VALUATION

Exit Planning for Venture-Funded Companies: 6 Key Acquisition Drivers

By Mahendra Ramsinghani and John Kerschen

For business founders, owners, private equity investors, and venture capital investors, the exit is the day to reach for the bubbly or antacid, depending on the internal rate of return (IRR). Private equity and venture capital portfolio companies are typically acquired by larger companies, termed a trade sale. At such liquidity moments, when the capital invested completes a full circle, the owners and investors exit by selling the stock of the company.

In a trade sale, a portfolio company is sold to a larger company. The transaction nets a return for investors, who, in turn, share 80 percent of the spoils with their limited partners.

A rarer exit path is the initial public offering, where company stock trades on the public exchanges.

One other exit event that we should mention is a redemption of shares. Venture investors typically include a redemption clause, where the equity is much like a debt instrument and repayment can be triggered after five to seven years! That is technically an exit, but no venture practitioner worth his IRR speaks of redemption in public. It's rarely considered a *real* exit, and it seldom occurs in early-stage venture capital investments. And yes, while a write-off is technically an exit, it doesn't need much deliberation. This is where you reach for the antacid.

In this article we will focus on acquisitions, as that is by far the most common exit path for successful venture-backed companies.

PRE-CONDITIONS FOR AN EXIT

Certain pre-conditions need to be established prior to any exit overtures. Alignment of interests of various stakeholders can determine whether passage of an exit will be smooth or a ride to the suburbia of hell. The cast of characters includes the board of directors, presumably with multiple investors, each with varying motivations and investor preferences. Next in line are the founders and CEO, and at the bottom are the common shareholders, whose interests are protected only by some mysterious higher power.

John Chambers, the CEO of Cisco, laid out five guidelines for acquiring companies, including these:

- The "chemistry between companies has to be right."
- "Long-term win for all four constituencies—shareholders, employees, customers, and business partners."[1]

At times, the founders and CEO of the target company may not see eye-to-eye on the timing of the exit, the value, or the quality of the partnership. If these primary factions are at odds and do not see the exit as a win, it may show during buyer diligence. At risk is the transaction itself, or a much slower and contentious closing process, potentially fraught with lawsuits and negotiations.

When Ted Dacko, CEO of HealthMedia, was getting ready to complete the sale of his company to Johnson & Johnson in Q4 2008, he was not worried about the exit value as much as the team culture. "I wanted to ensure every key employee understood the exit strategy and was tightly aligned—we did not have any passive-aggressive behavior," he says. He was referring to such negative behavior as withholding information, giving bad information, or stalling.

At times, misalignment can occur as a function of timing. In strong market conditions, investors may want an exit, while the founder may believe the best is yet to come. Consider what Tony Hsieh of Zappos expressed when his company was acquired by Amazon in July 2009. In his book *Delivering Happiness*, Hsieh writes, "We had a tough time convincing our board of directors who were also our investors to embrace many of our activities that would help build the Zappos brand and make the world a better place. The directors didn't fully under-

1 Glenn Rifkin, "Growth by Acquisition: The Case of Cisco Systems," *Strategy and Business*, Booz Allen Hamilton, 1997; www.strategy-business.com/article/15617?gko=3ec0c, accessed on December 13, 2010.

stand or were [not] convinced of things like brand or culture, dismissing many of these as 'Tony's social experiments.' Sequoia [Zappos's lead VC investor] expected an exit in five years and hadn't signed up for these additional things. I was pretty close to being fired from the board. I was learning that alignment with shareholders and board of directors [on exit timing, for example] was just as important."[2]

ACQUISITIONS: THE PRIMARY EXIT PATH

In a study of 11,500 VC-backed companies that raised capital between 1995 and 2008, 65.21 percent, or approximately 7,500 portfolio firms, exited through either an IPO or M&A. Of those 7,500 firms, only 9.61 percent of them exited via an IPO. Acquisitions are the preferred path for most venture-backed companies because of the speed and efficiency of M&A deals, compared with the regulatory and administrative challenges in IPOs. Acquisitions offer larger companies much-needed growth and expansion opportunities. And for venture investors, acquisitions offer a decent return. M&A deals are seen as the fastest way for larger companies like Google, IBM, and Cisco to expand, both vertically and horizontally. Such diversification strategies can bolster the acquiring companies' core strengths.

ACQUISITION DRIVERS

VC-backed companies make strong acquisition candidates if they have established revenues and customers, proprietary technology, and/or a unique and defensible market position. As a result, larger companies—especially those with significant cash, stagnant revenues, and limited growth potential—consider M&A deals as part of their growth strategy. Following are six key drivers, from the point of view of the acquiring companies.

1. Improved revenues and profitability. Cisco's sales increased from $650 million to $22 billion in the period from 1993 to 2001, with nearly 40 percent of its 2001 revenue coming directly from its acquisitions. Similarly, in the first six months of 2012, IBM has made five acquisitions. Large, publicly traded companies often struggle to meet the Street's rising expectations. Organic growth rates seldom suffice. Hence the acquisition of rapidly growing companies is seen as a way to bolster the revenues and margins.

2. Operational synergies. Larger companies seek to reduce costs and expand revenues and profitability by seeking synergistic companies that feed their value chain.

> ***Vertical synergies***: Vertical synergies occur when an acquirer moves vertically—up or down the value chain or supply chain. Also called forward integration or backward integration, examples include HP's acquisition of 3PAR to move into cloud computing, or Cisco's acquisition of Webex to expand its networking gear and voice-over-IP tools to Web presentation tools.

> ***Horizontal synergies***: Horizontal synergies occur when an acquirer moves to buy another company within a similar domain. Example: Oracle acquires Sun Microsystems to expand its server offerings.

3. Diversification of product lines to increase revenues. Google, a search engine, acquired YouTube, an online video repository, to establish its ad revenues in the online video market. Amazon acquires Zappos to expand its offerings to shoes.

Rich Levandov, an investor in several technology start-ups including Zynga, says, "Venture capital is about asymmetrical information and value—you know something that the buyer does not and you have something that a buyer wants—and wants now." One of his portfolio companies, a startup with an investment of $2 million, has no revenues. Five buyers are jostling to buy the company at $40 million or higher.

Another example of asymmetrical value is StubHub. Rick Heitzmann of FirstMark Capital made a nice return when a portfolio company, StubHub, was sold to eBay. "Before StubHub, there was an opaque and muddy view of the secondary market for tickets," Heitzmann said. "We were able to create value for both sides of the market, so revenues and growth followed. It was a good model." The company was profitable, with $15 million of total raise. "It is better to be bought rather than to sell the company, and we lived that cliché." When eBay came knocking, Heitzmann politely demurred, "We do not wish to sell, but if you are aggressive about buying, let's see your offer." Ultimately, StubHub was sold for $310 million—not too shabby for a company that had taken in just $15 million of invested capital.

4. Geographic penetration. Access to new geographic territories are often easiest with an acquisition. Tata, the Indian conglomerate, acquired Jaguar to gain access to European automotive markets. Corporations often use M&A to acquire valuable local market business and technology talent. Facebook has attracted technology talent into its fold via several

2 Tony Hsieh, *Delivering Happiness: A Path to Profits, Passion, and Purpose*, Hachette Book Group, New York, 2010, pages 209–211. Hsieh tried to buy Sequoia's stock for $200 million, but eventually Zappos was sold to Amazon.com for $1.2 billion.

"acqui-hires" such as Instagram and Lightbox. Another buyer motivation is access to new customer relationships—rather than subject themselves to a longer-term effort to green-field a new market, such tactical maneuvers are an advantage for the buyer.

5. Preemptive moves. Quick, grab the technology before your competitor does, and milk the opportunity. Oracle acquired Sun Microsystems in 2010 and subsequently released a statement announcing its plans not to share its software with future generations of HP's Integrity servers. In lawsuits that ensued, HP is seeking as much as $4 billion in lost profits. According to HP, Oracle attempted to bully the two companies' mutual customer base into switching away from HP hardware and toward Sun Microsystems-manufactured servers.[3]

Similarly, Google snapped up reMail, a popular iPhone application that provides "lightning fast" full-text search. reMail was yanked from the iTunes App Store as soon as it was gobbled up by Google. No predictions were made by Google on the future of reMail. Will it be integrated with the Google Android mobile platform? Or worse, as TechCrunch's MG Siegler predicted, Google is "just as happy to kill off what is hands-down one of the best e-mail applications on the iPhone—much better than the iPhone's native e-mail app."

6. Quash rising threats. Apple bought Lala, a cloud-based Web streaming music service and within a few months shut it down. Lala users are angry. Apple bought Lala simply to take it offline because it didn't like the price erosion—10 cents per track charged by Lala as compared to 99 cents on the iTunes music store. Better to get rid of it than to let it eat into your margins, or worse, let a competitor snag it and make the problem bigger.

ALL THE OTHER KIDS HAVE ONE

In his letter to shareholders in 1981, Warren Buffett writes about the three *real* reasons why companies engage in high-premium takeovers:

- Animal aggression. Don't just stand there, do something—buy a company.
- Ego. Being CEO of a bigger company makes me bigger. Larger acquisitions are better than smaller ones.
- Undue optimism on post-merger integration. "It will all work out—if not, all we lose is shareholder capital."

Buffet writes, "Some years back, a CEO friend of mine—in jest, it must be said—unintentionally described the pathology of many big deals. This friend, who ran a property-casualty insurer, was explaining to his directors why he wanted to acquire a certain life insurance company. After droning rather unpersuasively through the economics and strategic rationale for the acquisition, he abruptly abandoned the script. With an impish look, he simply said: 'Aw, fellas, all the other kids have one.'"[4] VE

3 Source: www.law.com/jsp/lawtechnologynews/PubArticleLTN.jsp?id=1338133295541&slreturn=1, accessed on June 28, 2012

4 Source: www.berkshirehathaway.com/letters/1994.html, accessed March 5, 2011.

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