Start at the End - Your Exit Strategy

New Ventures BC Seminar

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Exits are the Best Part

- I believe exits are the best part of being an entrepreneur or investor
- It’s when we get paid for all of our hard work and risk capital
- But it’s also the least well understood part of being an entrepreneur
- Simply because it doesn’t happen very often
- Our goal today is to provide information to help you design and execute your exit

Much of What You Hear is Wrong

- It’s surprising how much of what you hear about exits is wrong – dangerously wrong
- There are so many myths and misperceptions
- And so many ‘experts’
- And quite a few dirty secrets
- The economy has also changed – a lot
- This seminar is about what actually works today - in our current economy

The Two Types of Companies

- All companies can be divided into types:

    1. Companies built for cash flow to owners

    2. Companies designed for an exit

- Neither of us understood that when we started our first companies
- Only one type works for investors

The Truth About Investors

- We are a pain in the a__s!
- We will want:
- A ton of documentation and financial reports
- Board meetings
- To help (not always a good thing)
- To get our money back
- You need an exit strategy before you ask us
- The rest of this talk will explain why

First Exit Strategy, Then Finance

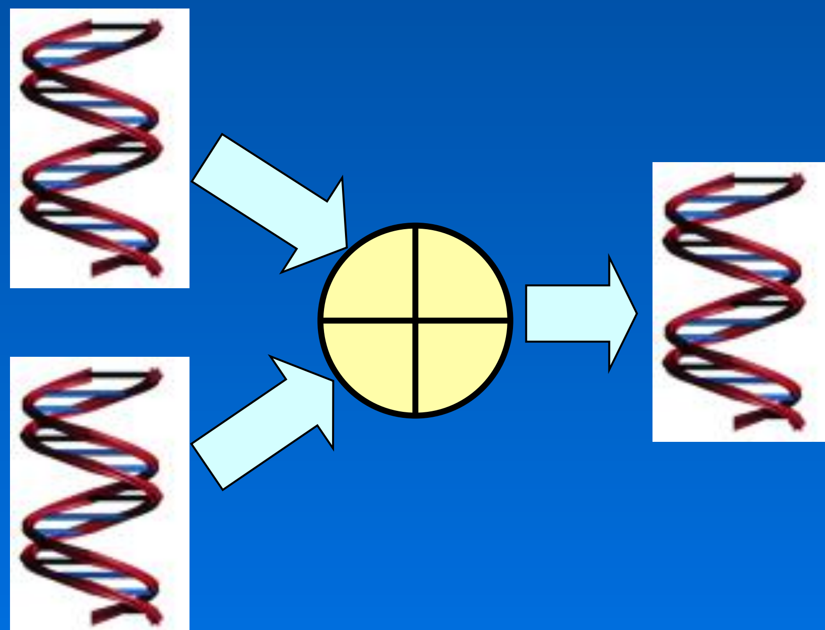
- This doesn’t happen most of the time
- But the right way to build a company is
- Determine the type of business
- Build alignment on the exit strategy
- THEN develop the financing plan
- And then start to contact investors

Check Financial DNA Before

Entrepreneurial DNA

Combined with

Investors' DNA



Resulting Corporate DNA is a Hybrid of Entrepreneurs' and Investors' DNA

Check the compatibility first

Why The Exit Strategy Comes First

- Different types of investors are compatible with different types of exit strategies!
- Making a mistake about this early on can easily cost you your entire company
- It almost cost me my first
- A video of my war story is online at:
- www.exits.com/blog/how-not-to-sell-a-business/

The Exit Is Just Another Process

- Whether it’s a financing, product development, marketing or sales goal
- The chances of success increase dramatically if you have a good plan
- Your exit strategy is the plan for your business – the entire business
- Your plan should start at the end (the goal)

The Important Elements

- An Exit Strategy could be as simple as:
- “Our exit strategy is to [sell the company] in about __ years for around $ __ million.
- We plan to execute the exit by engaging a [mid market M&A advisor] by _[date]_.”
- Or it could be an IPO or RTO and I-bank
- Formally check alignment at least annually

Check The Alignment

- It's surprising how often there is a mis-alignment between key stakeholders on the exit strategy
- The only way to check is to get a 'signoff' on a written exit strategy
- Usually takes at least one offsite planning retreat to build full alignment
- Even after, check alignment annually

Financing in Previous Times

- When I was a young entrepreneur,
- Didn’t matter if it was a hardware company or a software company
- Most companies cost $10s millions to build
- That created the enormous venture capital industry that’s still around today
- And many common misperceptions…

What are your financing options?

- Use your own resources – even if you don’t have any money
- Bootstrapping should <u>always be your first choice</u>
- (yes, I am an investor, but that’s the truth)
- Some business models just can’t be bootstrapped

If you really do need investors

- If you really can’t bootstrap,
- What are your options to raise private capital for your company?
- How many of you are planning to go to a VC fund to raise your startup capital?
- How many are planning on angel investors?
- How many on bootstrapping?

Who Actually Finances Startups?

- I asked how many of you were planning to raise your startup capital from VC funds
- A surprising number of entrepreneurs still think VCs finance startups
- The actual data is that Angel Investors finance 27x more startups than VCs
- www.AngelBlog.net/Angels_Finance_27_Times_More_Start-ups_Than_VCs.html

The Really Big Money

- In America, each year Venture Capital Funds invest about $20 billion
- Angel investors also invest about $20 billion each year
- Even more surprising, Friends and Family investors invest about 5 to 10 times more than either VCs or Angels
- From “Fools Gold” by Scott Shane 2009

Angel Co-Investment

- Just a couple of years ago, the conventional wisdom was that angel investment topped out at around $2 million per company
- Kauffman and ACA started talking about co-investment just a couple of years ago
- Now I regularly see groups of angels investing <u>$5 million to $10 million</u>
- Probably enough for 99+% companies

Ways to Exit

- There are basically only two ways to sell your company:

  1. An IPO (going public)

  2. An M&A transaction (private sale)

- These days it's almost entirely M&A

The New Big Story

- It’s human nature to get excited when you read about big transactions in BC like:
- Club Penguin’s $350 million sale to Disney, or
- Customs House $370 million sale to Western Union
- The ‘new’ big story is the much larger number of small exits

Most Exits Are Under $15 Million

- Mergerstat database shows the median price of private company acquisitions is under $25 million, when price is disclosed
- But the price is not disclosed in most smaller transactions
- It’s easy to show that the median price is under $20 million
- I think its probably below $15 million
- That’s seemed surprising to me the first time…

Why This Is Happening Now

- One of my friends from a Fortune 500 company explained it this way:
  - We (big companies) know we aren’t good at new ideas or start-ups
  - We basically suck at building business from zero to $20 million in value
  - But we think of ourselves as really good at growing values from $20 million to $200 million or more

Under $20 Million Is Easy

- A company priced at $100 million is already out of our sweet spot to buy
- But at $20 million, it’s really easy for me to get it approved just inside my division

- Many big companies are spending more on M&A than internal R&D
- Today, it’s the best way for them to grow
- It’s also what their shareholders want

Google Wants Even Earlier Exits

- I was surprised recently to learn just how early Google wants to do acquisitions
- Charles Rim one of the top Google M&A guys:
- "90% plus of our transactions are small transactions. … less than 20 people, less than $20 million and that is truly the sweet spot"
- "we do prefer companies that are pre-revenue"
- http://www.angelblog.net/Google_Wants_Even_Earlier_Exits_Than_in_Early_Exits.html

Big Corps Have So Much Cash

- Many big companies have so much cash that it’s a problem – shareholders complain
- For example:
- Google has $20 billion
- Microsoft has $35 billion
- Cisco has $43 million
- Apple has $97 billion ← cash and investments

Cash for Acquisitions

	Cash	Available for M&A
US Companies	$ 2 Trillion	Most
Global Companies	$ 8 Trillion	Most
P-E Funds	$0.4 Trillion	All
Boomers (US only)	$ 8 Trillion	Small but Growing
Family Offices (US)	$ 1 Trillion	Small but Growing

How Many is $1 Trillion?

- It’s difficult to put $1 trillion in perspective
- Most acquirers consider their ‘sweet spot’
- As somewhere around $20 million
- The median price is closer to $15 million
- Just one of these $1 trillion buys
- 50,000 acquisitions (at $20 million each)
- There are many times more buyers than sellers

Buyers Practically Unlimited

- For many exits under $50 million
- The number of buyers is, for practical purposes, almost unlimited
- Often see three or four types of buyers
- Simultaneously bidding to buy the company
- Each type of buyer thinks and acts differently
- They all have lots of cash
- And there can only be one successful bidder

A Sellers' Market

- The number of buyers and amount of cash available makes the current M&A environment:

1. A sellers' market
2. Fast moving and diverse
3. Talk is that prices are up 20% in a year

Our 21st Century Economy

- What works today:
  1. Small companies innovate and bootstrap
  2. Angels, Friends and Family finance them
  3. Big companies, and others, buy them early
  4. The buyers then grow the business
  5. Entrepreneurs and investors recycle the gains

A Common Misunderstanding

- A common misunderstanding about M&A exits is that you have to grow the company to be profitable
- Or grow it to be larger than $X millions of revenue
- The real threshold is to ‘prove the business model’

What it Means to Prove the Model

- In a recurring revenue business, for example, you have a spreadsheet that clearly shows actual results for:
  1. Gross margin per customer
  2. Customer lifetime (or churn)
  3. Cost of customer acquisition
- In other words, how much is a customer worth and what do they cost to acquire?

Proven Model and Value

- Some businesses have slightly different metrics to prove the model
- But when you prove the model you can build a credible projection that shows if:
  1. New owners added $X millions of capital,
  2. The business would have Y customers
  3. And be worth $Z millions

That’s When You Can Sell

- There are often additional factors like competitors and market changes
- But the important threshold to determine when you can sell is when you have proven the model
- That’s when you can have a reasonable negotiation on value and sell the company
- You do <u>not</u> have to be profitable

It's Often The Optimum Time

- As soon as you prove the model is often the <u>best time to sell</u>
- Always best to sell on an upward trend
- Sell on the promise not the reality
- Often when you can get the best price
- Very often 'stuff happens'
- Most entrepreneurs 'ride it over the top'

Exiting in Internet Time

- The internet has accelerated everything
- It allows entrepreneurs to market and sell to hundreds of millions of prospects in just days
- The internet has also accelerated almost every other aspect of the startup lifecycle
- Entrepreneurs now have “Weekenders” where they build entire companies in a weekend

Weekender Sold in 10 Days

- In 2009 when I wrote “Early Exits”
- I speculated that one day: “They’ll probably define an early exit as selling the company before the end of the weekender”
- That almost happened in November 2009
- A team of entrepreneurs in London built a business in one day and sold it online in ten days: www.24hour-startup.com <– great video
- Not an isolated example, see www.Flippa.com

More Exits In Just 2 – 3 Years

- Flickr sold for $30 million at 1.5 years old
- Delicious sold for $30+million 2 years from startup
- Club Penguin for $350 million at 2 years old
- YouTube sold for $1.6 billion at 2 years old
- Playfish sold for $275 million at 2 years old
- Mint sold for $170 million at 3 years old
- AdMob sold for $750 million at 3.5 years old

A B.C. Really Early Exit

- This Vancouver company asked me to keep their details confidential – for now
- This startup wanted to test the idea for their first product, so they called on a medium US corp
- The prospect soon asked to buy the company
- The CEO called me for help
- Three months later the money was in the bank
- Company was less than 12 months from startup and still hadn’t launched the first product

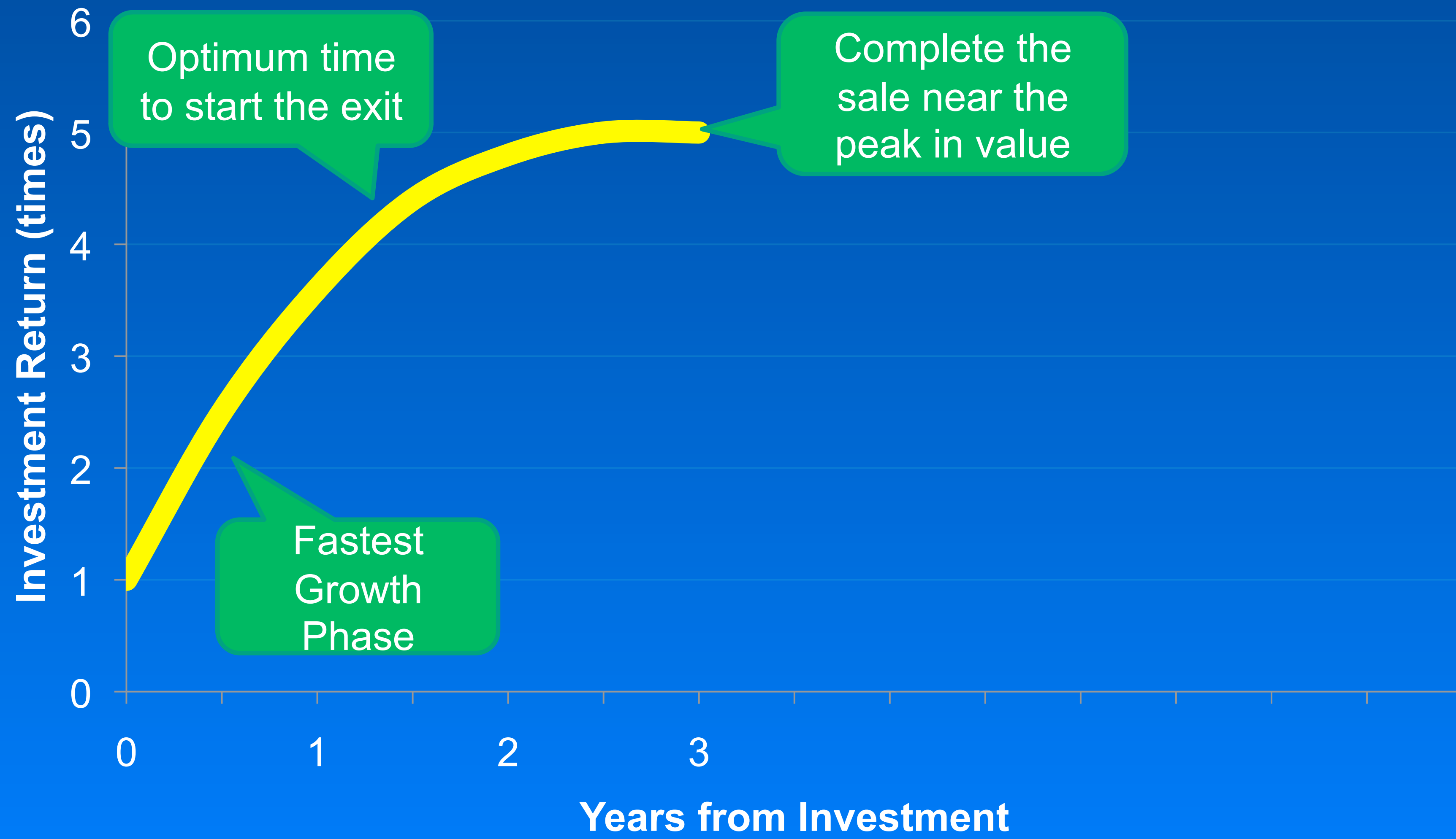
A New Really Early Exit

- Anyone heard of the company PumkinHead?
- How about their product - About.me?
- About.me was acquired by AOL
- Just four days after its public launch
- That may be a new record
- Better way to measure is from startup = 1 year
- This illustrates what experienced entrepreneurs and investors can accomplish in this market

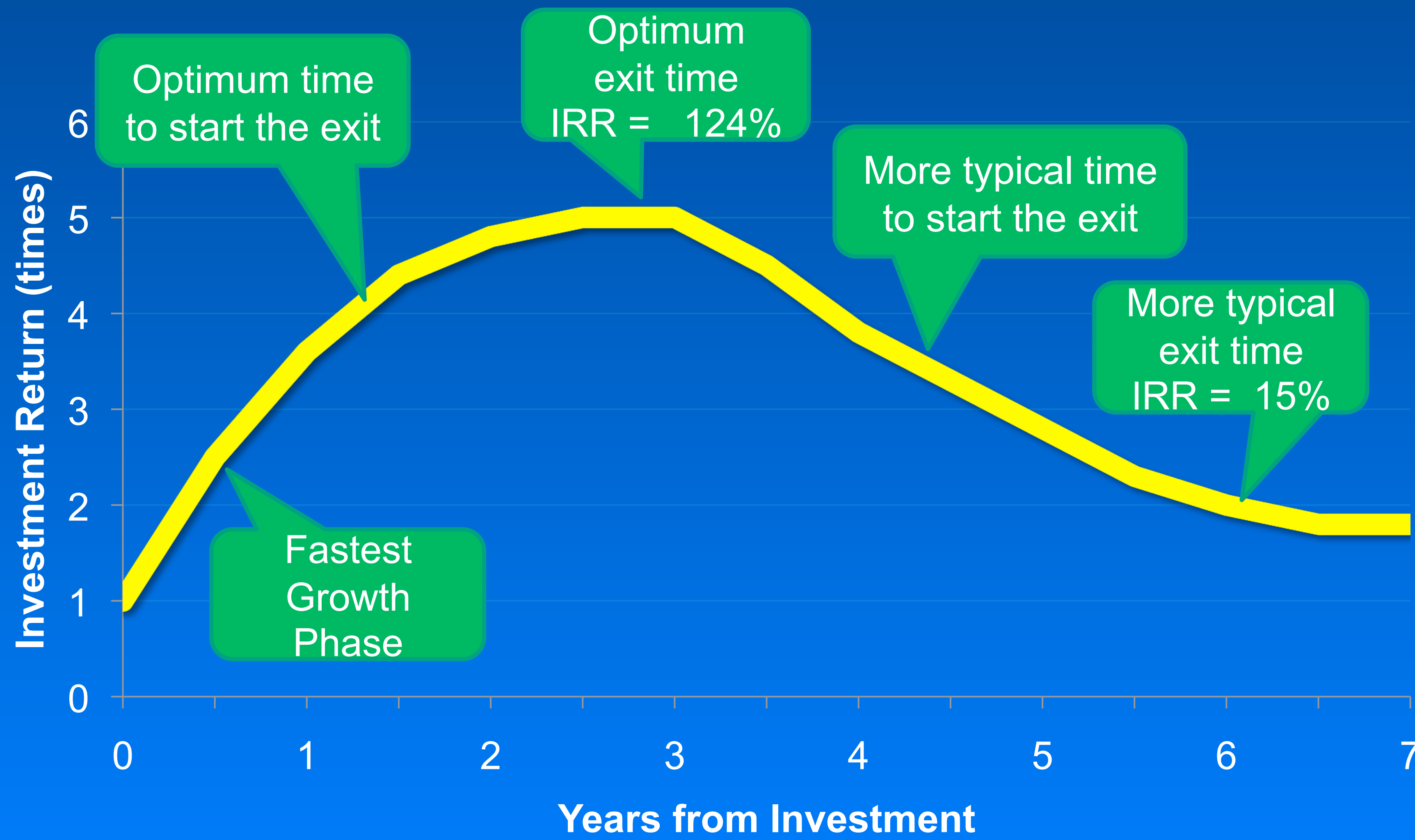
Ideal Exit Timing

- It usually takes 6 to 18 months to sell a company
- In an ideal situation, the company would incorporate this delay
- Into the company strategic and operating plans
- Look forward in time and then start the exit
- 12 to 18 months before the peak in the company's exit value

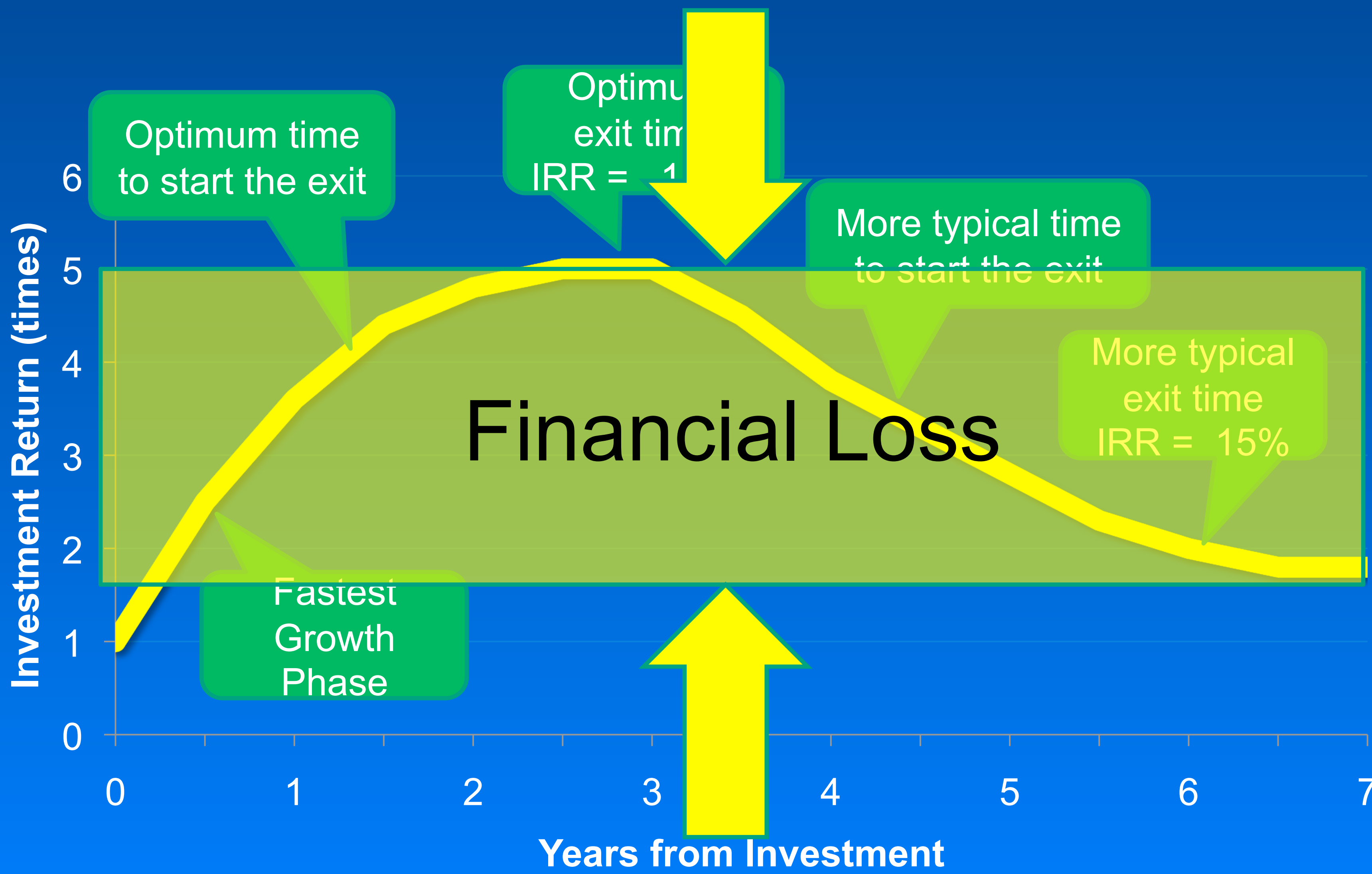
Ideal Exit Timing



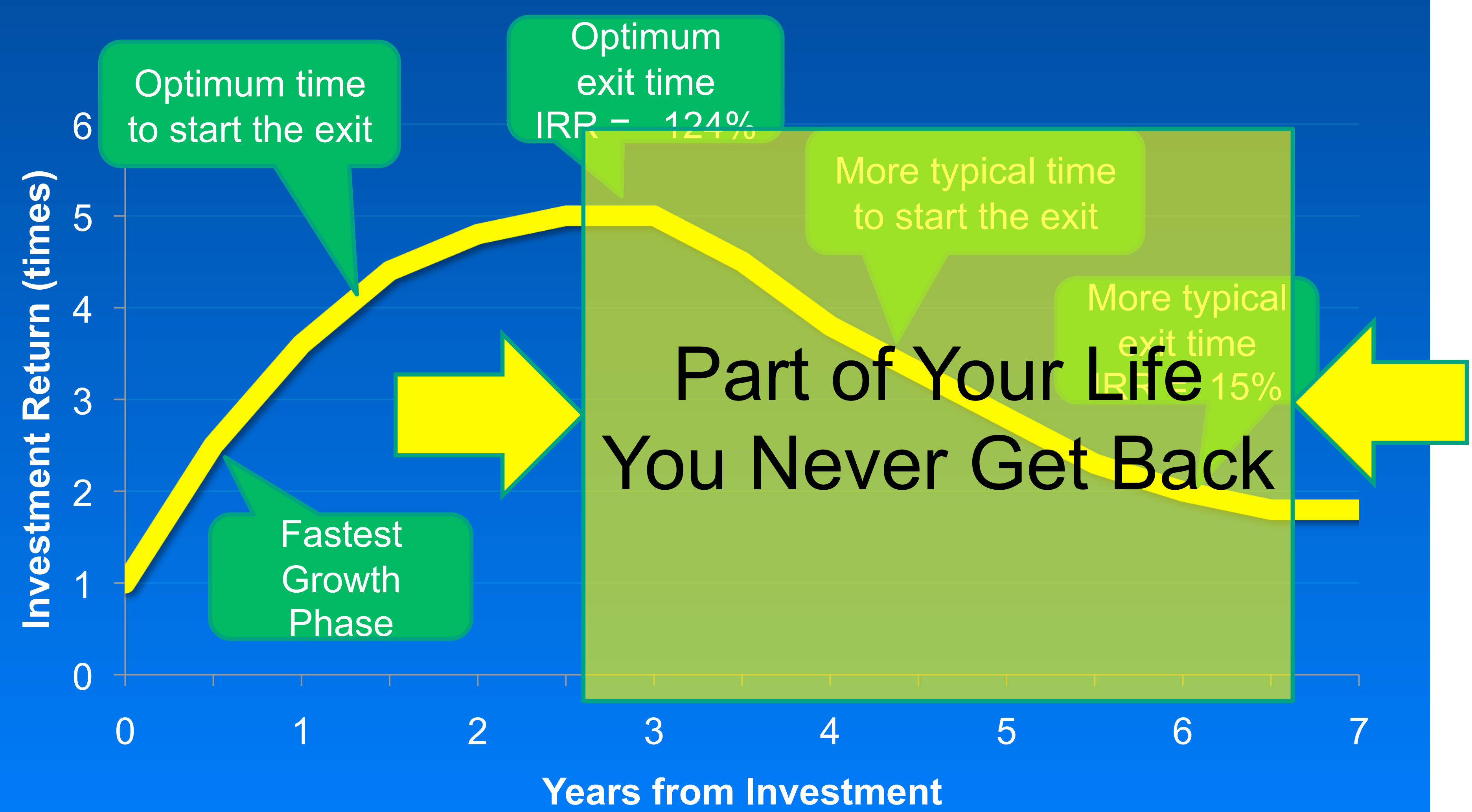
"Riding It Over the Top"



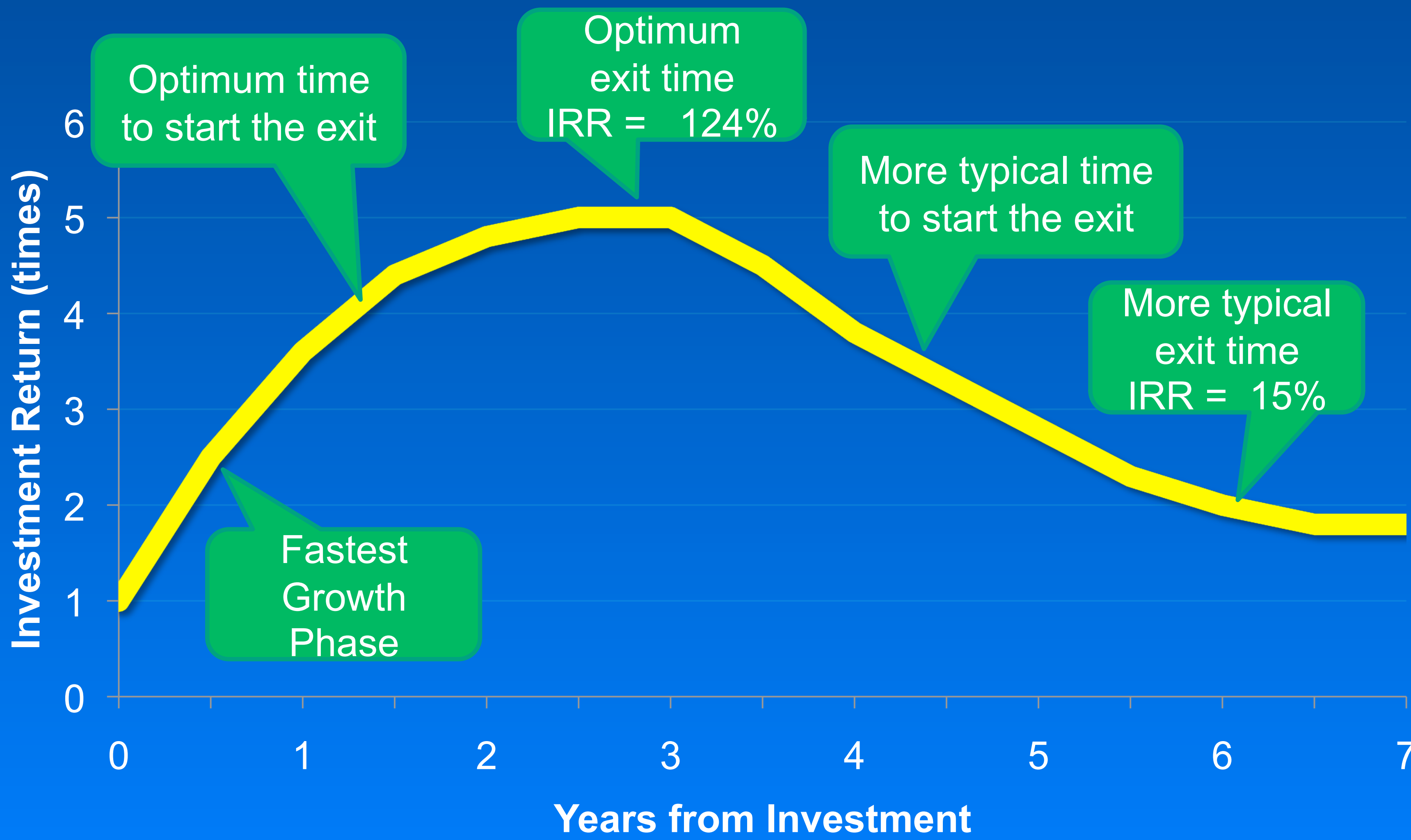
The Financial Loss



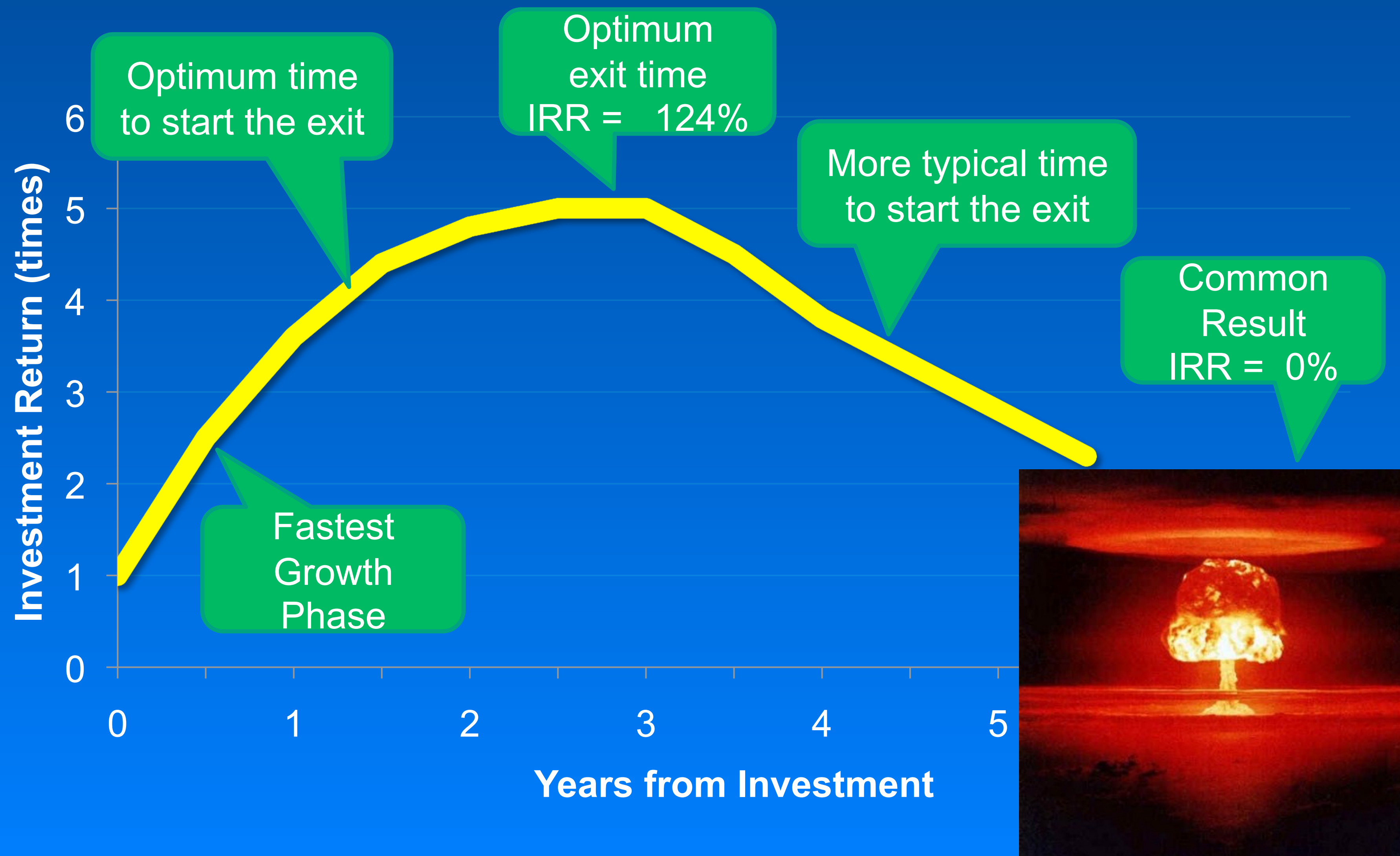
Part of Your Life You Never Get Back



This is Actually Optimistic



What Often Happens



Why ?

- After seeing this happen over and over again
- I started to recognize a few patterns
- And realized there were logical reasons
- Why if a company missed the ideal time to exit
- There was a good probability it would not just exit for less,
- But <u>end up never exiting</u>

Reasons This Happens

1. Competition
2. Over-investment by VCs
3. Negative momentum
4. Waves of Consolidation

(More on this in my other talks on the Wave)

Waves of Consolidation

- The most devastating reason that companies that miss the ideal time often end up never exiting is
- “Waves of Consolidation”
- This is a relatively new phenomena driven by:
- The huge amounts of cash
- The growing number of buyers
- And the internet
- Missing this is almost always fatal

The Beginnings of a Wave

- Today, we are all connected by
- The internet and especially social media
- Lets us see what’s happening in the world and our businesses better and faster than ever
- In business today, most competitors have immediate access to the same information
- Which creates a tendency for execs to make similar decisions at almost the same time

They All Get Interested

- M&A buyers all work in the same global market
- If an acquisition makes sense for one of them
- It usually does for others too
- M&A advisors work to get several buyers interested
- And develop a competitive bidding situation
- Which is good from the seller's perspective

But From the Buyers’ Side

- Buyers are smart too
- Regardless of whether they got the idea from an M&A advisor, or some other way
- Once they decide they want to acquire a business in a certain area, they
- Look at most of the companies in the field
- Let M&A advisors know they are looking
- And make direct, unsolicited offers to acquire

Why The Buyers Do This

- Buyers have several motivations:
- To determine which company is most attractive for them to acquire – i.e. price
- To give them more choices and therefore more negotiating leverage
- To ensure that if they don’t win the auction on their first choice,
- They have a backup acquisition opportunity

And People Start to Notice

- This starts a cascade of events
- The big company’s competitors hear they are interested in acquiring a certain type of company
- They don’t want to be late, so they also start
- And get their corporate development teams and M&A advisors looking
- Soon every company in the industry has received unsolicited interest

The Wave

- Which creates the beginning of the wave
- Buyer interest brings in more buyers
- And more M&A advisors – sell and buy side
- Which flushes out more companies that could be acquired
- Starting them on their own exit process
- All building to a flurry of acquisitions in the sector

It’s Too Late When You See It

- From the outside, it looks like this happened very quickly
- Often just within a quarter or two
- But it had actually been going on for much longer
- But because public companies, and NDAs, are involved it’s not easy to see from the outside
- Once a company sees the wave it’s often too late

What Happens After the Wave

- The wave ends with most companies who want to buy completing a transaction
- Almost overnight the buyer interest stops
- If a company did not get acquired during the wave, it is virtually impossible after
- And that’s not the worst news

The Market After the Wave

- After the buying crescendo
- Each of the successful buying companies have just paid a lot to enter this new sector
- Typically $10 – 50 million
- Most of the buyers will plan to invest a similar amount in growing their new acquisition
- And competing for market share against the competitors

Killing the Small Companies

- The companies that were not acquired are now in a very difficult situation
- Their market has become much more competitive
- Instead of fighting with other small, underfunded companies, they are up against giants
- With enormous investment capability and highly effective brands

Killing the Small Companies

- The small companies cannot afford to compete
- Or to operate in an industry where everyone is willing to lose money – possibly for years
- Often small businesses that were very profitable become unprofitable almost overnight
- And at the same time, their ability to raise capital disappears because the investors saw the wave
- And don't want to fund a fight with the big guys
- And know a future exit is very unlikely

An Unsolicited Offer

- One of my saddest jobs is to explain this to CEOs
- They often contact me all excited about a big company talking about an unsolicited offer
- I start by saying that's not usually good news for the shareholders
- After learning more, I dread seeing the signs of a wave of consolidation
- At that point they are dangerously late

Missing the Wave

- Missing the Wave of Consolidation is a particularly heartbreaking error
- Many of the companies that missed it were quite profitable and very valuable
- The wave destroys both
- For CEOs that have built successful businesses
- Not missing the wave might be their most important job

Summary

- Most acquisitions are under $15 million
- Modern companies don’t need much capital
- Bootstrap if you possibly can
- Angels can finance up to $5 to 10 million
- The optimum exit strategy is to target an exit for under $30 million
- <u>To maximize success - Start at The End</u>

Resources

- www.AngelBlog.net – blog for entrepreneurs and angel investors
- www.Exits.com/Blog - blog on exits
- www.Early-Exits.com – book on exit strategies for entrepreneurs
- www.BasilPeters.com – for this PowerPoint and videos of previous talks