Inside the Minds: Software Company Exit Strategies

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Build a Business, Not an Exit Strategy

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When a company initially discusses exit strategies, we want them to understand that you don't plan in the beginning to build an exit strategy; you plan to build a business. While you want to be careful not to take steps that might impede a potential acquisition, focusing early on plans for a future acquisition is problematic because it is difficult to predict the competitive landscape at the time when the company is finally ready to be acquired.

It is challenging but crucial to shape what a new company is doing to what the buyers may want rather than potential acquirers. Companies should concentrate on building critical mass and establishing themselves as self-sustaining businesses, because if they can accomplish that, they ultimately will be more attractive as acquisitions, since they will be potential threats to other companies in that space.

To Sell or be Sold

While the numbers may be different from industry to industry, software company exit strategies are very similar to those of other industries. Selling a company is the same as selling a product; it can be done by push or by pull. Doing it by push entails deciding that you want to sell and then trying to get somebody to buy. Doing it by pull means that there are buyers that are working to convince you to sell.

In a down economy, the push method is much harder than the pull, because once you announce that your company is on the market, buyers assume that the price will be very low. It sets the company up for a very difficult situation, because unless there happen to be multiple suitors lined up as buyers, the perception is that the company is distressed, simply by virtue of the fact that it is looking to be acquired. A company that appears to be failing or giving up will receive sinking ship offers.

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The pull method—when companies approach you to be acquired—is the ideal situation because in theory the buyers want you more than you want them. That lack of desperation is the key for increasing the selling price, because when it comes to selling, it is all about who wants whom more.

Once a company has decided to sell, it is nearly impossible to unwind that decision and go back to running the business again. Anyone privy to the plan, which usually includes the executive team, begin to think that it is now a short-term business and may start to lose focus on execution or even start looking for new jobs. If customers or prospects learn of an impending sale, it can have a devastating affect on sales, which may scare away buyers, leading to a downward spiral that might be irrecoverable. If buyers are approaching the company, however, the situation is just the opposite. You can and should continue to run your business as an independent entity while acquisition discussions are underway.

When Size Matters

Size and exit strategies are really a function of the dynamics of the marketplace and how mature a market space is. Being a small player in a mature marketplace could be good or bad. It is good if there are multiple companies that are successful in the same space and you have a unique defendable market position. Played correctly, you can start a bidding war amongst the established players, each of which should be loath to letting your company fall into the hands of one of their competitors.

On the other hand, if a company is more mature and the other companies in the industry are fighting for market share among each other, the market share that it can bring with it could command a premium. All in all, the more successful and large the company, the higher premium it can command, and the more success it will achieve in an exit.

Shakeouts and Exits

A shakeout occurs when the market gets large enough to attract really big companies, and they decide that buying one of the competitors is the fastest way to dominate the market space. The more market share one has, the more likely you will be acquired for a premium.

Occasionally the bigger players acquire smaller technology companies to make their product more competitive. They do that rather than acquire their larger competitors because it is cheaper and because they believe they can leverage their sales force to rapidly gain market share. If you are a smaller player, this is the time to sell. You do not want to be the last one standing when the music stops. If that happens, then you must compete against large players with similar technologies who have only gotten stronger through their competitive acquisitions.

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Knowing when to exit is really a matter of watching where the market goes, and unfortunately, you have no control over that. The market will decide when the best time to exit is. You just have to be aware enough to know when the time has come and make sure you are in a position to be acquired.

Forced Exits

Sometimes companies are forced into exits, such as when it reaches a point in its development where it outgrows the skill set of its management team. Typically, this occurs when a company reaches around $10 million in revenues. When in that painful transition stage, sometimes it is easier and more efficient to just sell the company, but that only works if the market is in a position where the major companies in the space are in the mood to acquire companies. Forced exits can also occur during industry shakeouts, when being the last small company left in a space after you competitors have all been acquired can prove to be an impossible barrier.

Investment Timelines and the Stock Market

In a typical market, the first opportunity to be acquired comes 3 to 5 years after company launch. Certain external factors, however, can radically change this timeline. One factor is the stock market and the ability to do an IPO. IPOs represent about 20 percent of exits, and a strong IPO market means that going public is a viable alternative to being acquired. In a strong IPO market, there is also a strong stock market, which means the currency of the larger competitors is worth more, and therefore they have more currency to buy companies. As a result, the acquisition marketplace in that environment is more active as well. When the market is up, it is like a perfect storm in both directions—IPOs are good and acquisitions are good because there is more money out there. The contrary is also true, however: fewer IPOs typically correspond to fewer acquisitions.

Making Valuations

Investment bankers and company brokers often try to devise formulas for valuing companies. The most common formula involves a multiple of trailing revenues—perhaps four to six times trailing revenues, but that number only applies if the acquirer is buying market share. If the company's technology is being bought, then revenues are far less important. A common formula for estimating the value of technology acquisitions is $1 million per engineer, so if a company has twenty-five engineers, then the company is valued at $25 million. However, with off-shore development rampant, this formula probably no longer applies.

There are many other back-of-the-envelope measures to determine value in a company, but it all comes down to a negotiated settlement between a buyer and seller as to what the opportunity cost is to the buyer. The opportunity cost is usually a direct function of how long it would take the acquirer to develop its own product or how much it would cost to acquire one of your competitors.

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I have sold companies to Microsoft, Novell, and Adobe. Each time the valuations came down to my ability to estimate the opportunity cost for those companies and hold out in the negotiations until they reached that number. That involves positioning the company such that the acquirer feels it cannot do without the purchase because the company fills a hole in the acquirer's strategy much faster than they could fill it themselves. It is all about time to market.

If a company is simply trying to sell technology for technology's sake, it will only get cents on the dollar. It will be bought for the cost of developing the technology, not for the cost of building the company. In most companies, the investment in building the rest of the company far outweighs the value that was invested in developing the technology. To recoup these costs and hopefully get a premium on invested capital, you need to sell a market proven product line to an acquirer, not just a technology looking for a problem to solve.

Maximizing Terms as a Seller

The best strategic buyer is someone who has a long-term (two- to five-year) strategy that happens to have a hole in it. The company that can fill that hole will get the best valuation because the buyer has already made the decision that they want to be in the business, but they do not have a product to compete in that space. In this situation, what an acquirer is buying is time to market.

The company that can fill the hole in a potential buyer's strategy should not approach the buyer and tell them that it is selling. If potential buyers know a company is for sale, its value goes down dramatically because they know it is vulnerable.

The first step is to understand the strategy of the potential acquirer. Web research is good means to obtain this information, because companies often tell analysts and/or potential customers what their strategy is and it will find its way into the press. Once the selling company has mapped the potential acquirer's strategy, they can begin to craft the story. The pitch should begin by outlining the strategy of the acquirer. While they should already know it, showing that you also understand it lets them know you understand the challenges they face. Then point out the product holes that need to be filled to be able to deliver on their strategy, and how your product can fill one of those holes.

The company should not initially tell the potential acquirer that they are selling the company; instead, they can say they would like to work out a reseller relationship. Then they let the acquirer decide that it makes sense to own rather than rent. If the acquirer makes the decision to buy in this way, the selling company is in a much better negotiating position.

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Finding a Buyer

There are two approaches a company can take to find a buyer. One is when the company decides it needs to sell and then goes out to look for a buyer. If a company is in that position, then it is typically in a weakened position. More often than not it either doesn't believe in its business plan, lacks the ability to succeed as an independent business, or its investors have lost confidence. It leaves the impression that company is admitting that it cannot succeed as a self-sustaining business.

If your company is in this position, time is your enemy. If you are not able to sell within the window of your cash, you are out of business. The goal is to sell when things are looking promising, not after you have exhausted all other options and are running on fumes.

Key Company Players

Ideally, the CEO should be the person leading the charge when a company is being sold. He or she represents the intersection of two constituencies that must agree. If one of the investors is leading the negotiation, it can be a challenge because the investor's economic incentives are often times different than those of the executive staff. Typically, the investors are preferred shareholders, which may mean they get their money out first before any money goes to the common stockholders. The common shareholders, who typically include founders, employees and the executive staff (including the CEO), may have a much different economic incentives due to preferred stock preferences.

The CFO should be a supportive player to provide the information and guidance that the CEO needs to provide the acquirer about the details of the business. Selling a company is really a game of choreography. It is making sure all the right pieces are in the right place at the right time with the right amount of detail and with just the right amount of paranoia. All those points must be in balance throughout the entire process. It is important to have someone who can provide the appropriate information and guidance on a real-time basis, and the CFO is generally the right person to do that.

The board of directors is best used as an advisor to bounce ideas off of. The problem that occurs when the board gets involved is that board members typically each become separate negotiators. Each has a slightly different agenda and/or idea, and there are, in effect, too many cooks in the kitchen. That often can make the company look either desperate for a sale or like there is no consistency.

The CEO can use board members in a complex game of bad cop / good cop during the negotiations. However, the CEO needs to carefully manage the process lest the board members end up becoming independent negotiators rather than just players in the CEO's larger plan.

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Other management members may be important depending on who is acquiring the company and why. If you are being acquired because of your market share and/or customer list, the vice presidents of sales and marketing become important players to help you position your product line relative to the acquirers. But if you are being acquired because of your product line or technology, then the vice president of sales is not a very important player. In that case, the more important players are the CTO and vice president of engineering because the acquirer will value your engineering staff and its ability to support the technology.

A big risk is the company getting overly focused on exit strategy planning. When CEOs start to get too focused on counting their take from an acquisition, they can easily forget they have a business to run. The most important point for the CEO going through an acquisition is to make sure the staff stays focused on running the business. If the staff becomes distracted with the acquisition transaction and the quarter revenue target is missed, the acquisition itself can be at serious risk to falling through.

Making the Sale

As is true in most business deals, the devil is in the details. The most common issues are stock vesting, investor preferences, escrow provisions, earn-outs, and lock-ups. Not surprisingly, most all of these issues deal with how the money is divided up amongst the interested parties.

The issues of who is paid first and how the options are handled are all resolved through negotiations between the CEO and the investors. A good CEO will negotiate with the investors to come up with a package—a carve-out—for the common holders/management team. Most high-tech companies have investors who have “participating” preferred stock. This means the investors get their money back off the top, and the remainder is distributed pro-rata with common holders. Sometimes there is a cap on the total preference, and sometimes there is a multiple preference before any money goes to the common holders.

If the acquisition price is less than the preference, then there is no money in the deal for the common stockholders. In these cases, the CEO needs to negotiate a carve-out with the board of directors and the investors. A carve-out is a specific amount that will be reserved for payment to the executive team, employees, and sometimes the other common holders to motivate them to go through with the sale of the company. A number of factors can go into how the formula is determined. For example, if there are many original founders who are no longer with the company, there is a great deal of incentive for the management team and investors to say they shouldn’t profit as much from the sale of the company as the current people on staff. Therefore, they come up with a formula that divides the carve-out based on employment status rather than on common stock ownership.

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Determining how to create that mix is a function of who owns that common stock and how much influence they have in the negotiations. If the founders are no longer actively involved in the company, they are probably not going to be well represented by the CEO.

IPOs

Ideally, doing an IPO should be based on needing to raise money and realizing that the public market is the most efficient place to obtain the necessary funds. Public market stock is generally the cheapest form of equity capital for companies. However, going public also has its own set of complications. Once a company goes public, it faces a slew of reporting requirements. The character and flavor of the company often change internally, which may make it more difficult to run the company. A company's competitors will know more about it and its financial condition after an IPO because of these reporting requirements.

At the same time, there are some significant benefits to going public. Going public can afford a company more credibility with customers. However, most IPO decisions are made because the investors want an exit. If the company has reached a point when an IPO can yield a nice return on their investment, then the investors will likely force the company to go public, whether or not the company needs the money.

Qualifying for an IPO

The hard part of an IPO is qualifying for it. A company must have enough repeatable performance to qualify for bankers to be willing to take it out. It should be showing a profit for multiple quarters and be showing a growth rate in excess of 50 to 100 percent per year. The public market is not going to buy what does not look like a fast growing business.

These days, a lot of investors are happy to get two or three times their money on an exit because they have had so many losers in the last few years. The economics are a little bit distorted because of that. Typically, investors would want to see five to ten times return on an IPO, but we are not in typical times. There are still some residual effects of the bubble that are affecting decisions made by investors, and this situation is likely to continue through 2007 or 2008.

The Bottom Line: Advice to Exit By

The best advice to remember is that when it comes to an exit, everything is negotiable. That means even if the investors have stock preferences, they need your cooperation to make the exit a success. This power allows you to reshape the pie in such a way that everyone can have an equal incentive to the desired outcome.

In general, however, the best course of action a company can take from the outset is not focusing on the exit. Focus on running the business. If you run the business well, the exit will happen at the right time for the best value.

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