the final selling price by 25-50% or more.

11.2.1 Protecting the CEO

One of the important jobs of the business broker is to protect the CEO, to the maximum extent possible, from the incredible burden of the exit transaction process. There is no way around the fact that potential acquirers will want to spend a lot of time with the CEO—he or she knows the business best. The CEO will also be the most important part of the team post-transaction. All the current shareholders need the CEO and every member of the team to be delivering their very best performance in the months leading up to the exit.

Even with an excellent advisor or broker, the CEO will still be stretched to his or her limits by the process of working the short list of candidates through the final bidding process, selection and closing.

Even the most capable, resilient, organized and effective CEOs will be completely exhausted by the end of the exit—even with an outstanding advisor or broker. The best advisors and brokers will burden the CEO the least.

11.2.2 Building the Sales Funnel

A well-designed and executed exit transaction often starts with a list of 50 to 100 prospects. It is the advisor's job to make the initial contacts and provide the first several layers of information to these organizations as they work through the sales funnel. It is only when potential acquirers have been fully qualified that they should be allowed to interact with the CEO.

11.2.3 Maximizing Price and Minimizing Time

The best advisors have the skills and experience to maximize the price and minimize the time to get the cash in the bank.

It's very difficult to quantify how much a good business broker, or M&A advisor, can increase the final selling price or reduce the total transaction time. This is one of those all-too-common situations in business where it is impossible to do a double blind study or accumulate a statistically valid sample set.

While there is no way to validate this, I believe a really 'good' M&A advisor can often increase the final selling price by 25-50%, and reduce the total transaction time by a third.

11.3 Pulling a Rabbit Out of the Hat

Perhaps a dozen times in my career, I've been around a table working on an exit transaction that just seemed like it could not be done. Some structural, valuation or legal hurdle just seemed insurmountable.

Occasionally, out of the blue, someone threw an idea up on the whiteboard—and time would stop. In the ensuing few moments of silence everyone appreciated the brilliance of the solution. Momentum rebuilt, the transaction moved forward.

These eureka moments are difficult to convey to someone who hasn't experienced both the despair of the situation and the elegance of the solution.

Every transaction needs a bad guy.

Most of the time these brilliant solutions to what seemed like insurmountable problems come from the advisor or broker who has 'been there and done that' many times before.

11.4 Every Transaction Needs a Bad Guy

Every complex transaction needs a 'bad guy.' The bad guy has several jobs, the most important of which are to:

- Get the transaction closed as quickly as possible.
- Get the best price and terms possible.

Perhaps the biggest value the bad guy provides is to maintain transactional momentum. There are so many individuals involved, and so many moving parts, in an exit transaction it's very easy for things to become stuck, sometimes for no reason other than simple human exhaustion. At times, there are sticking points where the only solution is the negotiating equivalent to a case of dynamite. These are normal occurrences in every exit transaction; often the only way through is with the appropriate amount of red-faced table pounding. Having good skills as a bad guy is indispensable in executing good exits.

At some point in the latter stages of most complex transactions, when the selling team is maximizing the price, someone has to have the job of pushing the buyers for that last few million dollars.

In almost every transaction, the professionals on both sides know that the job of the other team is to get the best deal possible for their side. Everyone wants to win.

The negotiating tactics that work best are those with one bad guy and one good guy. The bad guy pushes hard while the good guy watches carefully to see if the other side reacts more than expected, ready to jump in and smooth things over. The good guy's job is to ensure things don't get out of control.

Depending on the size of the team there are often different times when different team members will be the 'bad guy.' Sometimes the person who pushes to maximize the price won't be the same person that pushes to close the transaction soonest. With smaller teams, sometimes there is only one choice for the bad guy, and that person will have to do all of the unpleasant work.

The only rule about the bad guy is that they should never be the CEO. The CEO needs to have a good relationship with the buyers post-transaction, so it's never a good strategy to have the CEO take on any of the bad guy role during the exit transaction. Not only is it unfair to the CEO because it damages the relationship with his or her future bosses, it's just bad business practice.

The best and most experienced bad guys are the professional M&A advisors or business brokers.

12

Exit Costs

It's much easier to understand the pricing mechanisms for exit transactions if you look at it from the perspective of the professionals doing the business.

12.1 Professional Fees

It's surprisingly difficult to get information about the professional fees on exit transactions. Few professionals post their rates. I am not sure why this is, and even less sure that it makes sense in today's hyper-connected world.

12.2 Fees and Transaction Size

M&A advisor and business broker fees increase with the size of the transaction, but not in direct proportion. The amount of work required to complete a larger exit is not that much more than the amount of work to carry out a smaller transaction.

Where the relationship between fees and size becomes interesting is at the smaller end of the transaction size range. The professionals that do merger and acquisition (M&A) transactions fall into three rough categories. At the upper end of the range, there are the investment banks and accounting firms that have teams devoted to M&A. In the middle range there are boutique firms that usually include three to seven professionals. At the smaller end of the transaction range, most exit transactions are performed by individuals, or two to three person firms.

It's much easier to understand the pricing mechanisms for exit transactions if you look at it from the perspective of the professionals doing the business. Very large firms have offices in downtown towers with real human receptionists and assistants. The boutique firms have smaller offices in less expensive buildings and have automated phone attendants and no assistants. The individual professionals answer their own phones.

For a transaction to make sense for the big firms with downtown offices the total fees have to be in the $1 to 2 million range. For the boutique firms the minimum fee size is in the $500,000 to $1 million range. Individual practitioners can afford to do exit transactions where the fees are only a few hundred thousand dollars.

The big firms will compete most aggressively for exit transactions above $100 million because these transactions will produce several million dollars in fees. The $20 to 75 million range is the optimum range for the boutique firms. Smaller transactions are usually done by individuals. These numbers shift up or down depending on how busy the firms are.

The standard business brokerage, or M&A advisory, fee model includes a work fee, a success fee and a contingency or break fee.

12.2.1 Work Fees

Work fees are paid by the company up front or sometimes monthly over the first four to six months. This fee covers the professionals' direct costs during the initial stages, as well as their contribution to the preparation of the selling documents and due diligence materials.

For larger transactions, the work fees are usually $100,000 or more. For boutique firms working on a $20 to 30 million exit transaction, the work fees are usually in the $50,000 to $75,000 range. At the lower end of the transaction spectrum, the work fees don't usually go below $50,000 because no matter how small the transaction, there is still a fixed amount of early work that has to be done.

It's very unusual for a firm, or even an individual practitioner, to undertake an exit transaction without a work fee. Part of the reason is that anyone involved with exits has seen a situation where, at the time of the initial engagement, the shareholders and board are enthusiastic about an exit, but by the time an offer gets to the table the shareholders have reconsidered. Often this happens precisely because the advisor or broker has done a good job and shown the current shareholders that the company is worth significantly more than they thought. This alone can often result in shareholders changing their minds and deciding to continue to own the company for a while longer. The work fee is a fair way for the professionals to protect their initial investment of time. It is also a test of how serious the sellers are in actually selling the company.

While the amount of work required to perform exit transactions is similar whether the company is valued at $5 million or $100 million, the fees for large brokerage houses are higher due to their overhead and prestige.

12.2.2 Success Fees

Success fees for exit transactions in the $10 to 30 million range are typically 4-6% of the final exit value. This means that the business broker who successfully completes a $25 million exit transaction will usually be paid a fee at closing of about $1 million.

For transactions over $100 million, I have heard of success fees that are in the 2-3% range. This means that an M&A advisor executing a $100 million exit will typically receive a success fee in the $2 to 3 million range.

Where success fees become more challenging is in the smaller transactions because the amount of work required to execute a $5 million exit is not significantly less than the effort required for a $25 million exit. It takes just about as much manpower in either case, and in some ways the smaller sizes can actually be more work.

Let me explain. It can be even more difficult to sell a $5 million company than a $25 million company because the buyers for smaller companies tend to be either the junior people in the large company acquisition team or the CEOs and CFOs of medium-size companies. Their relatively lower experience levels and/or lack of availability means that these transactions often take more time for the advisor or brokers. So even the smaller boutique firms will be reluctant to undertake an exit transaction in which the selling price will be less than $10 million. Even at a 6% success fee, a $10 million transaction will only deliver a $600,000 success fee. This is approaching the minimum economic size that even the smaller firms can undertake. This is why transactions in the $5 to $25 million range are often done by individuals who have developed expertise in this area.

Because of the amount of work involved in a $5 million transaction the success fees are often in the 7-10% range.

While the amount of work required to perform exit transactions is similar whether the company is valued at $5 million or $100 million, the fees for large brokerage houses are usually higher because of their overhead and prestige.

12.2.3 Break Fees

For the same reason that work fees are charged, it's common to see a break fee paid to the professionals in an exit transaction. A break fee can be payable if a professional is engaged to execute an exit transaction and they bring a legitimate buyer to the table, but the shareholders decide not to sell. In this case, the business broker receives a payment that is a partial compensation for the work that was done. This can range from one-quarter to one-half of the entire success fee depending on the situation.

12.3 Legal and Accounting Fees

Legal fees on an exit transaction relate much more to complexity than to transaction size. If the company has done most of the work to organize the documents, the legal fees on a small exit transaction might only total $50,000 for both the buyer and the seller. For more complicated transactions the fees can easily become a significant fraction of $1 million.

Accounting fees can be even higher than legal fees depending on what type of statements the company has been producing. Most large company buyers will insist on audited financial statements. Depending on whether a company has been producing audited, review or notice to reader statements, the accounting costs can easily be over $100,000.

13

Getting Ready To Sell

In the most successful exits, the company should be delivering its peak performance for the months leading up to the final price negotiations and closing.

In every exit transaction this question inevitably comes up: when do we tell various groups of employees we are selling the company?

It is surprising how much anxiety there is around this question. Some people think employees shouldn't be told until the closing. The rationale is usually due to concern about the apprehension the sale would create within the workforce. Some people simply think it's 'none of their business.'

Ultimately everyone is going to know the company is for sale. It is impossible to keep something like that secret for long. Even in a company where the employees are used to seeing teams of outsiders in suits asking questions, the informal network of information transfer (i.e., the grapevine) in most companies today is so efficient that everyone will know fairly early, even if the board and CEO try to keep it secret.

I believe the best strategy is to be open. Being secretive about the exit process means that when employees inevitably do learn that the company is for sale, they will immediately make the association that something contrary to their interests is being done. Otherwise, they wonder, why was it being kept secret?

13.1 Preparing the CEO

Even CEOs who have been through a few exits are naturally concerned about what a change in shareholders will mean to their life and their future.

The CEO is an essential part of the selling team and must be perfectly comfortable with the process long before potential acquirers start to visit. The only way to ensure this is to have as much discussion as necessary as early as possible.

It is natural for the CEO and CFO to worry that if a big company acquires their company they might not be needed post-transaction. Their fear is that the big company will have more seasoned executives on the payroll who could replace them. It's a perfectly natural fear, but in my experience a completely unfounded one.

Acquirers want the entire team to remain intact post-transaction. They generally want the CEO to remain with the company—usually for as long as they can be retained. The last thing they want to do is buy a company, and then lose the person who has probably been most important in delivering the results.

In all my exit experiences, the more realistic concern is on the acquirer's side. They worry, and with some justification, that when they buy the company, and cash out the CEO's shares or options, the CEO will have the financial opportunity to consider doing other things with his or her work week.

In all the exit transactions with which I have been involved, I have never seen a CEO replaced by an acquirer. But I have seen many CEOs and CFOs leave after the transaction—most often because they can afford to.

13.2 Communicating With the Rest of the Team

In the most successful exits, the company is usually delivering its peak performance in the months leading up to the final price negotiations and closing. For this reason alone, it makes sense to get the management team onside as early as possible. The best way to ensure maximum performance is to openly explain to the team the reasons the company is being sold, ask for their best efforts and ensure they are appropriately incented.

13.3 Employee Ownership

Having a broad base of employee ownership, whether through shares or options, always helps an exit transaction. Almost every shareholder, all the way down to the most junior, will be excited about a sale. The extra excitement, enthusiasm and performance that ownership brings during the exit transaction can make a significant difference in the final selling price.

14

Due Diligence and Closing

It is highly desirable to have all the due diligence documents in the electronic data room before the rest of the selling process gathers momentum.

When a team has been charged with the responsibility of conducting due diligence on a potential acquisition, they will want to investigate every possible aspect of the company before recommending the transaction to their board.

It is highly desirable to have all the due diligence documents in an electronic data room before the rest of the selling process gathers momentum. As the potential buyers work their way through the sales funnel and start to conduct due diligence, everyone involved with the company being sold will be under enormous time pressure. The advisor or broker will have orchestrated interest among the competitive bidders so they will be trying to go through the same due diligence process at the same time. Experienced acquirers will know that they are in a competitive bidding situation and will often jockey for position to get more time with the seller's due diligence team to gain a negotiating advantage.

It is extremely inefficient if the buyer's due diligence team asks for a document and the company doesn't have it prepared. This creates a delay that is detrimental to the sales process and also shows the potential buyers that the company they are considering is less than perfectly organized.

14.1 Electronic Data Room

In earlier times, companies that were for sale would build a physical data room. This was a locked room, usually within their facilities (or sometimes at their law firm) where copies of all of the important documents related to the company were kept.

The data room would include the company's minute book, financial statements, material contracts, customer lists and other detailed information that qualified prospective acquirers would need to go through as part of their due diligence.

Today, most technology companies undertaking an exit transaction will use an electronic data room. This is simply a secure web platform where the company can grant different layers of access to prospective acquirers who have been properly qualified. Many potential acquirers will be less enthusiastic to engage with a company that doesn't have an electronic data room because it means that they will have to spend more time and money flying professionals to the company, or the company's legal firm, to review paper documents.

The fees for the set up and administration of an electronic data room are approximately $10,000, excluding document preparation and scanning, and are relatively independent of transaction size.

14.2 Signing the Reps and Warranties

One of the most difficult parts of an exit transaction for the management team is signing the representations (reps) and warranties.

Anyone reading a standard rep and warranty should be terrified

Every acquirer will demand extensive reps and warranties. These are always signed by the CEO and CFO. It is common practice to require other C-level executives and company officers to sign the reps and warranties as well. It is much less common for directors to sign them, but I have seen it done.

Anyone reading a standard rep and warranty should be terrified.

It is good practice for the signatories to have independent legal counsel so there is no question that they understand what it is they are signing. Often, their independent legal counsel's advice will be: "don't sign this under any circumstances."

This is one of the interesting paradoxes created by our legal profession. The lawyer hired by the CEO and other members of the management team to advise them on the reps and warranties has no choice but to advise them not to sign the document. It is the only advice they can give. The reps and warranties are always written completely in favor of the purchaser, and the penalties are as extreme as they can possibly be. The lawyers giving the independent legal advice know that in order to protect themselves, the first thing they have to do is to go on record advising their clients not to sign. Then, in the event that something does go wrong, the lawyer can say "I told you not to sign it."

The reality is no one buying a company will do so without standard reps and warranties. The standard reps and warranties are black and white, totally encompassing and provide maximum opportunity to collect damages if the reps and warranties are not true.

The buyers want to know that the CEO has thought long and hard about whether everything that was presented to them is, in fact, to the best knowledge of the signatories, completely true and accurate.

If any of the signatories know of any reason why they shouldn't sign the reps and warranties, that information needs to be disclosed. It is the only fair and equitable course of action for everyone involved in the sale.

15

Conclusion

Today, the optimum financial strategy for most technology entrepreneurs is to raise money from angels and plan an early exit to a large company in just a few years for under $30 million.

The financial world changed dramatically in the last half of 2008. These events created a time of change, but also one of opportunity—especially for entrepreneurs and angel investors.

The 21st century economy needs entrepreneurs—those magic few among us who can conceive and create new high-growth, knowledge-based companies—the companies that will keep our economies growing and provide jobs for our children and our grandchildren.

In the 20th century, knowledge-based companies needed huge amounts of capital. Companies like Intel, Microsoft, Amazon and Google required hundreds of millions of dollars to scale up to the size where they were proven winners. Those enormous capital requirements helped to create the huge venture capital (VC) funds we have today—funds so large that the smallest investment they can economically make is several million dollars.

Today, exciting startup opportunities may only require a small fraction of a million dollars to launch and prove out. These amounts are far too small to make economic sense to traditional VC funds.

Fortunately for entrepreneurs, this is a time when the baby boomers are at the ideal age to be angel investors. These angel investors have more than enough capital to fund today's technology startups. They also have the expertise to mentor entrepreneurs and help govern vibrant young companies.

This is also a time when large companies have lots of cash. Large companies know they are not good at innovation. Their greatest skill is growing businesses from values in the tens of millions to values in the hundreds of millions. Large companies also have to grow. They believe the best way to accelerate their growth is to acquire exciting young companies.

The convergence of these trends provides an ideal opportunity for entrepreneurs to adopt a new financial strategy. In the last century entrepreneurs aspired to start a company, raise some money from angels and then from VCs, and hope for a 'swing for the fences' initial public offering (IPO) exit or enormous acquisition.

Today, at the beginning of the 21st century, the optimum financial strategy for most technology entrepreneurs is to raise money from angels and plan an early exit in just a few years for under $30 million.

Good luck with your early exits!

Appendix

Case Studies on Exit Transactions

These case studies illustrate how a well-designed and executed exit can increase the final selling price of a company by 50% or more.

The most interesting way to learn about any business process is to study real-world examples of what other companies have done. When you want to learn about exit transactions, the really interesting information, such as the purchase price, is often not disclosed.

Fortunately, in situations where either the buyer or seller is a public company, much of the high level data is in the public domain. These case studies describe exits I've completed where either the buyer or seller was a public company and I can share the information. Each of the examples highlights one of the exit strategy principles described earlier in the book.

All of these case studies illustrate how a well-designed and executed exit can increase the final selling price of a company by 50% or more. Each case illustrates one or more of the points we discussed previously:

- The Nexus, Parasun and Sunaptic transactions all show how a competitive bidding situation can increase the final business selling price.
- The Nexus, PCS Wireless and Sunaptic exit transactions are examples of how the final selling price of the business can be increased by finding a buyer that can see a high strategic value in the acquisition.
- While it's hard to isolate this factor (and I might be biased), all of these transactions also illustrate that psychology and the skill of the selling team are big factors in achieving that extra 50+% value increase when selling a business.

1.1 My First Exit—Nexus Engineering

I started my first company, Nexus Engineering, in 1982 when I was still a grad student. A little over ten years later, the board decided it was time to sell. The company was the world's second largest manufacturer of cable TV headends—the central electronics in a cable television system. The number one and number three in our market were divisions of Fortune 500 companies.

1.1.1 Our Exit Strategy

Our exit strategy in 1992 was to sell to a Fortune 500 company in the defense business. At that time there was a general perception that the war business had seen its best years and that big defense companies should be diversifying more into peaceful businesses. After almost a year of hard work, we were at the term sheet stage with a Fortune 500 defense company who wanted to enter the cable television business. But I was feeling uneasy.

1.1.2 Bidder Attrition and Macro Economics

About six months earlier we had three companies on the bidders list. But as often happens, for one reason or another, two of the three had dropped off. We really only had one interested potential buyer.

Time was not on our side. After being cash flow positive for almost a decade we had been hit hard by the junk bond credit crisis that started in mid-1990. Almost all of our best customers were financed by junk bonds, many minted by junk bond king Michael Milken himself. When the US Federal Reserve decided to terminate the junk bond business to prevent the real estate market from blowing up, all of our customers in North America and Europe suddenly stopped buying at the same time.

1.1.3 A Hostile Takeover Attempt from Inside—Our VC

To make matters worse, we had a VC shareholder, with a board seat, working aggressively from the inside on a hostile takeover of the company. His plan was to delay us so he could complete a financing deal at a very low price—effectively 'washing out' all of the shareholders. The junk bond crisis would have made it impossible for us to find any other source of financing.

We also had a layer of subordinated debt in our capital structure. When the junk bond crisis hit, we were offside on some of the covenants. Luckily, I had developed a friendly relationship with our lender. He called me one day to warn me that someone was trying to buy our debt from them. That was all he would say, but it literally saved me from losing everything I had worked for.

I might have figured it out anyway because my VC director, and his wife, had suddenly started to wine and dine my other directors. They even entertained one of my original angel investors—someone this VC didn't like at all.

I knew that if my last interested buyer got sidetracked, or even delayed, I was dead. All of the value in my shares, my founding partners' shares and my angel investors' shares would be wiped out by our VC investor.

1.1.4 An Improved Exit Strategy

I went to our other directors and asked them for advice. One of my most experienced directors asked me what we had done with our major competitor. His question surprised me. I explained that we had discussed this issue and agreed not to approach them. We were terrified they would use the information to take advantage of us in the marketplace at the worst possible time—as we were trying to complete our exit transaction.

My experienced director carefully explained the shortcomings in that strategy. He went on to suggest that we pay a specific third party, who did business with our competitor, to 'leak' to them that our company was 'in play' (about to be acquired). I learned a few days later that this 'leak' was going to cost us a five digit amount. I thought the strategy was terribly expensive and incredibly risky. My director bought me another beer and explained to me that this was how big companies think and how companies get acquired.

His strategy worked brilliantly. Our biggest competitor 'heard' that one of their most aggressive Fortune 500 competitors was about to buy the second biggest company in the most strategic part of their business. They came thundering in and 'scooped' our company from their competitor.

1.1.5 A Very Close Call That—'Stuff Happens'

What they didn't know, and I have never written about before, is that our last defense bidder had gone quiet just a month after our big competitor came roaring in to make us an offer. If I had not taken the advice of my experienced director and developed multiple bidders, all of the founders and angels would have been wiped out by our VC.

1.1.6 The Most Valuable Lesson—A 50% Price Increase Is Often Possible

At the time, I thought the most valuable lesson in that experience was to always have at least two or three active bidders. That might have been the most important lesson, but it wasn't the most valuable one.

The most valuable lesson was that our major competitor paid about 50% more than what the big defense company had been offering. At the time, I thought that was a fluke. But, after seeing the same 50% increase in selling price over and over again, I came to appreciate that it was not a fluke, but something that can, and should, happen most of the time when an exit transaction is skillfully planned and executed.

1.2 The PCS Wireless Exit Transaction

Occasionally an exit goes much better than anyone dared to hope. This is the story of how the PCS Wireless exit worked out exceptionally well for some of the participants even though it appeared that the company was failing.

1.2.1 The Call That Started It All

After five or six years of consistent success, the board of Nexus Engineering was very comfortable with our ability to bring new products to market. As the CEO, I had discretion to undertake new research and development (R&D) projects without formal board approval as long as the budget was under $500,000.

One day, while I was in my car, I got a phone call from Nick Hamilton-Piercy, CTO at Rogers Cable. Nick explained that he had a top secret R&D project that needed a development partner, but I had to commit on the call because he was under a severe time constraint.

1.2.2 Our Relationship With Rogers

We'd done a lot of business with Rogers Communications. I consider Ted Rogers a friend, and regularly went fishing with his then chairman and CEO. We had worked hard to earn their respect as the technology leader in the cable television industry.

A few years earlier, Ted Rogers had decided to enter the cellular telephone business. He personally put up the money to bid for one of the two early cellular licenses in Canada. His bid was successful and Ted started a company called Cantel. The company is now branded Rogers, just like their cable products. One of the goals Ted set for his organization was to find a way to capitalize on his cable television network to enhance his wireless phone business.

1.2.3 The Big Idea—PCS Microcells or Distributed Antennas

The Rogers Cable engineering team was respected all around the world. They worked hard on Rogers' challenge and came up with an exciting idea. They'd finished the paper design, and now they needed a partner to actually build a prototype and put it into production.

I told Hamilton-Piercy our company was very interested. He went on to describe a fascinating idea that involved deploying a network of small microcells, or distributed antennas, to provide better next-generation wireless phone coverage using the cable television network for the communications backbone. I was excited by the opportunity and ten minutes into the call had committed to partner in the development and manufacture of this fascinating new product.

1.2.4 PCS Wireless Startup

When I got back to the office, we picked a team of our best research engineers and launched the project later that day. At that time, the wireless phone industry was calling the next generation of phones 'Personal Communication Services' or PCS. We called the project 'PCS Wireless.'

We worked hard on the PCS Wireless project for about a year. There were several times both Hamilton-Piercy and I thought there was a fatal flaw in the design. But after some serious head scratching and lot of hard work, our team of engineers found a solution for each technical hurdle. We built a demo network in our lab and then installed one on a real cable network in a then-secret location. By switching from several very large antennas to the new PCS microcells, the economics of deploying a new wireless phone network dramatically improved.

The PCS Wireless project was great fun for everyone involved. Working with the Rogers engineering team was challenging and exciting. From day one, we knew we had the best team in the world working on this concept and we maintained that lead even as others started to see the opportunity.

1.2.5 Beam Me Up, Scotty—the Product Launch

Once it was time to unveil the product in September 1991, there was a big media event, in true Ted Roger's fashion. Rogers hired Jonathan Frakes, of *Star Trek* fame, to be the spokesperson during the announcement. Ted and I stood on the stage at Science World in Vancouver with Jonathan Frakes. He was wearing a Star Trek costume and, as corny as it sounds, he opened up a PCS phone and said "Beam me up, Scotty." He pulled it off perfectly and the crowd went wild.

1.2.6 PCS Gets Sold the First Time

By the time we started to sell the Nexus Group, PCS Wireless was a separate company. We structured it that way primarily to provide a motivating equity incentive for the engineering team. This was part of the pay-for-performance philosophies that were a large contributor to our success.

During the Nexus sales process, we thoroughly disclosed PCS Wireless to the buyer, Scientific Atlanta (S-A), but at that stage in the development of the cellular telephone business S-A wasn't interested in PCS. This suited me just fine because my personal plan was to buy the PCS business and continue to grow it. Once the acquisition of Nexus Engineering and one of our other subsidiaries had been completed by S-A, I approached the Nexus Group board and offered to buy PCS Wireless.

I offered $1.75 million and was prepared to go as high as $2 million to buy the company. I was still young and I made a strategic error in my offer to the Nexus board. My board knew me too well. They knew if I was offering $1.75 million that it was probably worth more. They also knew that now I could afford to pay more.

Some of the board members wanted to sell me the business, but understandably had a problem because of the conflict. No matter what happened later, a sale of one of the Nexus Group companies to the CEO couldn't be done while following good governance unless there were other bidders.

1.2.7 Outbid By One of Our Team and PCS Goes Public

One of the rising star business unit managers at Nexus was Derek Spratt who ran our commercial satellite receiver division. Derek is a talented engineer and natural entrepreneur. His enthusiasm and passion for technology is infectious and has served him well in his recent CEO positions at Intrinsyc and Mobidia.

Everything was discussed openly in the Nexus Group, so Spratt was aware of the potential in the PCS Wireless business. He worked with a previous partner of his, Ralph Scobie, and put together an offer to acquire PCS Wireless from Nexus. I still remember Spratt walking up to me in the lunchroom and saying he wanted to buy PCS. I was a little surprised when I realized who my competition was, but on the other hand I was pleased it was him. It didn't take long for Spratt and Scobie to increase their offer to about $2.6 million, including a good sized block of stock. Our board approved the transaction.

The additional shares ended up adding the better part of a million dollars to the final sale price after Spratt and Scobie took the company public. So it worked out very well for everyone—as it should in a well-designed exit transaction.

1.2.8 TDMA vs. CDMA

But there was one catch. The entire idea of a PCS microcell overlay on a cable television network only worked with cell phone networks based on Time Division Multiple Access (TDMA). Qualcomm had a competing standard based on Carrier Division Multiple Access (CDMA). The TDMA standard was developed and manufactured in Europe, primarily by Nokia and Ericsson. At that time, there was an enormous engineering debate about which of the two multiple access technologies had better spectral efficiency.

This debate was raging because the major US telephone companies (telcos) had not decided on a standard for their wireless deployment. They knew they had to pick one standard so they could offer roaming services to their customers.

1.2.9 The Engineering Evaluation

The US telcos set up a multi-company engineering team in Atlanta to determine which of the two standards would be deployed by the major US telcos. Through an engineering connection in a dingy bar we got some fascinating technical insight into how this engineering evaluation was proceeding. As we heard it, and as it was described in the technical press, there didn't seem to be any significant technical advantage to CDMA over TDMA. TDMA was a much more refined technology and was a well established standard in dozens of countries around the world. The engineers making the evaluation were increasingly convinced that TDMA was the best choice for the US telcos. As a deadline for an announcement approached, there was an enormous amount of anticipation about which way the big US companies would go.

Friends of our friends who drink beer together were absolutely sure the US was going to go TDMA. If that had happened, the PCS Wireless business could have been worth billions of dollars. PCS, at that point, was a public company trading on the Canadian TSX venture exchange. The PCS stock steadily increased and was worth well over $100 million based in part on the belief that the US would go TDMA.

On the day of the announcement, to the absolute shock of engineers and wireless executives all around the world, the big US telcos decided to go CDMA. This made Qualcomm a much more valuable company and established CDMA as the second global standard. Nobody could understand it.

Years later, in a much classier drinking establishment, I had it explained to me. As I heard the story, in a last ditch effort the day before the announcement was to be made, someone very senior in the CDMA camp called someone very senior in the White House who called someone very senior at one of the big telcos. The person from the White House said he thought it would be better if the US went with a US technology. It was a fascinating lesson for me as a young CEO and engineer to see how politics trump technology and can shift enormous economic decisions.

Unfortunately for PCS, when the announcement came out, the stock cratered.

1.2.10 Testimonial from Ralph Scobie

CEO of PCS Wireless

> "Now that the sale has completed and I'm back from holidays, I wanted to write to thank you again for your outstanding and unique contribution to PCS Wireless. I came to you in early 1997 asking you to develop an entirely new business strategy for our company and to help with some acquisitions, or possibly, a sale.
>
> Your strategy of repositioning the company as a player in the broadband market was perfectly timed and brilliant. I clearly recall your assurances and conviction that this area would be white hot in a year or so. It happened just as you predicted. I remain extremely impressed and thankful for your vision and acumen in completing this terrific acquisition.
>
> Your introduction and strong recommendation to Unique Systems as a potential strategic investment or acquisition repositioned PCS to where it had a significant opportunity for growth over the near and long terms.
>
> Your strategy worked so well that the companies merged and on the back of the Broadband Network sale, our stock went up over 400%. Needless to say, my major shareholders and I are eternally grateful.

When we started to work together, someone asked me whether I thought the deal you struck with PCS was expensive. I said that it wasn't if you delivered. You delivered more than I hoped and today it looks like an incredible bargain even at twice the price.

Working with you in 1997 was both fun and lucrative for me. I hope we can find an opportunity to work together in the future."

1.3 The Parasun Technologies Sale

The 'original' founder of Parasun was Barry Carlson. Carlson is one of the pillars of our local tech community and has founded a number of local tech companies. He is also credited with founding the British Columbia Technology Industries Association, BC's largest tech trade association. He launched Parasun in 1996 as a dial-up ISP.

I believe Steven MacDonald should also be counted as a founder of Parasun. He joined the company when it was still just Carlson and a few others. It was MacDonald who conceived and built the business model that made the company a success. MacDonald started as the sales manager, going on to earn the positions of president and CEO as he demonstrated to Carlson that he was the best person for these jobs.

1.3.1 Parasun's Business

Parasun partnered with small- and mid-sized cable television companies to provide broadband Internet. When broadband-over-cable-TV networks became a reality, the large cable companies hired entirely new teams of people who understood high-speed data. These new teams built data centers, and other infrastructure, to deliver high-speed Internet to their subscribers. The small and mid-sized cable operators couldn't afford to, or didn't want to, build out their high-speed data offering in-house. Parasun offered them an alternative by delivering everything they needed to sell broadband as a turnkey service. This was an excellent early example of a Software-as-a-Service (SaaS) company.

When I first invested in mid-2004, Parasun had 35,000 end customers and revenues under $3 million. It was operating around break-even.

By the time the company was sold in May 2007, it had grown to provide broadband to 140,000 customers in 160 communities in North America. Over 80% of revenues were in the US. The company had been growing organically at over 30% annually, with revenues over $10 million and profits of approximately $1.5 million per year.

1.3.2 Parasun's First Almost Public Financing

Once it was clear to Carlson and MacDonald they had a winning model, they decided to look for financing to grow the company faster. They twice attempted to merge with public companies: one in a similar business and one that was a 'shell.' They thought this would be a way to provide financing, and some liquidity for their existing shareholders. In the shell transaction, they actually got to the point of signing documents before Carlson and MacDonald figured out that it wasn't the right strategy and they needed some help to extricate themselves from the transaction.

One of my partners at BC Advantage Funds, David Raffa, was a securities lawyer before becoming a full-time VC. Carlson and MacDonald found Raffa when they were trying to extricate themselves from the reverse takeover with the shell company. It was not easy to do, but Raffa was the kind of lawyer I'd want to have my back during a legal knife fight. He found a way to terminate the transaction.

Over the years, both Carlson and MacDonald often used the term 'saved' to describe the help David provided in getting them out of that transaction. I have no doubt that if they had completed that reverse takeover, it would literally have killed the company. It's not that the guys on the other side of the transaction were not honest sincere guys who wanted to do something worthwhile with their shell. It was much more because Carlson and MacDonald were just not the kind of guys, nor was Parasun at that time the kind of business, to make a successful public company.

Carlson and MacDonald invited Raffa to sit on their board and to be their company lawyer.

1.3.3 My Early Stage VC Fund and Angel Fund Investments

Raffa introduced me to Parasun in 2003 after we raised the first money in the BC Advantage venture capital fund. Parasun was the first investment in our early-stage, or seed, technology fund, the BC Tech Fund. In mid-2004, I invested $500,000 at $0.40 per share. The valuation was about 0.75x revenue.

In mid-2005 I made another investment in Parasun through my new angel fund, Fundamental Technologies II at $0.55 per share.

1.3.4 Two Secondary Financings

A primary financing is when the investors' money buys treasury shares and the cash goes into the company. This is the case in 99% of financings. In a secondary financing, the shares are sold by existing shareholders and the new investors' money goes to the existing shareholders as payment. There was a secondary in conjunction with the first $0.40 financing and the entire second $0.55 financing was a secondary offering.

It's normally very difficult to get a secondary financing completed. Investors want to see their capital going into the company to increase its value and it's never easy to convince an investor that you have a really great investment opportunity while at the same time trying to sell him your shares in the same great opportunity. Finally, most funds are specifically precluded from purchasing any shares other than those issued from the treasury.

One of the reasons Carlson and MacDonald almost merged Parasun with a public company twice was in an attempt to create some liquidity for their existing shareholders. Some of these individuals had been shareholders in the company for eight years when I first invested, so it was understandable that some of them wanted to sell some of their shares.

As the manager of a new fund, this created a potential problem for me. I knew there was a good chance that after I invested, some of the early shareholders would probably sell some of their shares to someone. In a secondary transaction, the price is usually lower than the price paid for the same shares issued by the company. The discount is often in the range of 30-40%. This reflects the challenge in finding buyers for secondary share offerings.

If a significant subsequent transaction had taken place, I would have had to 'mark to market,' which would mean in the financial statements for the BC Tech Fund, it would look like the value of my Parasun investment had decreased by 30-40%. A knowledgeable observer would understand that the investment had not actually decreased in value, but it was still a marketing challenge we didn't want to have with a new fund.

As much as I would have liked to, I was legally precluded from buying those secondary shares in the BC Tech Fund. Raffa and I agreed to help the company and shareholders find some accredited investor buyers for the secondary stock. This strategy worked so well that some of these early shareholders came back to us a year later and asked us to do the same thing again. That's how my new fund, FTII, managed to invest at $0.55 per share (I designed FTII not to have any restrictions on secondaries). This worked out well for everyone involved: the selling shareholders and the new investors—who ended up receiving about $1.30 per share.

1.3.5 Monthly Board Meetings

When I first invested in Parasun, I joined the board as Chairman. The board consisted of Carlson, MacDonald, Raffa and me from the date I invested until we sold the company three years later. We set and maintained a monthly board meeting schedule. To his credit, MacDonald managed this process with great efficiency. At various times during these three years, I met with the CEO and other members of the management team weekly as we tackled specific business challenges.

1.3.6 Annual Strategic Planning Retreats

We also had annual strategic planning retreats. I believe this is an essential element in growing every company. Strategic retreats are an invaluable opportunity for the board and senior management to develop and agree on the major strategic initiatives and goals for the company. They are an essential way to build and maintain alignment.

At the second Parasun strategic planning retreat in September of 2005, shortly after my second investment, the board and management developed a clear exit strategy. It was agreed that "Our Core Purpose is to sell the company for more than $10 million by late 2006 or early 2007."

1.3.7 The Exit Strategy and Execution

Before I invested in Parasun the first time, I spoke with Raffa about my concerns on exit strategy. It was clear that there were shareholders who wanted to sell some of their shares. Even though Carlson and MacDonald were sure they did not want to try another reverse takeover, I was still concerned that they might become enthusiastic about some other exit strategy that might not maximize shareholder value. This was the single biggest hurdle I had to overcome before I was comfortable making an investment.

Raffa and I approached Carlson and MacDonald with an idea to bundle our investment with an agreement to have us lead the development and execution of the exit strategy. They both really liked the idea. Carlson was looking forward to retiring and building a big house somewhere. MacDonald was having fun growing the company but, as always, put the best interests of the shareholders first. Both also liked the idea because Raffa and I had each sold a number of companies before, and they believed we were the best choice to facilitate the eventual sale of their company.

The execution of the exit strategy followed our design almost perfectly. We started with over 100 prospects on both sides of the border and ended up with a healthy competitive bidding process all the way to the signing of the term sheet. The successful buyer was Uniserve, a local public broadband internet provider. They made the best offer because Parasun provided them the greatest strategic value.

In the end, we closed the sale of Parasun in May of 2007 and the effective price for the Parasun shareholders was about $14.8 million, 48% higher than the goal we all thought was ambitious at our retreat two years earlier. This worked out to about $1.30 per share, providing an excellent return to both of my funds and all of the other shareholders.

This is another excellent example of how a well-designed and executed exit transaction can increase the final business valuation by around 50%.

1.3.8 Testimonial from Steven MacDonald

Co-Founder & CEO of Parasun

> “The addition of David Raffa and Basil Peters to our Board was a crucial step in our development. The relationship between the Board and management was highly productive with David and Basil working close with us on strategic issues while allowing us to focus on operations.
>
> David and Basil brought considerable experience and insight into strategic matters and served important roles as mentors to our young management team.
>
> During the sale of the company, they built a funnel of potential acquirers and verified the legitimacy of every potential acquirer before involving management in the sale process.
>
> This allowed us to be a part of the sale process while leaving us the time necessary to continue to grow revenues and EBITDA.
>
> David and Basil delivered an outstanding result for the shareholders of Parasun and we are thrilled to have had them involved.”

1.3.9 Testimonial from Barry Carlson

Co-Founder & First Chairman of Parasun

> “When the shareholders made the decision to prepare Parasun for sale, we met with Basil and agreed that he would invest in the company, assume the role of Chairman, and with David Raffa, undertake to make a transaction happen.
>
> For almost three years, Basil managed the Board processes to position the company for sale, and worked with the management team to develop a viable strategic plan and implement it in detail. He drove the Board and management politely but relentlessly to maximize the value and attractiveness of the company.
>
> I suppose that the sale might have happened without him, but not as soon as it did and certainly not at the valuation the shareholders realized. The shareholders, and remarkably the management team as well, were delighted with the outcome.”

1.4 The Sunaptic Sale

The acquisition of Sunaptic by Visiphor is another good example of how multiple bidders can increase the final price by 50% or more.

Sunaptic was run by two equal partners, Mike Hilton and Jame Healy. They’d worked in an earlier company I’d invested in and I had a high regard for both of them. They offered to buy me lunch in return for some advice on an unsolicited offer they had received to buy their company.

Hilton and Healy had grown Sunaptic from zero to about $3 million per year after about four years. They focused on .NET and BizTalk server application custom development. Their biggest verticals were healthcare and financial services.

1.4.1 The Unsolicited Offer

Between 2003 and 2007, Sunaptic won several significant healthcare contracts, beating out some of the much larger national firms. These wins got the attention of a large acquisition-oriented software services company in Toronto, about 3,000 miles away.

This company purchased businesses like Sunaptic on a regular basis. They had a very good idea of what the company was worth and what they were willing to pay for it. The Toronto company approached Hilton and Healy with an unsolicited offer to buy Sunaptic.

1.4.2 They Invest In a Lunch

Over lunch, Hilton and Healy said they were open to an early exit but wanted my thoughts on ways to improve their negotiating position and valuation. Another factor was neither of them wanted to be part of a company whose headquarters was 3,000 miles away. They knew that would mean a rapid accumulation of frequent flyer points.

Sunaptic was in a hot business sector and it wasn't difficult to think of several other companies who would see strategic value and possibly pay a premium for the company. I said I could get a competitive bidding process going in a relatively short period of time. While I didn't make any promises, it was clear to Hilton and Healy that this strategy could significantly increase the final value they'd receive for their company.

1.4.3 Strategic Value

My first thought was a company that I'd invested in—Visiphor. This company was focusing on similar web services technologies but had put all of their efforts behind a couple of early wins at the Department of Homeland Security (DHS). Unfortunately, after significant technical success with their first two DHS installations, things had gotten bogged down with internal changes and politics at DHS. Every quarter, the big projects dragged farther and farther out into the future. The Visiphor board was eager to diversify and their first choice was healthcare.

1.4.4 A Competing Offer

It didn't take long for Visiphor's CEO, Roy Trivett, to appreciate the strategic value in acquiring Sunaptic. He knew Visiphor was in a competitive bidding situation against a larger, eastern-based company, but wasn't sure who it was.

Trivett moved quickly to make an offer to acquire Sunaptic. After a short round of negotiations, the transaction closed at a final purchase price of $3.2 million, consisting of $2.7 million in cash and 1,066,666 shares of Visiphor. This was approximately 1x current annualized revenue.

It was interesting to see how much more aggressively Hilton and Healy negotiated once they knew they had multiple bidders. The acquisition was completed less than four months after Hilton, Healy and I had lunch.

1.4.5 More Than a 50% Price Increase

It wasn't until months later that I learned the Toronto company had offered significantly less for Sunaptic. Hilton and Healy very nearly accepted that first unsolicited offer. Calling to get my advice was almost an afterthought.

This is another situation where the difference between an unsolicited offer and a competitive bidding situation meant a difference of over 50% in the final selling price. The difference to Hilton and Healy, because they still owned most of the stock, was a significant amount of money.

Hilton, Healy and Trivett were all very happy with the transaction—nobody accumulated more frequent flyer points.

1.4.6 Testimonial from Mike Hilton

President of Sunaptic

Mike was kind enough to send me this testimonial a few months after the big check cleared his bank.

> “Basil has shown himself to be an incredible matchmaker and judge of what makes a good acquisition.
>
> Within less than a week of discussing with him the concept of selling our business, he had found a potential buyer. More importantly, he found a buyer that was a great cultural fit for the company and for senior management.
>
> He then worked tirelessly to ensure that the entire process went smoothly for both parties, brokering discussions, suggesting solutions to impasses, and generally supporting the process.
>
> Having been through the merger/acquisition process three times before, this was the most painless. That ease of transition can be predominately attributed to Basil’s ability to find and judge a good match and support it to the end.”

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