

DR. TOM MCKASKILL

Invest to Exit

***A PRAGMATIC STRATEGY
FOR ANGEL AND VENTURE
CAPITAL INVESTORS***

INVEST to EXIT is a highly pragmatic strategy for Angel and Venture Capital investors which focuses the investment, business development and harvest activities on strategic value.

Investment decisions are targeted towards those ventures which can create a strategic buyer exit.

The period of investment is often shorter, operational execution risks are lower and return on investment is higher.

The author hereby gives permission for any recipient to forward this publication to others for their personal use. The recipient is authorized to reproduce, store in a retrieval system, transmit in any form or distribute by any means for the personal use of any recipient. This publication may not be sold or resold for any fee, price or charge without the permission of the copyright owner.

“This book is a must read for the Angel Investors who wish to have profitable exits.”

John Mactaggart
Chairman, Australian Association of Angel Investors

“ Every entrepreneur seeking to work with outside investors should first stop, read *Invest to Exit*, and then proceed. Angel investors and venture capitalists want a partnership, a spousal relationship while they grow scalable companies – but there must be an exit, a separation agreement at some point of the investment relationship. Tom McKaskill provides the blueprint for discussing and analyzing those exit options and I recommend both parties use *Invest to Exit* as a guide.”

John May
Chair Emeritus, Angel Capital Association, USA
Co-author, “Every Business Needs an Angel” *Crown Business:2001*

“Tom McKaskill’s insights into the ‘art of the exit’ provide a great roadmap for all Angel and Venture Capital investors. In a misguided investment world that relies too heavily on IPOs, mega-exits and too much quantitative analysis, McKaskill has taken an enlightened and straightforward approach to a topic that should be foremost on startup investors’ minds.”

Joe Platnick, Pasadena Angels, USA

“After reading Tom’s latest E book, *Invest to Exit*, I not only have a deeper understanding of what an angel investor should be looking for in an investment but it has given me a mind shift on how I think about an exit strategy for my current business and any businesses I might invest in..”

Michael Valitutti, Angel Investor, Gold Coast, Australia

“Tom provides explanations of how to connect the fundamental drive for an exit to strategy in each phase of investment, management and exit. His easy to read, conversational style leads the reader to challenge cherished preconceptions, consider new approaches and develop better strategies. This is a valuable read for the first time entrepreneur or investor, as well as for those of us with more experience.”

Jordan Green
Founder/Chairman Melbourne Angels,
Co-Founder/Deputy Chairman
Australian Association of Angel Investors

“*Invest to Exit* is a must read for the Investor looking to maximize their returns from their private equity investments. Tom McKaskill’s latest book concisely distills the merits of Investors focusing on strategic exit from inception. This book provides a solid foundation from which to understand the difference between a financial and a strategic sale for a company and how to build a plan to maximize the returns for both. Understanding the significant value in focusing business resources towards the execution of the strategic sale will enable earlier and higher exit returns for Investors and Entrepreneurs alike. A successful exit may be achievable much sooner than originally anticipated and with significantly less capital requirement.”

Andrew Loch
Chair Gold Coast Angels
Angel Investor & CEO of the Gold Coast Innovation Centre

“The high-growth model has claimed many casualties, especially in smaller economies such as New Zealand where companies pursue growth from a very limited human and financial resource base. While there is nothing wrong with high-growth strategies, they are often inappropriately applied as the only strategy. The world has changed, its time to take a fresh look at investable assets and investable exits before committing.

While working with several hundred technology companies I noticed that patterns began to emerge. Tom McKaskill not only reads these patterns, he connects these themes to offer new insight and he creates pragmatic linkages through to investor returns. If you can’t get him in person, I suggest you get across McKaskill’s body of knowledge in this self-contained book. It is a ‘must read’ for investors, advisors, founders, managers –anyone charged with the creation of value. I have introduced Tom to more than 50 local firms and advisors and will continue to do so because of the amazing feedback he generates.

There is a huge opportunity cost in failing to apply these patterns. There are limited investment candidates with the true hallmarks of success and while we might start with the right material, it can go horribly wrong from there. This book emphasizes tactics-backed strategy and focuses the reader on drawing the narrowest line between an investable exit and the present.”

Matt Yallop,
Repertoire Management, New Zealand

“Goal setting is part of life. Athletes set themselves goals – say, winning the triathlon at the next Olympics. Companies set themselves goals – say, doubling revenue by introducing a new product line. However, setting goals is a meaningless fantasy unless you also devise a methodical approach to achieving that goal.

Yet surprisingly, goal setting and planning are often missing from venture capital investing where investors often become intrigued by the initial concept to the point that they completely overlook the endgame. Investors have an obvious goal – to make money via a highly profitable exit. So why is it unusual to find investors focusing on exits from the very beginning. If done properly, mapping out a methodical plan to achieve a profitable exit, brings a host of benefits as well as removing much of the risk from venture capital.

Tom McKaskill provides the “how to” in his usual accessible style. In fact, it must have been tempting to call the book “Exit Planning for Dummies” since the book provides a step-by-step approach which can be understood and followed by anyone investing in technology-based start-up ventures. Not only does the approach improve the risk/return for the investors, but the roadmap it provides removes much of the uncertainty and angst from the post-investment period which often sees investors become disenchanted with an investee’s progress.

In my view, the book should be compulsory reading for all entrepreneurs and inventors who should work through the book before fronting investors. Their fund-raising prospects would be greatly enhanced if their presentation began with: “Let’s talk about our technology later. I want to start by describing our exit scenario and our plans for getting there”.

Ergad Gold
Principal and Executive Director
Momentum Investment Group

“For the professional Angel and Venture Capital investor, Invest to Exit is the first book to succinctly capture the importance of aligning the combined interests of investor, management and shareholder when making the investment to produce an optimum result on exit regardless of underlying economic conditions. Commencing exit planning much earlier in a company’s development, combined with planning and then flawless execution will always produce an outcome better than starting later and hoping a buyer “will be just around the corner”.

Dr. McKaskill has captured the essence of the issue, providing examples which clearly highlight the challenges and issues faced along the way.

This is compelling reading for investor and companies alike as they work collaboratively to achieve a superior result when they sell.”

Greg Sitters,
Sparkbox Investments Limited, New Zealand

“Tom is undoubtedly one of the foremost thinkers on what it takes to achieve strategic value in a business. With the strategic end game firmly in mind right from the outset, investors can focus their money and management resources on the right activities which drive this value and lead to significant investment out-performance.

Tom’s hands on experience in this area comes through clearly in his writing, including focus on the importance of establishing strong personal relationships with the decision makers in potential buyers. I apply many of Tom’s principles on a daily basis in my investment and advisory activities – these principles are timeless and not dependent on the vagaries of short term market movements.

I strongly recommend Tom’s latest book for all investors looking to profit from a strategic value mindset.”

Barry Palte
CEO EQ Capital, Australia

Dr. Tom McKaskill



Global serial entrepreneur, consultant, educator and author, Dr. McKaskill has established a reputation for providing insights into how entrepreneurs start, develop and harvest their ventures. Acknowledged as the world's leading authority on exit strategies for high growth enterprises, Dr. McKaskill provides both real world experience with a professional educator's talent for explaining complex management problems that confront entrepreneurs. His talent for teaching executives and his pragmatic approach to management education has gained him a reputation as a popular speaker at conferences, workshops and seminars. His approaches to building sustainable profitable ventures and to selling a business at a significant premium, has gained him considerable respect within the entrepreneurial community.

Upon completing his doctorate at London Business School, Dr. McKaskill worked as a management consultant, later co-founding Pioneer Computer Systems in Northampton, UK. After being its President for 13 years it was sold to Ross Systems Inc. During his tenure at Pioneer, the company grew from 3 to 160 people with offices in England, New Zealand and USA, raised venture capital, undertook two acquisitions and acquired over 2,000 customers. Following the sale of Pioneer to Ross Systems, Dr. McKaskill stayed with Ross for three years and then left to form another company, Distinction Software Inc. In 1997 Atlanta based Distinction raised \$US 2 million in venture capital and after five years, with a staff of 30, a subsidiary in New Zealand and distributors in five countries, was sold to Peoplesoft Inc. In 1994 Dr. McKaskill started a consulting business in Kansas which was successfully sold in the following year.

After a year as visiting Professor of International Business at Georgia State University, Dr. McKaskill was appointed Professor of Entrepreneurship at the Australian Graduate School of Entrepreneurship (AGSE) in June 2001. Professor McKaskill was the Academic Director of the Master of Entrepreneurship and Innovation program at AGSE for the following 5 years. In 2006 Dr. McKaskill was

appointed to the Richard Pratt Chair in Entrepreneurship at AGSE. Dr. McKaskill retired from Swinburne University in February 2008.

Dr. McKaskill is the author of eight books for entrepreneurs covering such topics as new venture growth, raising venture capital, selling a business, acquisitions strategy and angel investing. He conducts workshops and seminars on these topics for entrepreneurs around the world. He has conducted workshops and seminars for educational institutions, associations, private firms and public corporations, including KPMG, St George Bank, AMP, AICD and PWC. Dr. McKaskill is a successful columnist and writer for popular business magazines and entrepreneur portals.

To assist Angel and Venture Capital investors create strategic exits for their investee firms, Dr. McKaskill conducts seminars, workshops and individual strategy sessions for the investor and their investee management teams.

Dr. McKaskill completed a number of e-books for worldwide, royalty free distribution. He has also produced over 150 YouTube videos to assist entrepreneurs develop and exit their ventures.

Tom McKaskill is a member of the Apollo 13 Angel Group on the Gold Coast and of the Australian Association of Angel Investors.

Dr. Tom McKaskill
Australia

April 2009

info@tommckaskill.com
www.tommckaskill.com



The Ultimate Deal 1

Selling your business

This book is aimed at those businesses which need to maximise their profit and growth opportunities for a sale to a financial buyer to leverage the best sales price. It sets out a breakthrough process which includes reducing risk, improving sustainable profits and building growth potential in the business to maximise the sales price. This world first process can increase the value of the business between two and ten times the conventional sales value of a firm.



The Ultimate Deal 2

Get an unbelievable price

This book uncovers the secret of how to leverage strategic value in the business to create a large revenue opportunity for a strategic buyer. Dr. McKaskill's is the world's leading authority on selling a business to a strategic buyer and sets out a comprehensive and systematic process for selling a business to a large corporation. Sales values of 40 times EBIT and/or many times revenue are highly probable using his Strategic Sale Strategy for a business with underlying strategic assets or capabilities.



Angel Investing

Wealth creation through investments in entrepreneurial ventures

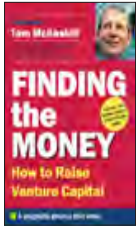
Designed to help high net worth individuals become successful Angel Investors. Angel investing involves active mentoring and coaching of an early stage management team towards sustainable profitability or additional funding, probably from a venture capital firm. This book sets out a comprehensive and rigorous process that will help the Angel generate deal flow, evaluate investment proposals and manage the investment and subsequent harvest. The book also provides a useful guide to managing operational risks in the venture.



Get A Life!

An inside view of the life of entrepreneurs - from around the world

This book is a collection of stories from entrepreneurs around the world where they describe their work and their lives. They explain what it is like to be an entrepreneur, how they got started, the successes and failures of their ventures and the highs and lows of their personal and business lives. The stories are rich in content and provide deep insights into how entrepreneurs think. If you are an entrepreneur this will resonate with your inner being. If you are not, this will provide you with a great understanding of entrepreneurs.



Finding the Money *How to raise venture capital*

The purpose of this book is to educate the entrepreneur on how Venture Capital firms work, what they seek in an investment and how they manage that investment through to an exit transaction. It helps the entrepreneur judge whether they have a venture suitable for VC investment and whether they wish to be part of such an activity. It lays out a comprehensive process that the entrepreneur can follow which will assist them in raising VC funding.



Winning Ventures *14 principles of high growth businesses*

Explains the major contributors to high growth success. Includes a comprehensive Growth Check list for each principle as well as a robust Growth Potential Index to help the reader judge the growth potential of their venture. Based on established theories of growth, venture capital selection criteria and the author's personal experience, this is a must for entrepreneurs.



Masterclass for Entrepreneurs

Creative solutions for resilience, growth and profitability

This book is a collection of published articles by Dr. Tom McKaskill. This volume expands on 30 of those articles to provide a wide-ranging guide for entrepreneurs on how they can manage their businesses more effectively.



Fast Forward

Acquisition strategies for entrepreneurs

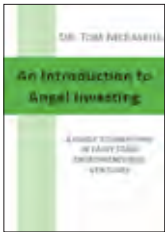
In this book, Dr. McKaskill sets out a systematic and pragmatic process for identifying, evaluating, valuing and integrating financial and strategic acquisitions. He draws extensively on his own experiences as a CPA, entrepreneur and academic, as well as his experience with acquiring and selling his own businesses. He brings a systematic and comprehensive approach to growing business through acquisitions.



Raising Angel & Venture Capital Finance

An entrepreneur's guide to securing venture finance

This book is aimed at those entrepreneurs who have high growth potential ventures and seek to raise finance to assist them to develop their business. To secure the finance, the entrepreneur will have to demonstrate that their business is capable of achieving a premium on exit, usually through a strategic sale. The book provides a checklist for the entrepreneur to assist in developing a strategy to raise finance.



An Introduction to Angel Investing

A guide to investing in early stage entrepreneurial ventures

Designed to help high net worth individuals become successful Angel Investors. Angel investing involves active mentoring and coaching of an early stage management team towards sustainable profitability or additional funding, probably from a venture capital firm. This book sets out a comprehensive and rigorous process that will help the Angel generate deal flow, evaluate investment proposals and manage the investment and subsequent harvest. The book also provides a useful guide to managing operational risks in the venture.



Invest to Exit

A pragmatic strategy for Angel and Venture Capital investors

Investors in early stage ventures need to focus on strategic exits if they are to achieve a high return on their investments. This book explains the characteristics of strategic value, how the investor should negotiate the investment and how they should manage the process to a strategic trade sale. The book includes a very detailed discussion of the problems of high growth ventures, the unrealistic expectations associated with IPOs and the advantages of investing in strategic value ventures.

Published by:
Breakthrough Publications
RBN B2173298N
Level 1, 75A Chapel St.,
Windsor, Melbourne, Vic 3181

www.tommckaskill.com
Copyright © Tom McKaskill 2009

All rights reserved. This publication may be reproduced, stored in a retrieval system or transmitted in any form by any means for personal use without the permission of the copyright owner. This publication may not be sold or resold for any fee, price or charge without the permission of the copyright owner.

Every effort has been made to ensure that this book is free from error or omissions. However, the Publisher, the Author, the Editor or their respective employees or agents, shall not accept responsibility for injury, loss or damage occasioned to any person acting or refraining from action as a result of material in this book whether or not such injury, loss or damage is in any way due to any negligent act or omission, breach of duty or default on the part of the Publisher, the Author, the Editor, or their respective employees or agents.

National Library of Australia Cataloguing-in-Publication data:

McKaskill, Tom.
Invest to Exit - A pragmatic strategy for Angel and Venture Capital investors.

ISBN 978-0-9806458-0-4 (on-line), 978-0-9806458-1-1 (CD/DVD)

1. Investments. 2. Investment analysis. 3. Entrepreneurship. 4. Business enterprises - Finance.

I. Title.

332.6

Cover design: T. McKaskill

Page design and production: T. McKaskill

Table of Contents

Preface	xiii
Acknowledgements	xiv
1. Begin with the end in mind.....	1
2. High growth - high risk.....	13
3. Spot the IPO.....	34
4. Financial v.s strategic exits	53
5. Threats and opportunities	72
6. Identifying strategic value.....	92
7. Finding strategic buyers	124
8. Enabling the opportunity.....	142
9. Reducing risks to the buyer	158
10. Setting up the exit deal	178
11. Evaluating potential investments.....	198
12. Executing the exit strategy.....	217
13. Structuring the trade sale deal	231
14. Selecting professional advisors	249
15. Conclusion - impatient capital	259

Preface

Over the last few years I have advised countless entrepreneurs, Angels and Venture Capital fund executives on exit strategies. Almost without exception, I have found that they have a poor understanding of strategic value or how to set up a strategic trade sale. Far too many are consumed with the goal of an IPO even though this is rarely achieved by an early stage venture.

I have taken the opportunity in the book to set out what I believe is the best way for an Angel or Venture Capital investor to approach an investment opportunity. Basically, don't invest unless there is a clear path to a strategic sale. A focus on a highly probable premium exit aligns investor and venture management interests, provides a very clear path to a harvest for all parties, significantly reduces the business development hurdles and usually results in a much shorter investment period.

I hope you find this book of great value in your investment program and look forward to receiving your feedback on its implementation.

Acknowledgements

A very large number of people have contributed to my knowledge of this topic. This includes hundreds of entrepreneurs who have been through my classes and workshops, Angels who have attended my training sessions and discussed their investee firms with me and VC executives who I have worked with on exit strategies for their investee firms. Each conversation, question and problem has helped me refine the strategic sale model.

My life partner, Katalin Johnson, has been with me every step of the way, participated in the seminars, workshops and most of the conversations. She has assisted me greatly by asking the hard questions, reviewing the material and making her own contribution to the content.

1 Start with the End in Mind

It seems very obvious that an Angel or VC investor will ultimately seek an exit, whether that be a trade sale or an IPO. It therefore makes sense to keep this objective in mind as the investment is progressed as this would hopefully improve the outcome and thus the return on the investment. While that might seem obvious, few Angels or VCs actually approach their investments this way. Most seem content to build the company with the expectation that, when they are ready, a buyer will be found or an IPO achieved. In reality, the outcomes are poor and few deals achieve high returns.

But lets go a little further. What about planning the exit from the outset. That way the manner in which the business is developed continually keeps the exit in mind and this ensures that we don't veer off track in terms of meeting our major objective. Some Angels and VC investors do this but they are in the minority.

Now lets get even more radical. Why don't we change our investment criteria to only focus on investments where we have a high probability of a premium exit. In order to do this, we have to have a very good idea of what creates premium exit conditions, that is, what do we have to do to set up the conditions where a premium

exit is highly likely, whether this be an IPO or a trade sale? What would we have to do to make this happen?

At the same time, we want to reduce our risks of failure, ensure that we can extract maximum value if the business gets into trouble and be ready to take advantage of an opportunistic exit.

A tall order – actually no. My personal experience and my research into strategic exit strategies over the last several years has shown me that you can set out to create the conditions for a premium exit. This book will show you how to do it.

You have no doubt heard of highly successful exits, the stuff legends are made of. There are enough examples of trade sales of 10 times revenue or better, 100 times EBIT or 50 times investment to know that such deals happen. We also know of IPOs which gave staggering returns to the early investors. Was it just luck? Was it simply a matter of ‘right time – right place’? Probably. But there is enough evidence around to show the underlying patterns for why these results occur and under what conditions.

If that is the case, can we turn luck into a systematic process for achieving a high return on exit? I will show you how.

My own experience has shown me that the process is obvious and that it can be applied with a high probability of success. But there are some pre-conditions. You have to start at the right place if you are to get the result you want. You can’t turn lead into gold and you can’t create a premium exit unless you have the right material to work with. Thus getting into the right investment at the outset is a precondition to achieving an outstanding return on the investment.

You would be right at this point to ask the question – if this is so obvious, why don’t I know about this already? I have asked myself this same question many times over the last few years.

What we first need to accept is that the VC investment model of the 1970s through the millennium is a flawed process. It was built during the periods of boom markets, focused wholly on IPOs and had a fallback plan of a trade sale. All

this happened in large population markets which made it easier. Our investment environment is radically different now. That is not to say that we won't see these conditions again as they do tend to repeat themselves with each new breakthrough innovation, but you can't bet the farm on that happening. We need a different approach which will work in the current economic environment with greater resilience to changing conditions.

Even so, we know very little about how to set up a successful IPO outside boom markets. I have done enough research in this area to provide a more reliable guide to IPO exits which I will cover in a later chapter.

But what about trade sale exits. This is one area where you would think we would have considerable documented experience but, in fact, the opposite is the case. When I first started my research activities in the area of trade sale exits, I discovered that there was not a single published piece of research in this area. Not one! I canvassed a number of highly reputable scholars in venture capital investments and entrepreneurship and was informed that it was a black hole. Not so the acquisition literature which has thousands of published articles.

The literature which is available on selling a business is aimed at very small businesses and very much takes a consulting or business broker approach. But if you want to sell a high growth venture or if you want to sell to a strategic buyer – there is nothing for you.

There is no question that there are people who understand the trade sale process very well and even some who are very skilled at setting up premium deals and strategic deals, but they had never documented their experience or developed a process for others to follow.

My objective over the last several years has been to fully understand the exit process and to document a best practice model which would have a high probability of success. I have now published this in many articles and several books. In this book I wish to focus on one specific issue – how can the Angel and VC investor use this process to achieve a high return across a wide spectrum of economic conditions.

In this book I will articulate how to choose the right ventures to invest in and then show how to progress them towards a premium outcome.

Firstly, let me explain how my personal experience in trade sales has shown me that the conventional Angel and VC exit models are far too limited and fail to take into account strategic value exits.

For over 20 years I was involved in setting up, building and selling companies, first in England and then later in the USA. Since then, I have been teaching graduate students about harvesting their firms and have come to see just how unique my journey through the years has been.

THE FIRST COMPANY I started, Pioneer Computer Systems (PCS), which was started in 1979 by three partners in my dining room, took us 13 years to build to 160 staff located in three offices; Northampton and London in England and San Diego in the USA. The company developed and sold Enterprise Resource Planning software (ERP) for discreet and process manufacturers. In 1985 we raised US\$1.5 million in venture capital to buy out a 4GL supplier in order to gain control over a critical part of our R&D. Around 1990 we decided that we wanted to be able to take out some of our hard earned wealth. In order to do so we needed to sell the business. At the time of our initial enquiries valuations in our sector were running at about 4 x EBIT. We were generating about STG500,000 in EBIT at the time and so it looked like an attractive exit. However, by 1991, the UK headed into a depression. We were still interested in selling the company but found that acquisition prices were down to around 2 times EBIT. Unfortunately, by then we were also in decline and looked like barely breaking even that year.

We turned to the USA in order to find a buyer.

We looked for a company that needed us. It needed to have its products based on the same computer operating system as we used as that was a significant factor in being able to integrate our software. We looked for a company that could take us into a larger market and could benefit from our development of the first fourth generation soft-

ware development language (4GL) based ERP system for the process manufacturing sector. We identified Ross Systems Inc., a firm generating about US\$40 million in sales.

We made an approach and were asked to come and present a case to them. We did not learn until after the acquisition that they had identified us as their best acquisition possibility. However, at the time of our approach to them, they were unlisted and we determined the risk was too high to sell out to a private company but as they were proceeding to an IPO, we decided to wait. A few months later we signed up their Asian distributor. This provided ROSS with a way of evaluating the software through the sales and implementation processes. It also proved to them the global potential of the software. Five months later they listed and within a week we had someone come to the UK to undertake due diligence on the software and our operations. Six weeks later we had negotiated a deal worth 10 times our prior year EBIT.

Within 9 months of the purchase, our software was the flagship for the combined business and our technology was used on every new software development. ROSS increased the sales of our product by a factor of 5 in the first 18 months of the acquisition. Twelve years later, ROSS was still based on the same software and had made few changes to the basic functionality. ROSS was subsequently acquired by Chinadotcom.

In hindsight, it is easy to recognize this as a strategic acquisition by ROSS. What they really wanted was our manufacturing software and they were able to considerably increase the sales of the product because they had a much larger sales force, a number of key strategic partnerships and the funding to undertake a significant push into an emerging market. They bought the product with its supporting infrastructure, not the customer base, the revenue or the profit (or lack of it). When you are making a loss, it is difficult to see how an EBIT multiple can give you a positive value on sale. However, when you see it from the buyer's viewpoint, the price paid was small compared to the market potential of the product suite.

My next venture was an even greater radical departure from conventional valuation.

TWELVE OF THE PCS key employees relocated to Atlanta in 1992. In my last year with ROSS, 1994, and before my contract expired, I established a consulting firm in Kansas. I had already helped to establish an affiliated firm in New Zealand of which I was a small shareholder. The Kansas operation would trade under the same name, CIMDEC Systems, but be mostly owned by myself and two local executives. About 6 months later and before we had started any operations, the NZ firm was acquired by a Scottish listed company. In order to expand their operations into the USA, they needed to buy back my distribution rights to the CIMDEC software. I had it – they needed it. We settled on a price of US\$1 million for the business. I had made US\$500,000 from an investment of US\$10,000. Our USA business had never undertaken any work, never entered into any contracts and never generated any revenue.

Basically, the new owner purchased the NZ and USA operations to generate new revenue from outside their core construction business. They combined several businesses into a global IT company. Entering the USA through Kansas was a key factor of the deal.

When you consider that the normal approach to valuation is to multiply an EBIT by an industry norm, it is hard to see how you can get \$1 million from a zero position. But it does tell you that the existing paradigm is lacking if it can't explain how this outcome was achieved.

In 1995, soon after I left ROSS, I co-founded Distinction Software Inc. with US\$200,000 and about 12 people that joined me from ROSS Systems. We started building a forecasting package and gradually expanded it to a full suite of supply chain optimization modules. Our intention was to build the 'missing piece' of the ERP solutions in the process manufacturing software applications sector. Our intention was to sell back into our old customer base and then use this as a platform to grow the business in the sector.

About a year or so after we started, a small scheduling software company, Red Pepper, was acquired by Peoplesoft for something like 26 times revenue. Peoplesoft wanted to move into manufacturing software and needed an icon product to launch their campaign. Red Pepper was the product they used to do so. It gave them the momentum and market credibility to become a major player in the enterprise wide manufacturing software market. We used the Red Pepper deal to demonstrate that our sector was now in a high growth phase. It allowed us to raise US\$2 million in venture capital.

In order to generate sales, firms in our sector typically partnered with very large application software companies like SAP, PeopleSoft, JD Edwards, Baan and Oracle. However, we came badly unstuck when a few years later SAP announced the development of a suite of products across this space and terminated our partnership arrangements. Within a few months all their competitors announced similar developments. The market for the likes of Distinction Software evaporated.

We decided to sell rather than retrench most of the staff. In one day I contacted 8 firms who were potential buyers and all were interested in negotiating. A week later, armed with two large boxes of documents which described every part of our operation, I met with Peoplesoft. They were given 7 days to come up with a deal. The deal was negotiated over the phone and 2 weeks later we sold the company for US\$12 million.

By the time of the sale, Distinction Software was hemorrhaging badly and running at about a \$1 million loss. We effectively had zero prospects and only about 6 months worth of cash left. Basically we were dead.

However, this was a great deal for Peoplesoft. They had just written off US\$13 million on a failed forecasting software product. We provided them with 5 modules of which forecasting was one. Instead of spending 5 years to develop a suite of products (even if they could), they

entered the market with one of the few complete, proven solutions. None of their competitors had anything to match it and were probably some years away from having a competing product.

In hindsight, we sold out cheaply. The public relations value alone was worth the US\$12 million we achieved for the business. Then, of course, there was the potential sales just into their existing customer base which could easily have earned them 50 times their investment in a few years.

What is remarkable about this story is that it was possible to achieve a great outcome for the Distinction shareholders in just a couple of weeks in a situation where it was truly a fire sale.

As a Professor of Entrepreneurship, I used these personal experiences to look at the entire process of preparing a business for sale. What I found was that very few advisors understood how to value the strategic value of a business and no one I talked to had ever implemented any systematic process for preparing a venture for a strategic sale.

The existing literature on selling a business takes the same approach for every business, simply increase the profits and sell out on an EBIT multiple. This approach to selling is typically promoted as a series of steps in a linear process that ends up with a sale to a buyer. It is very much a 'one size fits all approach'. Not only does it not do justice to those businesses which are capable of proactively changing their operations to increase their profits and growth potential, but it seriously undervalues those businesses that have assets and capabilities that can create large revenue opportunities for potential buyers.

In the conventional approach there is a serious lack of strategy. No attempt is taken to alter the business to suit the buyer or to proactively change the external environment in which the business will be sold. Historically, selling a business has been managed predominately as a real estate transaction and this approach has failed to develop or utilize any underlying theory about how value is created for the buyer.

The literature on IPO preparation is similarly lacking. Not only is there a complete lack of understanding of what it takes to be a successful listing but

the only guidelines available are about the listing process not the strategy to follow to create a listing opportunity.

If we are to improve the probability of successful investments for Angel and VC investors, we need a much more sophisticated and systematic approach to the exit, whether it be a trade sale or an IPO. Our literature and our training is seriously lacking in this area. While we spend a lot of time on showing investors how to get into an investment, there is little to show them how to get out successfully. What is apparent is that the exit event itself is not linked back to the criteria for investment and the development strategy of the investee firm.

The conventional model of business development focuses on revenue and profit growth and yet little attention is given to the risks associated with high growth enterprises. If the only model going is high growth, then where is the literature on how to manage a high growth enterprise. What I have seen is that it is seriously lacking. Our understanding of what it takes to generate high growth and how to manage it is very immature and yet the dominant model for Angel and VC investment are built on the premise that high growth is the only way to achieve a high return on exit. As I will show later, high growth is not only high risk but rarely has good outcome.

VC and Angel investors experience a reasonably high rate of write-offs and negative returns. Even their positive exits rarely achieve high returns. It is only the exceptional investment that achieves returns in double digits. This is partly due to an outdated investment model fixated on high growth but also because they fail to plan for an exit under less than ideal conditions.

Very few firms choose the timing of their sale. Most are forced into a sale by external events or through poor management. A smaller number are approached by a potential buyer and take the opportunity to sell. Only a very few control the timing of their sale by taking the initiative to find a buyer when they are not under pressure to sell.

If you cannot reliably predict when the business will be sold, you need an investment approach in which the business is able to be sold at any time, if you need to or want to. Being prepared to sell at any time is the only way to protect the value in the business.

You need to sell

Not everything is going to go according to plan. Sometimes market conditions change and the business is no longer capable of reaching the targets initially set or may no longer be viable. Rather than let the firm become insolvent or bankrupt, the exit plan should be set up so that there is little delay in executing a trade sale. This way the maximum benefit can still be extracted from the failing business.

Often time is against you. If the management team has not put an exit strategy in place and they have little time to prepare or to set up discussions with potential buyers, you will have a fire sale as an exit. If they have not already set up the relationships in advance, especially with overseas buyers, it probably is not going to happen the way you would like. Without the planning, the ability to attract the buyer that will pay a premium value for the company is significantly constrained.

By setting up relationships in advance and by knowing why the corporation would want to buy the firm, management can execute the acquisition discussion quickly. As long as the firm has several potential buyers, the competitive tension in the deal can still result in a very attractive sale price.

The firm is approached with an offer to buy

Many Angel and VC funded firms are targets for acquisitive corporations. However, when the offer comes management may be unprepared and are unsure what the price should be. If management are unprepared and need to go through extensive due diligence, this not only takes considerable time, but it uncovers risks to the buyer. Instead of closing a good deal, the firm will end up with a disrupted business, staff who are stressed due to uncertainty and a price that the shareholders would normally not have accepted. Now management has taken their eye off the ball and have a lot of work to recover their prior momentum. They may also have talked themselves into the deal.

How much better would the firm be if they had already lined up several possible buyers? They can now announce that they are prepared to sell and consider all offers. Management will have prepared the due diligence files and

can execute the deal quickly with little disruption. The staff understand the process and have incentives to ensure the best deal is done. This should be canvassed with staff from an early stage so that they understand the need for a planned exit for the external investors.

You and management decide to sell

Experienced Angels, VC investors and a good management team should already know of the best potential buyers and through its business strategy it should have already put itself in a position to actually know those parties. If management have prepared the company for sale over many years then they are best placed to be able to drive the exit process rather than have it drive them. You and management simply need to decide on the timing.

You decide to list the business

What is clear is that there are many advisors who want to help you. Rarely do they tell you not to list as they all get the chance to charge you high fees and commissions, whether you make it to the IPO event or not. Even if you do list, you may not have a positive experience afterwards if you don't have the right business model. It is an expensive process if it goes wrong.

A New Approach

As an Angel or VC investor you need a better process. Not only should you have a systematic method of preparing an investee firm for a good exit but you also need to have better criteria for selecting the businesses you invest in.

If you want to invest in growth businesses, then you need a much better understanding of what drives sustainable growth. You should also have a better appreciation of the risks associated with high growth. If you desire to take a business to an IPO, then make sure you get into the right business from the outset.

However, if it is simply a high ROI you seek, then take a new approach. Stick to strategic value deals. Not only are these less risky than conventional growth investments but they can be exited earlier with a much higher probability

of positive returns. If you do decide to take this approach, then you need to ensure that the investments you do make have strategic value potential, thus you need to have a very good understanding of how strategic value is created and harvested but also, how to identify it before you invest.

Whether it is an IPO or a trade sale you seek as an exit objective, you need to invest with the exit in mind. This informs everything you do from choosing your investments to managing the business and securing the premium on exit.

In the next chapter, I will look at the process of high growth, what creates it and the risks associated with pushing a venture into a high growth mode of operations. Following this discussion, I will look at the IPO process and how this can be achieved.

The remaining chapters of the book will examine the nature of strategic value, how it is identified, developed and used to structure a strategic value trade sale.

2 High Growth

High Risk

Almost without exception our measure of business worth is expressed in terms of profit; even better if that is growing year on year. Thus any small firm interested in raising finance is going to be asked to show revenue and profit growth and be able to demonstrate that its 'business concept' has substantial future potential in these areas. Without exception, by business concept we usually mean the entrepreneur has to demonstrate how the business is going to make money. The future profitability of the business can then be readily translated into an IPO or trade sale valuation.

Since an IPO exit has been historically seen as the preferred exit route, the conventional investment approach taken by Angels and VC investors is to invest in companies which have higher growth potential. They see the business as a stand-alone entity increasing in value through revenue growth and increasing profits. Value is seen as a direct multiple of EBIT and so getting to higher levels of revenue and profits is the business development strategy.

What this means is that the new investee firm has to develop a stand alone profitable growing business in order to be a 'good' investment in the eyes of the investor. An even better business is one that grows faster and generates higher profits.

Actual growth or potential growth, especially high growth, is seen by Angels and VC investors as an essential component of all successful exits, i.e. trade sales and IPOs. However, to get a reasonable return on the investment, the venture will have to post relatively high growth rates. Even then it will take some time to achieve the levels of profit required for a good exit.

Lets start with some basics, time, growth rates and ROI. If you look at the basic relationship between time and valuation, the time element is critical to a healthy return on investment. The longer it takes to achieve the same exit valuation, the lower the ROI as the following table demonstrates.

Example:

THE VENTURE IS currently generating an EBIT of \$100,000 on revenue of \$1 million. The investors agree a \$1 million pre money valuation and invest \$1 million for 50% equity. The funding will be used to undertake market development, fund working capital and complete product development. Thus, while revenue rates will kick up, the venture still has to mount a sales and marketing campaign, close deals and deliver quality products. Let us assume that they are able to grow the business to \$5 million revenue and \$500,000 in EBIT. At this time the business is sold for 10 x EBIT or \$5 million. The return to the investor will depend on how long it takes the business to achieve this result.

ROI to investor

Year	1	2	3	4	5	6	7	8	9	10
ROI	150%	58%	36%	26%	20%	16%	14%	12%	11%	10%

In this specific example, the IRR also represents the growth rate of revenue and profit. Since most Angel and VC investors look to a risk hurdle rate of 25% or higher, only an exit before year 5 will achieve that. That means very high growth rates during the early years of the investment. However, we know from the research on high growth ventures that only a fraction are able to generate double digit growth rates, so growth rates above 20% would seem to be exceptional. A more realistic growth rate of 10% to 12 % which, over time is still

difficult to achieve, only provides a reasonable return after 8 years. Few Angels or VC investors would wish to invest on this basis.

It would seem unrealistic to expect an early stage venture to develop to a point where it can generate reliable profits within a few years. What is clear from this example is that investee firms need to get to a reasonable size if the venture is to return a good ROI to the investors. The research would suggest that this only occurs in exceptional situations.

A lower exit price, which is more realistic, dramatically reduces the returns. Also, the longer it takes to exit, the more likely returns will be poor. The only way such a result can be offset is if the entry valuation is pushed down aggressively. While that is possible it does create considerable tension between the investors and the founders.

A large proportion of Angel investments and a small percentage of VC investments are at a very early stage in a venture's life, often when it has only a few employees. Firms at this stage are especially vulnerable to failure. Early stage ventures are characterized by high levels of uncertainty due to a combination of factors:

- The product is often unproven
- The management team is inexperienced
- There are gaps in the management team
- The market is developing and yet to be established
- Competition is still uncertain with new products emerging

Thus the business has to first survive and secondly, grow to achieve a reasonable return on investment. So why do companies fail and why is growth so hard to achieve?

Let's start with an understanding of what causes early stage firms to fail.

Understanding the causes of failure

The major causes of business failure are now well documented and there are modeling techniques that are able to predict with considerable accuracy whether a particular business will fail. While there is no one characteristic of a business that will, by itself, cause a business to fail, a combination of weaknesses can create a situation where failure is highly likely.

Let's start with some data on failures.

Although there are definitional problems in measuring what is meant by 'failure', the data on the rate of failure is open to speculation. Even so, while 'exits' are not the same as failures, the data is enlightening. 1997 ABS report of business exits in Australia, reported that exits accounted for 8.5% of all business per annum (their definition of exits included cessation, liquidation, receivership, change of ownership and mergers). They report a much higher exit rate in new businesses. The ABS data provide the following rate of exits of new ventures; 18% exit after 2 years, 24% after 3 years, 35% after 5 years, 55% after 10 years and 65% after 15 years.

Several Australian and overseas studies have measured start-up failures. David A. Garvin writing in the Harvard Business Review (July 2004) in an article entitled 'What every CEO should know about creating new businesses' states that, during the 70s and 80s, 60% of small business start-ups failed in their first 6 years. Similar studies over different periods and in different countries have found similar rates of failure. There is, however, some level of disagreement across all these different studies as to the primary causes of failure. It is thus difficult to be definitive and arrive at a simple predictive model which could be universally applied. There also appears to be distinct differences between the causes of start-up failures and failures of established business. Even with this reservation, it is instructive to see some of the conclusions.

David A. Garvin stated in his HBR article that start-up failures demonstrated one or more of the following problems:

- Customer failure (unwillingness of customers to pay for product or service, or insufficient demand)
- Technological failures (inability to deliver the promised functionality)
- Operational failures (inability to deliver at the required cost or quality levels)
- Regulatory failures (institutional barriers to doing what's desired), and
- Competitive failures (a competitor's entry changes the rules of the game).

He concluded that success rates rise substantially when a new business targets familiar customers and is staffed by people well acquainted with the market. His test of survival was being able to clearly answer the following question; "What's the pain point for customers and how does our offering overcome that pain?" I will return to this point when I discuss the underlying drivers of high growth, especially an attribute termed 'the compelling need to buy'.

In more established businesses, the consensus of opinion suggests that the primary causes of failure are; a lack of adequate funding, a failure to recruit good quality personnel, the lack of a written business plan and a failure to use professional advice. Characteristics such as being the sole founder, not having parents who own a business, a lack of prior management experience and the younger age of owners have all been found to explain venture failure in some studies but are not supported in others and thus do not seem to have general applicability.

What all these studies do show is that there are some very good predictors of failure. While individual characteristics might not be decisive, there can be no question that the more of these deficiencies a firm has, the higher the likelihood of failure.

The overwhelming evidence does show that it is possible to predict in advance that a specific business idea has a limited chance of success. Thus a

market that has too few potential customers, where the customer's don't have any money, where the technology is unproven, where competition is fierce, where costs are highly uncertain or where the entry costs are prohibitive, are situations where the idea should be rejected. Opportunity screening models or 'investor ready' models and checklists used by Angels and VC investors greatly help avoid investment decisions that have low probabilities of success. Even so, market conditions can change, especially in emerging markets and thus failures often cannot be avoided.

Given our knowledge of business failure, the more sophisticated investor should be able to avoid the obvious mistakes. Even so, some Angel and VC investments do fall into these traps, perhaps due to unforeseen changes in market conditions. Ventures that fail end up being closed down and the investment written off or put into a fire sale where the investor loses most of their investment.

Smart investors can usually avoid these basic flaws. Their risks are much more to do with aggressive growth. As far as the Angel or VC investor is concerned, it is not sufficient for the venture just to survive, it must generate sufficient profit and revenue growth to create a good exit event. However, as we will see, high rates of growth are difficult to achieve. What is often forgotten in the drive for high rates of growth is that growth itself is a high risk game and is often the cause of business failure.

Achieving high growth is challenging

Private businesses which grow beyond a few employees are in the minority. Achieving a size which can generate a significant sale price is challenging. Just how challenging – check out these statistics from the ABS – similar data would exist for all major developed countries.

As at June 2007, there were 839,938 (42%) employing businesses and 1,171,832 (58%) non-employing businesses in Australia. Thus over half the registered business had no employees.

Of the employing businesses, 755,758 (90%) employed less than 20 employees. This comprised 527,445 (70%) businesses with 1-4 employees and 228,313 (30%) businesses with 5-19 employees. Of the larger business, there were 78,304 (9%) businesses with 20-199 employees and 5,876 (<1%) businesses with 200 or more employees.

If we assume that any reasonable sale price is going to need a business with over 20 employees, you can see from this data that you have a 1 in 10 chance of building a business to this size. Size of business by annual revenue shows a similar challenge.

AS AT JUNE 2007, there were 501,467 (25%) businesses with turnover between zero and \$50k and 742,288 (37%) businesses with turnover from \$50k to less than \$200k. This was followed by 646,458 (32%) businesses with turnover from \$200k to less than \$2m, and 121,557 (6%) businesses with turnover above \$2m per annum.

Source: Australian Bureau of Statistics 8165.0 - Counts of Australian Businesses, including Entries and Exits, Jun 2003 to Jun 2007

You would certainly want to invest in a business which was capable of growing to more than \$2 million in revenue in order to have a good exit, but this seems to be somewhat difficult to achieve based on this data.

Clearly if growing a businesses was easy, there would be many more larger businesses. Since the data shows that this is not the case, it begs the question – why is growth so difficult?

What the research demonstrates is that the growing business has to go through major changes as it copes with the challenges of increasing size. The business of 2-5 employees will not look the same when it has 5 times the number of employees and/or 5 times the revenue. It is almost inevitable that it will have to change the way it does business in order to manage the increased complexity of a larger business. Different stages of grow will require it to change

fundamental aspects of the business. Too many businesses fail to plan for these changes and put the business at risk by trying to make major changes on the fly.

Entrepreneurs who have grown a business from a start-up will tell you of the transitions that they had to go through as the business grew. I discovered major transition points in my own business at 12, 50 and 100 staff. The business also went through a major organizational crisis when it undertook an acquisition 12,000 kilometers away.

Complexity increases dramatically with the volume of staff, customers, products and locations. In order to achieve 5 times the level of the current business, most of these size attributes will increase significantly. What is not so obvious to most entrepreneurs is that the business will need to be managed differently with each additional level of complexity.

Almost without exception, small businesses face a crisis of management as they grow. In the start up phase, the entrepreneur is able to drive the business through sheer energy, passion and vision. He or she knows everyone and the staff are motivated because they are part of the grand adventure.

As the firm adds staff, new people come into the business who were not present when the grand vision was created and their motivations and needs are likely to be different. They may see it more as a job than a mission. They have different needs and thus management styles have to change. At the same time, the growth brings with it specialization of tasks and more formal organizational structures. Reporting lines become more rigid, job descriptions become the norm rather than the exception and performance targets and monitoring is introduced. Soon there is a new layer of management between the CEO and the operations. What was once a project has now turned into a real business.

As the business grows further, communication becomes increasingly formalized as communication lines become longer. The left hand no longer knows what the right hand is doing. Customer service quality may fall as new customers no longer have the advantage of personal links with the founders. Problems escalate with the second location and daily face to face communication is not physically possible. External shareholders and/or external Directors force more

transparent decision making and thus the entrepreneur can no longer make decisions on the fly. Larger numbers of staff, customers and other stakeholders now depend on the business for their livelihood.

As the business develops the entrepreneur discovers, often too late, that they have the wrong organizational structure for the more complex, larger business. They will almost always find that some of their best staff are unable to make the transition to the larger enterprise. They may lack the skill, personality, work ethic or experience to work effectively in a more complex situation.

As the business grows, the entrepreneur will also find that the data collection and reporting systems are inadequate for a more complex, larger business. The same may well apply to the distribution channels, alliance partners, manufacturing processes, professional advisors and so on.

Many entrepreneurs simply are not able to make the transition. They may not have the skills, personality, drive and energy, leadership skills, knowledge or business acumen to be effective in the growing firm. Just because a person is a natural entrepreneur does not mean they have any business training or skill. The inventor may be great at the discovery of new products but that does not make them a good business leader. Thus the person in place as the business manager may well be the source of its failure or its lack of capability to grow.

The drive, skill and experience of the CEO is only one of the many elements which have to work effectively for the business to grow successfully. The business still has to deal with getting its products, markets, distribution channels, financing, recruitment and training and many more things right to drive successful growth. Each one of these many facets can undermine growth processes.

We also know from the research into high growth businesses, the 'Gazelles', that very few businesses are able to maintain double digit growth for more than a few years. Even the best companies have difficulty managing the exponential complexity of an integrated growing business.

Let me demonstrate the high growth problem with a simple example:

I RECALL REVIEWING a budget projection for one of my businesses where we were examining the cost of recruitment. The recruitment cost seemed somewhat low. When I queried the underlying assumptions, I was told that it represented the cost of recruiting an additional 20 staff, a 40% growth. However, the numbers did not take into account that, of the current 50 staff, we had replaced 12 in the last year. Some had moved interstate with partners, some had gone back to full time education and a couple had taken maternity leave. In fact, we had actually only dismissed two for poor performance. Thus instead of recruiting 20 new employees, we had to recruit 32, 64% of our current staff.

When you look at average retention rates, you can expect some percentage of the employees to leave, not because they did not perform well, but because they have personal and family plans that might take them on another path. Thus recruitment and training in a high growth business becomes a real challenge. If you are growing at 100% and replacing 20%, you are recruiting 150% of those that are left at the end of the year. Now, add to that the cost of training and the impact on the productivity of the remaining staff who have to work with large numbers of new employees.

If you think that is a daunting task, work out the cost and work involved in putting in place the infrastructure needed to support them. Accommodation comes in discrete sizes, so when you run out of space you can't simply add enough space for one more person, you might only be able to acquire space in blocks able to accommodate 10 or 20 staff.

AT ONE STAGE I ended up with three separate offices in Northampton in England as we kept growing out of space. Since I could not predict the growth further than about 6 months ahead, I was not prepared to invest in too much extra space, thus I ended up in a completely sub-optimal spread of staff with people in three separate offices around the town. I had the same problem with the phone system. It came in

discrete sizes, up to 12, 64 or 128 extensions. However, when you moved up to the next system, all your investment in the prior system was wasted and you started again. Other infrastructure costs include computers, desks, meeting rooms, storage space and so on.

When firms grow quickly they have great difficulty managing the basic operations. Quality often suffers as firms grow quickly. Staff are recruited too quickly, job descriptions are loose, reporting lines are blurred, performance metrics are ill conceived and systems for dealing with complaints are poorly established. IT systems take a long time to choose, implement and bed down. People simply haven't got the time to figure out how to work together. Often one part of the business does not know what another part is doing.

By far the biggest problem is financing the growth. Very few businesses are able to fund the growth through internally generated funds. When you consider the costs that are incurred in recruitment, training, accommodation, computers and supervision, few firms generate the level of profit margins that can cope with more than a 15% growth rate. For most fast growth firms, external funding is an imperative. Even if some of the investment is in equipment, inventory and buildings, only a portion of that investment is going to be covered by traditional asset financing. What can't be covered by internally generated funds has to be sourced from public or private investors. That activity will also take senior executive time away from running the business. Cash management is probably the most critical activity for the high growth emerging firm.

These factors not only make it hard to sustain growth but the constant changes being forced on the organization sow the seeds of failure. Not a lot has to go wrong with such a finely tuned engine for it to collapse or get into serious trouble. Most will recover, but they will lose a lot of the gains made in prior years. Others will not be able to turn the ship around in time and will end up insolvent, unable to raise debt to fund operations or will have lost key customers and employees during the disruption.

For the investor waiting to reach a stage and size where an exit can be successfully undertaken, these setbacks are not uncommon. Very few growth ventures exit successfully. Many are written off and a good portion of the remainder are exited with losses or low positive returns. It is only the exceptional venture which gains a significant return on investment.

What is the probability of success?

I would think there are very few Angels or VC investors who would not desire the investee to grow to at least \$2 million in revenue and yet we can see from the ABS data that only 6% of all private businesses exceed this threshold. I very much doubt that the same investors would wish to enter into an investment which would not see employment numbers exceed 20 and yet only 10% of all businesses in Australia in the 2007 data exceeded this number.

We can see from the prior explanation that there are significant challenges in growing the business and no doubt this is the underlying reason for such results. Another way of looking at this problem is to see it from a predictive approach. If we know that there are certain characteristics which have to be present for success, it is possible for us to rate any venture in each of these elements and then calculate the overall chance of success. The venture capital sector has been using this technique for decades to decide when to invest. However, even the best rated ventures are still problematic.

In this next example, each of the important characteristics had a relatively high score – but look at the combined outcome.

Individual Event	Probability
Company has sufficient capital	80%
Management is capable and focused	80%
Product development goes as planned	80%
Competitors behave as expected	80%
Production and component sourcing goes as planned	80%
Customers want product	80%
Pricing is forecast correctly	80%
Patents are issued and are enforceable	80%
<i>Combined probability of success</i>	<i>17%</i>

Source: Article published in Harvard Business Review
November - December 1998

When we see the probability of success in these terms, we can understand the level of complexity that must be managed in order to achieve success. This specific model was developed to explain VC investments where the investment is typically made when the business has already developed some traction in the market. Most VC investments are at the market expansion stage where products are already proven and a management team substantially in place, thus we would expect these ventures to have lower risks than early stage ventures.

To understand the risks of earlier stages of growth, we need to look at a wider range of growth attributes.

What are the Drivers of Growth?

As part of my research into high growth businesses, I reviewed the available entrepreneurship literature, the various theories of business growth, the venture capital investment models and my own 20 years of experience managing growth ventures. In the end, I identified 14 characteristics of high growth businesses.

This work has been published in my book ‘Winning Ventures – 14 principles of high growth businesses’.

Those fourteen attributes are:

The Market:

1. Right place, right time

It is not just luck. The best ventures are based on a dramatic change in technology, regulations, the economy or in the way society operates. That change generated an opportunity for a new product or service, a new process or a new way of delivering an existing product or service to meet an unmet need or solve an existing problem in a much more effective manner.

2. The compelling need to buy

Business is driven by transaction revenue. The best high growth businesses solve a problem that has high urgency, high utility or resolves a high physical or psychological need for the customer. Situations where customers have extensive choice, can delay buying or are indifferent about buying the product or service are very difficult situations in which to drive a high growth business.

3. The right customer

While it is possible to sell to everyone, the successful high growth business typically has a very tight definition of the ideal customer and knows how to go find them. The best customer is easily identified, able to be approached and is willing and able to purchase. Businesses that

rely on the potential customer finding them have difficulty proactively influencing their growth.

4. Channels to market

High growth businesses develop and/or secure capacity in the necessary distribution channels that allow them to reach their target customers. This might be through a wholesale or retail distribution system, direct through a sales force or via an e-commerce facility. Without the bandwidth of the distribution channel(s) the enterprise is not able to sustain its growth plans. Since many channels have pre-existing agreements, finding ways to access the appropriate channel is an essential key to successful growth.

Realizing the Opportunity:

5. Innovation as the driver

Innovation is the fuel of the high growth enterprise. This could be an invention such as a new or enhanced product or service. It might be in a new way of working such as a new manufacturing process or a different consulting technique. Lastly, it could simply be a new way of delivering an existing product or service to market – a new business concept. Innovation either creates more value by reducing costs or by enhancing customer utility or experience.

6. A competitive advantage

Obviously the best place to be is to have no competition, however, few businesses have such a luxury and, of itself, is no guarantee of success. High growth requires that the business is able to carve out a place in the market which allows it to have some freedom around its target market. Along some dimensions of user utility and customer experience, the business needs a superior position that matches the needs of its focal market.

7. Sustainability

While the initial conditions for high grow can be created through innovation, ultimately competitors will chip away at that advantage.

Only by establishing long term barriers around the business can the venture hope to secure its existing customers and ward off competitors. Sustainability requires the business to find new ways of protecting its entire supply chain as, over time, competitors will find ways of eroding any single advantage.

8. Scalability

High growth, by its nature, requires the business to solve the problem of scalability. Many businesses are constrained by the shortage of skilled staff or essential ingredients. Only by developing a robust process where the business can be expanded through scalable systems and/or processes or be readily replicated, can the business grow rapidly over an extended period. This also means that knowledge has to be codified, decisions have to be devolved and organizational structures have to be built that will cope with the demands of such growth.

Making it Work:

9. A clear vision

Knowing who you are, what you are doing and where you are going is an essential ingredient to a successful enterprise. Too many businesses fail to have a focus that clearly sets out their position in the market place. This lack of vision results in taking them in the wrong direction and away from the conditions that will drive their growth.

10. A long term strategy

Sustained growth requires the business to set out a path of product/market activities over a medium term horizon. High growth firms typically create ideal future scenarios that they want to achieve and then develop the tactical plans to get there. Constraints to growth then become apparent and investment can be made to overcome them. Often acquisitions are used to underpin growth. Acquisitions can bring new products, new customers, experienced staff and new competitive advantages.

11. Robust margins

Almost without exception, high growth businesses have above industry average gross margins. This may have come from their product, process or business concept innovation or may simply have come from superior management that has enabled the business to be run more effectively and efficiently than it's competitors. Where a competitive advantage can be created around a compelling need, especially in a growing market, prices are less sensitive and thus higher prices and better margins can be achieved.

12. Management of risk

There are always going to be bumps in the road, but sustained growth requires that the management team anticipate what might go right and what might go wrong and plan for contingencies. Successful ventures mitigate their risks by involving partners, building resilience, putting in place options, shoring up their risk exposures and staying on top of events as they unfold. They undertake continual risk scenario planning so that they understand the likely impact of different assumptions on their business and work to reduce the negative impact of things that might go wrong.

Turning the Wheel:

13. A capable management team

No one person can do everything and, as the business grows, many specialists will be required to support the operation. Senior management of the business must collectively represent the set of skills, knowledge and experience necessary to carry the business through the growth phases. They must also work as a team rather than a collection of individuals. High growth businesses are driven by entrepreneurial activity – an opportunity focus that stimulates and drives activity.

14. Profitable

Any business that is well funded can sustain a period of losses, but ultimately the business has to make a profit to survive. The basic business

concept must generate a healthy return on investment for the shareholders for it to have a future, otherwise the investors would be better off selling out and putting their money somewhere else. Profitable operations over time require the business to have very good performance setting and monitoring systems, clear lines of responsibility, accountability and authority and a proactive attitude to fixing problems. The fundamental economics of the business must be able to support a long term positive cash flow.

With this insight, I have restated the earlier table but used the 14 principles as the elements to estimate the probability of growth success. You can see the result on the next page.

Under this scenario, even if you did everything reasonably well at 80% of excellent, you would only have a 4% chance of achieving high growth. This result lines up well with the earlier data from the ABS on firm size where only 6% of all businesses had revenue exceeding \$2 million. At 90% on each of these elements, the success rate jumps to 22%, but for that to occur, the venture would have to be exceptional across a wide range of attributes. You can see from this model that one weakness, say at 40%, can substantially undermine the outcome.

Clearly to be attractive as a potential IPO, the business would have to greatly exceed \$2 million in revenue. Even for a reasonable trade sale, you would want to aim for revenues well in excess of this threshold. From what we can see from the ABS data, the VC success model and my own 14 principles is that high growth is a challenge and few enterprises are capable of meeting the necessary preconditions to create substantial wealth using revenue and profit growth as the yardstick.

Individual Event	Probability
Right place, right time	80%
The compelling need to buy	80%
The right customer	80%
Channels to market	80%
Innovation as the driver	80%
A Competitive advantage	80%
Sustainability	80%
Scalability	80%
A clear vision	80%
A long term strategy	80%
Robust margins	80%
Management of risk	80%
A capable management team	80%
Profitable	80%
<i>Combined probability of success</i>	<i>4%</i>

Where to From Here?

My own experience over several ventures has shown me that growth can be elusive. My first business, Pioneer Computer Group, grew from 3 partners working in a dining room to 160 employees over three continents 12 years later, a compound growth rate of 36%. However, during the early years, we were close to insolvency several times. This was a classic case of feast or famine due to the size and timing of large deals. During the middle years our business was disrupted by litigation which we brought against the prior owners of our subsidiary in the USA. Just before we sold out, we were faced with a significant decline in revenue and profit as the UK went into recession. Some years we would grow dramatically and in others we would go backwards. But recall that this business was still able to raise US\$1.5 million for a 20% stake.

In the case of my last business, Distinction Software, we also raised venture capital. In that case, \$2 million for 20% equity. That business had all the attributes necessary to assure success. The business was staffed by very experienced managers and employees. It sold back into a known niche market. The product suite had a very rapid payback for the customers. Basically, it looked like a very good VC investment. However, sales were slow because customers could do without the product – a low compelling need to buy. In the end, the business went into severe decline when new competitors entered the market.

It is impossible to foresee everything that can go wrong. All we can do is use the best information we can access at the time of investment to ensure we get into the best deals. Given the risks associated with these types of ventures, the more rigorous the evaluation, the greater the chance of success.

My personal experience suggests that you cannot fix most of the fundamentals of a business. If you have the wrong product or the wrong market going into the business, it is doubtful that you can fix it later on. However, if the market characteristics are right for growth, a lot of the execution issues can be dramatically improved with good people, good advice and good internal monitoring and governance systems.

Without exception, high exit values are created when growth potential is a dominant characteristic of the venture. But as we have seen, ventures

which pursue high growth are more likely to fail than succeed and more likely to stall than sustain long term growth. Only the exceptional venture has the characteristics to get to a size which allows an IPO or a good EBIT based trade sale.

From my own observations, Angels and VC investors fail to put a priority on creating the exit event. Given the risks associated with high growth ventures, it is critical to have a very tight focus on the exit so that the business is directed towards that outcome and does not become sidetracked into suboptimal deals or markets.

3 Spot the IPO

Since the 60's the private equity market has been mesmerized by the IPO exit. This can be tracked back to the early days of venture capital. Fortunes were made by Silicon Valley entrepreneurs and their investors in the rapid growth of the computer industry. Because of the size of the market and the ever increasing demand for computers, peripherals and software and services associated with the sector, it wasn't difficult for a venture to be taken to an IPO. There was sufficient pent-up demand that most reasonable businesses could generate the revenue to support a push into a stock exchange listing.

The IPO became the yardstick to measure the worth of a venture as well as the success of the VC fund. Entrepreneurs wanted to list as they saw this as a measure of their own personal success as well as providing an exit for themselves and their investors. VC funds selected investee firms on the basis of their likelihood of delivering an IPO exit rather than a trade sale. Even so, not all ventures made the grade. Even in these years of staggering market growth, only about 20% of investee firms achieved an IPO.

Even in recent years when markets were very receptive, the number of IPOs was relatively small.

In 1999-2000, 24 companies were sold, 12 companies went public, four companies were bought back and

19 investments were liquidated. The value of exits during the year 1999-2000 was \$536 million. The average trade sale was \$3.7 million, while the value of all IPOs was \$346 million.

(Source: Venture Capital in Australia (Research Note 28 2000-01)
<http://www.aph.gov.au/library/pubs/rn/2000-01/01RN28.htm>.
 Accessed 31/12/2004)

Data from Q3 2005 from the NVCA showed that there were 19 IPO exits compared to 76 trade sales (25%).

(Source:<http://www.nvca.org/pdf/2005Q3IPOreleasefinal.pdf>
 Accessed 5/12/05)

Angel Investor Exits by the Tech Coast Angels, 1997 – 2001

Activity	Number
Investments	52
Operating independently	32
Exits	20
• Out of business (-1 X)	• 10
• Partial return of capital (0 to -.9X)	• 5
• Sale to private companies - exit pending	• 3
• IPO (2X to 3X)	• 1
• Sale to public companies (+120X)	• 1

Source: William H Payne and Matthew J Macarty, 2002, The anatomy of an Angel investing network: Tech Coast Angels, Venture Capital, Vol. 4

Exit data from the UK for 2004 show that, by value, 28% was from trade sales, 20% were sales to another private equity firm, 13% were write-offs and 10% was from IPO flotations.

(Source: www.bvca.co.uk)

Angel investors have not been as fixated on the IPO as an exit path preferring trade sales as the preferred exit event. However, some ventures were still able to make an IPO exit, but as you can see the percentages are relatively small.

UK experience suggests that IPOs happen less often for UK Angels.

UK Angel Investments

Exit Route	Technology Firms		Non-Technology Firms	
	No.	%	No.	%
Flotation	6	14.3	3	3.9
Trade Sale	12	28.6	19	24.7
Sale of shares to existing shareholders	3	7.1	16	20.8
Sale of shares to third party	6	14.3	6	7.8
Written off/shares have no value	15	35.7	32	41.6
Asset break-up	0	-	1	1.3
Total	42	100	77	100

Source: Colin Mason and Richard T. Harrison, 2004, Does investing in technology-based firms involve higher risk? An exploratory study of the performance of technology and non-technology investments by business Angels, Venture Capital, October 2004, Vol 6. No. 4

We should expect Angel and VC investee firms to have a higher probability of an IPO than the average private firm. After all, VC investees are selected in the first instance for their growth potential and these firms will have professional advisors along the way. The USA experience suggests that about 25% of new listings have had some VC investment. That being the case, we can estimate the chance of a startup going public.

In most western economies about 4 in 10,000 firms will have venture capital investment. If the VC sector achieves an IPO in only 20% of their ventures and about 25% of new listings have VC finance, we can expect any start-up firm to have about a 4 in 10,000 chance of getting to an IPO. Thus an IPO is a fairly rare outcome for a private venture.

The possibility of an IPO for an Angel or a VC investment, however, needs to be taken with a dose of reality. Many of the IPOs by VC firms over the last 40 years happened during periods of boom markets. Take out the IPOs which occurred during the computer boom of the 70s and 80s, the application software boom of the 70s and 80s, the internet boom of the 90s and the biotech boom of the turn of the century and the number of IPOs is reduced to a much smaller number.

We also need to adjust for IPOs undertaken through large private equity deals. These are typically large family businesses, MBO and MBI projects and public to private to public turnarounds. In addition, there were a number of rollups and consolidations which would be classed more as a PE deal than a VC investee exit.

Once we make these adjustments to the IPO data, we find that the number left as 'normal' IPOs, even over a long periods of time, is insignificant. It is indeed a very rare venture which can be taken to an IPO, even when the market is receptive.

Achieving an Initial Public Offering

Attribute	Requirements for long term attractive public listing
Revenue	\$20 million + (\$100+ the most successful)
Net Profit	Profitable for three years with minimum of \$2 million in the year prior to listing. Projected profits growing over next few years
Scope	National or international markets
Portfolio	Range of products with some in different markets
Potential	Major national leadership or global markets
Management	Majority with public corporation experience and some with experience in larger corporations
Board	Significant industry and public corporation experience
CEO	Able to deal with market analysts, institutions and shareholders
R&D	Products in various stages of development to ensure continued market leadership
Cash	Sufficient funds to meet forecast plans without further capital raisings
Funds Use	Funds raised to be used for market development, innovation, overseas expansion, acquisitions, working capital, repayment of debt

Attribute	Requirements for long term attractive public listing
Advantage	Clear competitive advantage based on strong intellectual property and/or proven innovative business model
Public Awareness	Products and their benefits are easily understood by the public.
Support	Listed shares are large enough in value and number in institutional and public ownership to encourage market analysts to track the stock. Generally this means a market capitalization of at least \$100 million.

The table above shows the types of characteristics that best suit an Initial Public Offering (IPO) (excluding speculative ventures such as biotechnology and resource ventures).

The requirements for listing a firm are quite onerous and expensive. Unless the listing results in a share price that can maintain a position at least as good as the sector index, the listing will not achieve the exit the private equity shareholders anticipated (assuming the private equity shareholders hold shares in the listed company). Just having liquidity of the shares via a market listing does not in itself guarantee that the value achieved by the shareholders will be greater than they would have achieved in an outright sale to a corporation.

Since few companies in private ownership can meet these requirements, an exit strategy aimed at an IPO is not a viable option for most privately held firms. That is not to say that smaller company investors cannot exit through an IPO, but without being able to satisfy the above attributes, it is highly unlikely that an IPO will be possible.

Instead of a formal listing, many firms have taken an indirect path to a public listing by taking advantage of a dormant listed company or a currently listed company which is willing to undertake a merger to reinvigorate the business.

The dormant company approach, referred to as a 'back dor listing' is often seen to be quicker and cheaper but it is not without its problems. Typically, back door listings are done with smaller listed companies. The firm undertaking the activity has to deal with a seond group of shareholders and their advisors which can be problematic when it comes to valuation and shareholder rights.

Example:

Mr Scrinis paid \$350,000 to Infosentials creditors last year for the right to approach shareholders with an offer. But negotiations with investors, corporate advisers and other interested parties slowed down the process and forced Moonlighting to postpone its original plans of floating by the end of 2001.

Source: Accessed 22nd April 2008 <http://www.smh.com.au/articles/2002/04/02/1017206193858.html>

Example:

Global Approach and the vendors of Teys agreed to revisit the acquisition structure, including the consideration. Additionally, given the growth of the business and the anticipated future growth, Teys shareholders said they wanted to have a higher equity position in the enlarged company.

Source: <http://www.businessspectator.com.au/bs.nsf/Article/Global-Approach-and-Teys-revise-backdoor-listing-p-D9K2U> Accessed 22nd April 2008

An alternative indirect approach using a reverse merger can be just as problematic. Again, the firm has to deal with another group of shareholders and their advisors. While this may seem attractive as a quicker path to an IPO, the results are somewhat dubious as it can bring on additional problems. Both backdoor listing and reverse mergers also inherit whatever issues are inherent within the other business. The additional due diligence, negotiations and delays may not be worth the cost of disruption to the firm.

Example:

29 January 2007

SunFuels, Inc., and its operating subsidiary Blue Sun Biodiesel LLC, are executing a reverse merger transaction with M-Wave, a publicly-traded printed circuit board supplier. When the transaction is complete, SunFuels execs will assume control of M-Wave, which will change its name to Blue Sun Holdings, Inc. The operating subsidiary will be renamed Blue Sun Biodiesel, Inc. The resulting company will continue to be publicly traded.

Source: http://www.greencarcongress.com/2007/01/blue_sun_biodie.html Accessed 22nd April 2008

Some private companies undertake an IPO, or a backdoor listing, with the intention of using it to raise funds or to sell off shares. However, unless the size of the shareholding in public hands is significant, generally thought to be above \$100 million, there will be insufficient liquidity to create a market to sell shares.

Generally it will take a minimum of \$500,000 in legal and accounting expenses for even the smallest and simplest IPO. According to KPMG Corporate Finance's 2004 Australian Capital Markets survey, the average cost of raisings up to \$10 million was 10.1%, falling to 4.7% for raisings greater than \$500 million. If only a small amount is to be raised, this cost is very high for the funds received. At the same time, an IPO usually involves significant work for the top executives. This has often been thought to be 50% of the CEO and CFO's time over the six months prior to the IPO. This is a very significant burden on the firm and requires that the rest of the management team bear the burden of day-to-day management during this time. A USA listing would be more expensive and more costly in annual expenses due to greater disclosure requirements.

It is very difficult to get unbiased, objective and knowledgeable advice on what it takes to prepare a venture for an IPO. The market has a wide variety of IPO listings from very small businesses to quite large family businesses coming on the market. The mix includes highly speculative resource stocks, high stakes biotech drug discovery ventures to the conventional retail and manufacturing

concerns. Even then, the number of IPOs is still relatively small. Thus it is hard to get sufficient data to be able to build a predictive model for a specific type of enterprise. Another difficulty is that the market itself can be very fickle, usually driven at the lower end by a herd mentality and a desire for quick returns which creates a feeding frenzy in limited markets for short durations. It is this greed factor which perhaps explains why VC firms are able to list quite limited ventures in boom markets.

There is also the problem of objective advice. Too many advisors earn fees or commissions whether the listing occurs or the after market is successful, thus it is somewhat difficult to find any advisor who will say no.

During my time as Professor of Entrepreneurship, I conducted many interviews with professional advisors on IPO readiness and undertook a survey of a large number of advisors to discover some insights into the preparation process. The overall consensus of private equity advisors is that only four factors are considered critical to a successful IPO.

The first factor is that the venture should have a strong competitive advantage and sufficient growth potential to achieve a \$100 million capitalization value within about 5 years of listing. Neither the current level of revenue or profit is considered significant compared to anticipated revenue and profit. This factor alone goes a long way to explaining why low growth firms that have low margins either don't make it to a listing or have to be significantly larger before they can.

The next major factor is the depth and experience of the management team and the industry experience of the Board of Directors. Again, this is not surprising when you consider that the shareholders are backing a group of individuals to take them to the size necessary to support a \$100 million capitalization. Thus, a new management team or one that has significant technical depth but little management depth is not going to be received well.

Knowledge of the IPO process itself by the management team is a major factor. This demonstrates just how important the roadshow to the brokers and the presentations to institutional investors are. Achieving significant share purchase commitments up front is almost a necessary condition for a float.

Knowledge of retail and institutional investor risk and return requirements and being able to convincingly show growth potential is an imperative. Investors are typically risk averse and will quickly zero in on potential risks in the venture. The management team must be able to convincingly demonstrate during the roadshow a deep knowledge of their business, their industry and of how to mitigate possible risks.

Finally, the firm must have the best possible advisors it can attract. The best advisors and investment bankers are expected to have the best due diligence processes, require the highest standards of preparation but also carry the highest level of credibility to the market. Thus they tend to be very selective in who they represent.

A firm that wants to undertake an IPO exit needs to build out the IPO profile above. So, to the extent that it cannot meet the requirements organically, the additional attributes need to be developed or acquired. With 3- 5 years to execute the IPO strategy and especially with Angel and VC financing, a firm may be able to achieve the necessary characteristics given the right starting point. Many companies which attract Angel funding have already identified strategic acquisition opportunities to bring economies of scale and growth to the company.

Often in emerging markets, there will be several firms with complimentary products, often selling to the same customers or working with the same alliance partners. These could be brought together to provide a platform for an IPO vehicle. However, there needs to be an obvious and demonstrable synergy between the products and the firms. Just lumping a number of firms together to reach the revenue and profit targets is unlikely to convince the institutional investors that they are investing in a sound platform of future growth.

At the same time that the underlying product portfolio is being built, the firm needs to construct the management team that is capable of running a growing public corporation. Public corporation experience, experience with larger businesses, deep experience in the industry and a good track record, are all essential characteristics for the IPO management team.

The IPO strategy needs to show in considerable detail how the IPO prospect profile will be achieved. Underpinning the plan should be documented representations from respected accountants, lawyers, bankers and brokers who are willing to work with the firm on building the IPO strategy.

For an explanation of the USA IPO process and the costs associated with it see:

Note on Exits Prepared by Fred Wainwright and Angela Groeninger
Center for Private Equity and Entrepreneurship, Tuck School of Business
at Dartmouth University 12/2004

What is obvious from this analysis is that high growth and, especially high potential growth, is a key factor in an IPO. What is also critical is that the growth potential must have a high degree of resilience and predictability to secure the market capitalization needed for successful listing. Thus firms ideally should have strong IP, multiple distribution channels into multiple markets, good recurring revenue, a strong pipeline of future products and experienced management for a successful IPO. Given the challenge of high growth, these additional attributes simply make it even more challenging to create a venture which can successfully undertake an IPO.

Timing is Critical

The IPO market is very sensitive to economic conditions and investor confidence. Even though there have been large numbers of VC backed ventures for which an IPO exit would have been attractive, the number which have successfully listed varies greatly over the years. The table below shows that years with strong economic growth have had significantly larger numbers of IPOs, but when the market is depressed, very few IPOs occurred.

Periods of higher numbers of IPOs also coincided with 'hot markets' in specific sectors. The 1970s and 80s were dominated by computer hardware related IPOs. The 1990s had large number of internet related IPOs and the late 90s by biotech venture IPOs.

Going Public Since 1970

Initial Public Offerings USA 1970 - 2003

1970	138	1981	348	1992	597
1971	253	1982	122	1993	808
1972	495	1983	685	1994	631
1973	95	1984	357	1995	570
1974	9	1985	310	1996	853
1975	9	1986	726	1997	615
1976	6	1987	548	1998	370
1977	40	1988	288	1999	541
1978	32	1989	251	2000	446
1979	38	1990	213	2001	99
1980	62	1991	400	2002	92
				2003	87

Source: [http:// www. ipovitalsigns.com/Content/Going%20Public%20by%20Year%20since%201970.htm](http://www.ipovitalsigns.com/Content/Going%20Public%20by%20Year%20since%201970.htm). Accessed 26th April 2009

Hot markets, or boom markets, have a number of characteristics in common.

- The initial fuel is provided by a breakthrough innovation (e.g computer power, disc capacity and memory chips in the 70s and 80s, the internet in the early 90s and the genome project of the late 90s).
- The breakthrough innovation has to be widely available with relatively low cost of entry for new ventures.
- The innovation has to support numerous applications, many of which have global potential.
- New ventures need to be open to external investment, especially through IPO activity.
- The applications have to be understood by the general investing public.
- Early entrants into the market have very high revenue growth rates.

You can see how these conditions were met by the various computer, internet and biotech booms in the last few decades. In these conditions the public investor sees high growth potential in every venture and wants a part of the action. Putting a startup into an IPO in these conditions is not difficult and certainly explains the high rate of IPOs which occurred during those periods. However, in a market downturn and in the absence of a breakthrough innovation, IPOs are very infrequent for early stage ventures.

The difficulty for the investor is guessing the length of time the boom conditions will last. If it takes 18 months to 2 years to prepare a venture for an IPO, the critical question must be how long the boom will last. If it dies before the venture can list, the investor might be left with a lemon.

Boom conditions do tend to close quickly and are usually associated with an event which questions the high growth expectations of the retail investors. Typically a boom will end when one of the following occur:

- A market leader fails to meet a revenue forecast.
- A market leader is found to have misrepresented revenue recognition or has some other significant reporting irregularity.
- A potential market leading product fails to satisfy a major milestone such as FDA approval or a product release date.
- The whole market enters a downturn because of a major economic crisis.

Example:

Remember the good old 1990's - Webvan, Kozmo, Pets.com and all the other spectacular IPOs that raised hundreds of millions in the dot.com boom? (Pets.com raised \$82.5 million in an IPO in February 2000 before collapsing nine months later.)

Source: <http://www.rumormillnews.com/cgi-bin/forum.cgi?noframes;read=144096> Accessed 27th April 2009

When such events occur, the market revises the growth prospects of the market leaders and scales back their revenue and profit expectations. Given that significant potential growth underpins the valuations, any major downturn in growth will seriously negatively impact share prices. This usually creates a selling frenzy as retail investors dump the stock. This in turn creates a downturn across the entire sector with a mass sell off of investments. Once this happens, the IPO market in that sector is basically dead.

Without the demand from the retail investor, early stage IPOs are near impossible. Given that market collapses cannot be predicted with any accuracy, any Angel or VC investment in a boom sector has to be something of a gamble.

More recently, the global financial crisis has seen only a trickle of IPOs. VC firms with potential IPO exits have had to wait or seek a trade sale as an exit.

Example:

The number of U.S. initial public offerings (IPOs) decreased 73% for Q1 2008 compared to the same quarter a year ago, as reported today by Hoover's Scorecard. In Q1 2008, only 12 companies went public on the major U.S. stock exchanges, raising \$18.9 billion, compared to Q1 2007 when 44 companies went public, raising \$8.5 billion. However, Visa Inc.'s mega IPO contributed the lion's share - \$17.9 billion - of that Q1 2008 total. This represents the first year-over-year decline in the number of U.S. IPOs since Q3 2006 and is a far cry from the 70 IPOs of the immediately preceding fourth quarter of 2007.

Source: <http://resourceshelf.com/2008/04/15/statistics-business-hoovers-ipo-scorecard-reveals-major-year-over-year-in-new-offerings-for-q1-2008/> Accessed 26th April 2009

What we are also seeing in recent times are more withdrawals from the IPO process, that is companies which intended to list but have pulled out, probably due to the lack of market interest in IPOs at this time.

Example:

GlassHouse Technologies is the latest in a long string of companies withdrawing IPOs. The IT consulting firm had been in registration for 15 months before finally pulling the plug, citing “market conditions.” The company has raised \$64 million through six funding rounds (presumably a seventh is on the horizon). \$30 million of that is already gone: the company did four acquisitions last year.

Source:<http://lawshucks.com/2009/03/11/ipo-withdrawals-coming-fast-and-furious/> Accessed 26th April 2009

Example:

2008 was the year of withdrawals from the initial public stock offering, with eight New England tech companies pulling their plans to go public, up from as little as one in 2007.

Source:<http://masshightech.com/stories/2009/01/05/weekly18-IPO-withdrawals-increased-in-2008.html> Accessed 26th April 2009

Many of these companies had already incurred significant costs in IPO preparation.

Example:

But going public can require many painful changes for a company — in addition to the considerable regulatory and reporting burdens, say executives. BioTrove already had strong governance and adequate financial accounting processes in place before it ever filed the S-1, said Luderer. However, he noted companies that have prepared for an IPO incur several millions of dollars’ worth of legal, accounting and other costs.

Source:<http://masshightech.com/stories/2009/01/05/weekly18-IPO-withdrawals-increased-in-2008.html> Accessed 26th April 2009

Angel and VC investors need to be very wary of planning an IPO exit. Even with the best high growth venture, many things can go wrong both internally and externally. Basically the investor needs to be able to wait until the market is receptive, however, this can significantly delay the exit as markets can sometimes take several years to bounce back to a situation where IPOs are attractive. Even then, if the market is then flooded with a backlog of IPO candidates, the chances of listing are marginal at best.

But what about post IPO?

(When is an IPO not a successful exit?)

Most VC investors believe the IPO is the holy grail of exits, however, this is a hangover from the days of the computer and internet booms. With the hindsight of a lot of failed boom ventures, the public investor is much more wary of being ripped off by misleading forecasts and management who trade on insider knowledge. Quality Investment Banks and professional advisors are reluctant to put their name to a firm with a poor chance of a successful post IPO performance. Without the right advisors behind the firm, it is doubtful that the IPO itself will get the underwriter support to successfully list.

Also, just because you have managed to get the venture to a public listing is no longer sufficient to guarantee you can exit, or at least when you want to, at an attractive price.

My own experience with the sale of Pioneer Computer Group certainly demonstrates the IPO trap.

WHEN WE SOLD OUT to Ross Systems, they had only just listed on NASDAQ. We received all our shares at the market price at the time of US\$13.50. ROSS had carefully planned their revenue over the next two quarters following the listing in order to show increased revenue and profit. This pushed the share price to \$18.50. During this period, I was an officer of the company and subject to the purchase agreement escrow and then, later, the blackout dates which applied to any officer of the company.

Even though ROSS had generated significant new sales of the PCG products, they had not planned for the complexity of installing the Pioneer software and thus they were unable to successfully complete the installation of the large number of systems. By the third quarter after the acquisition the early sites were complaining about missed deadlines and budget blowouts on implementation consulting. The effect of this was that we lost nearly all of our reference sites in the USA. By 18 months after the IPO, ROSS was unable to sell anything like the earlier volumes and the revenue and profits declined and so did the share price.

I decided to start selling my shares when the price hit \$17. However, I was immediately asked to withdraw the sell instruction on the basis that I could trigger class action litigation against the Board and the senior managers. Basically, if the share price continued to fall, it would be held that I knew of impending doom and the market should have been informed of the information that I clearly had. I was forced to hold off selling my shares and eventually was only able to sell out after I resigned some 18 months later. I then sold all my shares but at a price of \$3.50.

What you have to be sensitive to in a public company is that the market has to be told everything relevant to the decision to invest or sell the shares. Thus you may not have the ability to sell whenever you feel like it. A large block of shares being sold by a founder or a key investor can have a very negative effect on the shares. This can trigger an investigation or a class action if the shares decline further.

There is also normally a block on founders and key investors selling shares for some period after the IPO, called the escrow period. If this is one to two years, this extends the lockup period of the investment. A lot can happen in that period and not all of it will be positive. You might find your shares have seriously declined in value.

An effective IPO exit needs to not only achieve a successful public listing but it must ensure that revenue and profit performance over the next few years

meets retail and institutional investor expectations. Failure to manage the post IPO performance can result in delays in exiting or a drop in the exit value.

Professional advisors who I consulted on post IPO management identified the following as the most critical aspects of post IPO performance.

- The business must meet or exceed its financial and non-financial prospectus forecasts. Generally over 70% of recently listed IPO firms fail to meet this goal.
- Investor relations need to be managed carefully.
- Current investors and prospective investors need to be encouraged to invest in the company in order to create a liquid market. Many newly listed firms believe that the brokers will continue to support the business after the listing which is often not the case. The firm needs to be proactive about communicating with the market.
- Investor and market expectations have to be managed. This means an effective public relations activity as well as frequent communications with current and interested prospective investors.

The problem which many newly listed smaller firms face is the lack of an active market. Where there are few transactions, prices tend to fall. Even if the earnings multiple is relatively high at the time of listing, the share price can be expected to fall back to sector norms within a few quarters as the market absorbs the actual financial results. Unless the firm can post significant growth in earnings quarter after quarter, the market expectations will be reset and a more normal PE ratio will apply.

Founders and pre-IPO investors who expect to exit on a high PE who are locked in for some time in an escrow arrangement are likely to be disappointed if the price falls significantly due to the lack of an after market support program or if results do not meet expectations. It is only an exceptional business which can sustain a high PE.

An IPO exit is almost always going to perform better for the early investors than a financial trade sale, however, as I will demonstrate in later chapters, a strategic sale will almost always outperform both in terms of investor ROI. More

importantly, there is usually no delay in receiving the exit funds nor is there a requirement to manage the business beyond the exit event to ensure your return.

4 Financial v.s Strategic Exits

There are basically two types of exits. Financial exits create value on exit via a financial trade sale or an IPO, by assigning a value to the future profit generating power of the entity being sold. Alternatively, a strategic exit assigns value to the entity, not on the basis of what profit it could inherently generate, but on the basis of what future profit could be generated by the buyer exploiting the underlying assets or capabilities of the entity being acquired. These are fundamentally different views of how value is created for the selling shareholders and the preparation for sale needs to align with the creation of value.

In order to assess the potential exit value of any entity, we must first understand how the business creates value for its buyer (financial or strategic sale) or its future public shareholders (IPO). Those businesses that deliver inherent profitability must create value for its future owners through enhanced profitability and future profit growth. By contrast, strategic value businesses create value by enabling a large corporation, the strategic buyer, to exploit a significant revenue opportunity enabled through the combination of the two companies. The strategic seller builds value by developing strategic assets and capabilities which the large company will exploit.

In the case of a strategic sale, it may not matter whether the selling business is making a profit, has revenue or is growing. This is in direct contrast to a financial exit which is entirely based on revenue and profit growth which the business itself must deliver to its new owners.

Because these outcomes are very different, the manner in which Angel and VC investors should plan the exit for their investee business depends greatly on which type of exit will generate the highest exit value.

I have grouped financial trade sale and IPO under the financial exit as they both have the same basic value creating process, they both need to generate a future stream of positive earnings to create a successful exit event. As we have seen, the IPO exit is an extreme situation where the projected revenue levels and the projected market capitalization needs to be relatively high. While the IPO exit requires a more sophisticated organization to be successful, the fact is that both the financial sale and the IPO require a proven high growth potential business concept to generate a successful exit value.

Smaller firms and firms with limited growth potential which create value through projected net earnings need to be directed towards a financial trade sale as they will not be able to meet the rather high threshold of revenue and potential growth requirements needed for a successful IPO. Given that only a very small percentage of firms are able to achieve IPO status, the vast majority of firms need to be prepared for a financial sale. For the purposes of this discussion, I am going to refer to all financial exits as a 'financial sale' with the understanding that some exceptional firms will be able to achieve an IPO. But for the purposes of this discussion, I am going to assume that all financial exits will be to an individual or corporation, that is a 'financial buyer', and that the buyer is setting the purchase price based on the anticipated future stream of earnings from the acquired firm alone. That is, the buyer is not assigning any synergy or benefit to the acquisition based on what is happening, or could happen, in the rest of the buyer's organization.

The financial sale is very different from a strategic sale where value is created through the combination of the buyer and seller businesses. We have all heard of businesses that were sold for many times revenue and staggering multiples of profit. These situations are all cases where the business being acquired

had something that the large corporation needed to counter a major threat or to chase after a major new revenue opportunity. Most of these acquired businesses had unique intellectual property, deep expertise or well established brands or rights (e.g. to exploit forests, minerals, fishing etc). The assets or capabilities being acquired were considered by the buyer to be too expensive to copy, build or develop, or would take the buyer too long to assemble or to create internally. The delay in acquiring the asset or capability may also expose the acquiring corporation to an unacceptable level of risks.

In a strategic acquisition, a small business can often provide the means by which a large corporation can quickly generate many times the purchase price by leveraging its own assets and capabilities alongside those being acquired. Such acquisitions are bought, not on the basis of the profits of the acquired business, but on the value that can be generated within the combined entity. Few acquisitions, however, fit this profile. I will use the terms 'strategic sale' and 'strategic buyer' to describe a situation where a business is sold on the basis of its strategic value to the acquirer.

Businesses that are typically sold to a strategic buyer are those in biotechnology, information technology, research and development, designer fashions, mineral exploration, agricultural science, computer hardware and telecommunications. Also companies in consumer packaged goods with strong brands or with manufactured products that have global market potential can often secure significant premiums on sale. Acquisitions which can deliver very significant synergies in operating costs through integration would also fit into this category.

Probably about 95% of all private businesses which are sold are acquired by a financial buyer. In some, there will be synergies in the acquisition but these will be minimal and not sufficient to override the need for the acquired business to show its inherent profitability. Most companies don't have the type of assets or capabilities that can leverage large scale opportunities for an acquirer. Instead, they build profits through their own inherent competitive advantages for a local customer base.

A financial buyer seeking an acquisition will often have many choices of similar businesses, although sometimes geographically separate. The buyer may

simply be buying a business to own and manage or a corporation undertaking a consolidation strategy by acquiring many businesses of a similar type. What the financial buyer is acquiring is a profit stream and so the basis of the purchase is simply how much profit the firm makes now and is likely to make in the future. Purchase value is calculated almost purely on the inherent profitability of the acquisition with little regard to the combination synergies in the acquisition, the seller to a financial buyer must put effort into increasing profit and profit potential.

Businesses that would normally be sold to a financial buyer are professional services firms, marketing firms, management consultancies, distribution companies, trucking companies, most retail businesses, wholesalers, import/export companies, agricultural enterprises, printers, professional practices, builders, construction companies and so on. Non complex manufacturing also attracts a high proportion of financial buyers. Basically any business that does the same as many other businesses will fall into this group.

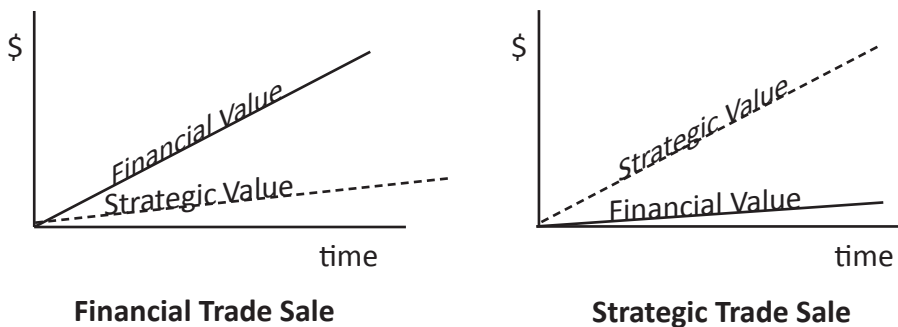
Businesses acquired to be operated as a stand alone business will be purchased on the basis of their inherent profitability as there are no synergistic benefits in the deal for the acquirer. Therefore, a business bought by an individual who wants to invest retirement or redundancy funds to buy a business to manage will be a financial sale. Similarly, a business purchased by a private equity fund that intends to increase its profitability through new management, increasing its debt level and refocusing the business will also be a financial sale.

Businesses acquired by corporations can be expected to have both financial and strategic contributions. Many acquisitions are undertaken for roll-up, consolidation or expansion purposes. These businesses typically are purchased to add revenue and profit generation through their own inherent operations although the acquirer may gain some synergistic benefits from operating at a larger scale or some benefits through reducing duplicate functions, but the prime consideration is generating operating profit from the business purchased. The purchase price would be driven by the current and potential profit of the acquired business itself. While the additional synergies may make it more attractive, the seller would need to prepare the business for a financial buyer.

Acquired businesses which are expected to contribute significant synergistic benefits to the acquiring corporation may contribute little inherent profit. They are acquired because of the benefits that the acquiring corporation expects to achieve through the combination of the businesses. In most cases, these acquired businesses bring some asset or capability to the acquirer that the corporation is able to leverage through their own operations generating significant future revenue and profits for the acquirer. A seller who was able to make such a contribution would seek out a strategic buyer.

Some firms will be able to do both. That is, they will have good profit capabilities and also be able to provide strategic benefits to the acquirer. But one will be more significant than the other. To the extent that strategic value benefits are greater than inherent profitability benefits, the seller would be much better off seeking a strategic buyer. Financial sales are always going to be limited by the profit generating capability of the seller. A strategic sale, however, is only limited by the size of the opportunity generated within the acquiring corporation. Thus, a very large corporation that can significantly leverage the strategic contribution of a small acquisition may be prepared to pay many times its financial sale value to ensure it receives the benefits of the acquisition rather than allow it to be acquired by one of its competitors.

I have extensively examined the process of a financial trade sale and have documented a methodology in my book, *The Ultimate Deal 1*, which can be used by business owners to significantly improve their sale value.



My book, *The Ultimate Deal 2*, examines strategies that owners of businesses which have strategic value will use to sell their businesses to a strategic buyer.

Financial or Strategic sale – Which one?

I often confront entrepreneurs with a stark choice – what is the best strategy to prepare your business for a sale – build up the profits or develop underlying assets and capabilities for a strategic sale. You might well ask ‘Why can’t you do both?’.

Financial v.s Strategic Buyer Strategies

Attribute	Financial Buyer	Strategic Buyer
Source of value to the buyer	Profitability, risk minimization, growth potential.	Threat elimination and/or revenue potential in the combination of the two businesses.
Value created by	Increasing profits, reducing risk, future growth and proven growth potential, roll-up or consolidation opportunities.	Underlying assets and capabilities that the buyer will leverage to eliminate a threat or exploit a large revenue opportunity.
Additional value created by	Increasing current profits, increasing growth rate, developing additional substantiated growth potential.	Reducing integration time, increasing rate of scalability and speed of exploitation, adding additional strategic assets and capabilities for the buyer to exploit.
Buyer	Individual, investment trust, private equity firm, corporation undertaking a roll-up or consolidation strategy.	Large corporation which can exploit the strategic assets and/or capabilities in a large customer base.

Attribute	Financial Buyer	Strategic Buyer
Impact of increased profitability	Major impact on value.	May be irrelevant. Profits are only needed to ensure survival prior to a sale.
Size	Any size.	Large acquisitions may have difficulty creating sufficient new incremental revenue.
Existing growth	Significant impact on value.	Size must be sufficient to allow a critical mass platform for opportunity exploitation. Growth itself may not be important.
Growth potential	Significant impact on value.	May have no impact on the buyer's opportunity.
Underlying assets and capabilities	Must deliver competitive advantage within the seller's business as a stand alone entity.	Must deliver a sufficiently large and robust base for exploiting a strategic opportunity in the combination of businesses.
Inherent risks	Must be eliminated wherever possible.	Must be eliminated wherever possible.
Succession planning	New buyer must be able to run the business if the senior management leave.	Key manager and key employees needed to exploit the opportunity must be retained.

Attribute	Financial Buyer	Strategic Buyer
Advisors	Business broker, professional services firm, business advisor	Large professional services firm, investment banker
Preparation time	18 months to 2 years	Normally 2 years or more
Level of integration	Most often continues as a sole business or might be loosely integrated bolt on acquisition. May contribute administrative synergies in a consolidation	Varies. Often fully absorbed. Sometimes integrated into only one part of the business. Could be left as a stand alone entity passing products, IP or processes to group.

I am sure that some companies can, but when you look at the processes involved and the priorities which will determine where to use your surplus cash, you often see is a clear choice – you don't have the resources to do both so you need to decide which strategy is going to give you the highest exit price.

Companies which are sold on an EBIT multiple are those which provide the buyer with a platform which enables the buyer to generate a stream of future earnings through the use of the resources contained within the acquired business. While these might be augmented by the buyer through the insertion of better processes, more capable management and better funding, essentially it is the same underlying business which is generating the profit stream. Thus any acquisition valuation will be based on net present value of those future earnings. Most businesses fall into this category. Thus financial buyers typically buy retail, wholesale, light manufacturing, transport, property and services based businesses.

You increase the value of such businesses by reducing the inherent risks for the buyer, improving the visibility and reliability of future earnings forecasts,

improving on-going profitability, building growth into the business and finding ways to create growth potential for the buyer.

By contrast, those businesses which appeal to strategic buyers have some underlying assets or capabilities which a large corporation can exploit through the buyer's own organization. Small companies will often develop products or services which can be sold by the acquirer through the buyer's very large distribution channels. In the right circumstances, a buyer might be able to scale the revenue by 50 to 100 times that of the seller just by having the right access to global customers. The key to a strategic sale is to find a large corporation which can exploit the underlying asset or capability of the seller to generate very large revenues. In these situations the size, revenue, number of customers or employees or level of profits of the seller may be entirely irrelevant. It is the size of the revenue opportunity of the buyer which is the key to strategic value.

Thus a business which has the right type of assets or capabilities which can generate strategic value may be much better off putting additional effort into developing those assets and capabilities to provide greater or earlier revenue generating power for the intended buyer. A higher exit price will be achieved if the buyer can scale or replicate the asset or capability faster and can integrate the seller's business quicker. The only size consideration for the seller is to be big enough to provide the launch platform for the buyer to fully and quickly exploit the strategic value.

Traditional Sale Process

Very few firms take the time to develop a strategic plan for selling their business. Most arrive at a decision to sell their business because they have to. This may be due to external or internal events that have forced the sale or simply because the owner has no natural successor or does not wish to continue involvement in the business. Time pressure often determines the pace at which the sale needs to be made. Even where there is no need to sell, the owner may feel that he/she simply wants to have the process over and done with.

Many Angel and VC investee firms end up in fire sales through lack of sale preparation. Often this is the result of the firm being pushed towards an IPO and, when that fails, the groundwork has not been put into a sale process. The

firm is often exhausted of reserves having spent significant funds preparing for the failed IPO. At this point the investors don't wish to put any more funds in and instead put it up for sale.

The seller may go to a conventional business broker and put the firm up for sale to the highest bidder. Alternatively, the seller may use the services a professional advisor who has wider networks and greater capacity to find a more strategic buyer. However, in both circumstances, the seller is unlikely to have planned for the sale. The impediments to the sale include:

- Little or no evaluation of actual or potential risks to the buyer
- No preparation for after sales integration or disruption
- Documentation for due diligence needs assembling or is unavailable
- Little or no thought has gone into selecting potential buyers
- There is little time to develop relationships with potential buyers
- It may simply be bad timing for the better buyers
- Financial records may be ill prepared or out of date
- Little thought has been given to developing strategic assets or capabilities for sale
- Key employees may be lost due to the future uncertainty of the business

The professional advisors are typically under pressure to perform but are given little time and funding to achieve the best outcome. The net of potential buyers is limited by the speed by which the advisors can establish interested parties and by their own existing contacts. Little time is available to develop overseas interest or to encourage wider participation in the bidding. Many potential buyers will be put off by the pressure to respond quickly and because they have inadequate time to undertake their own internal evaluation of how the acquisition may be integrated and value garnished.

Even if more time is available, the firm may simply not have positioned itself correctly for the best of the potential buyers. A potential buyer that is

approached over a possible acquisition may have no knowledge of the selling firm and may simply be busy with other ventures. Alternatively they may feel pressured to make a decision.

Preparing a Business for Sale

The objective of a Proactive Sale Strategy process is to position the firm for sale well in advance of the actual sale event. You can see from the chart below that the early stages are to prepare the internal aspects of the business for sale. This means ensuring an agreement between all the stakeholders as to the merits of the sale as well as reducing or eliminating risks to the buyer.

These activities should be undertaken over time where they can be absorbed into the normal development of the business. Many of the business processes which are reviewed and improved are basic to efficient and effective operation of the business and should be undertaken anyway. However, in this strategy, they are undertaken with a view to how the potential buyer will integrate the firm into a larger corporation.

Financial and Strategic buyers rarely arrive at the office door. They need to be identified, investigated and tracked. Formal trading relationships and/or informal relationships need to be developed over time so that the potential buyer knows of the firm, its capabilities and how the operations may be integrated (if required). Of particular importance, both parties need to understand how additional value may be extracted from the business.

When it comes to selling the business, the seller does not have to go cap in hand and plead to be acquired. Rather, the firm is put up for bid among several possible buyers, each of which understands the nature of the acquisition. At the same time, the preparation work undertaken by the firm in conjunction with their professional advisors will have eliminated or reduced the potential acquisition risks to the buyer.

The key to a successful sale is to be able to execute the deal quickly with both parties being fully aware of the value to be acquired. At the same time, the buyer can appreciate the effort that the seller has taken to prepare the business

for sale. The seller can show a full appreciation for the acquisition issues and risks and can show how these have planned for and, where possible, minimized.

You can see from the chart below how much more effective the process is and how much less effort is required at the time of sale. This process empowers

Alignment of interests

- Directors, Manager and key employees
- Build after-sale scenarios
- Agree trade sale objectives

Due Diligence

- Audit contracts
- OH&S
- Business plan
- Develop incentives
- Standardize Agreements
- Audit infrastructure
- Protect IP
- Professional Tax advice
- Due diligence files

Strategy

- Review assets and capabilities
- Select potential buyers
- Build valuation model
- Build additional value
- Understand acquisition processes
- Build scalability

Sale Negotiation

- Define value for buyer
- Create competitive tension
- Negotiate contracts

the seller and allows them to have a much greater level of control over who is likely to buy the firm. It also allows them to dramatically improve their ability to extract a premium for the business.

Lastly, this process greatly aids the professional advisor who can fully employ their expertise to ensure the Proactive Sale Strategy is applied effectively. This will greatly help them to support a sale. By helping to create a more robust set

of circumstances and better positioning, the professional advisor can help to ensure that the selling shareholders maximize their return.

Selling to a financial buyer

If you have invested in a conventional business then you will almost certainly be selling to a buyer who will value it based on some multiple of earnings, usually EBIT (earnings before interest and taxes). Part of the process of increasing the valuation is to generate higher sustainable profits. Easily said but how can this be achieved in a systematic manner?

The difficulty here is to find approaches which can be used across a wide variety of businesses. What I am going to recommend are a set of processes or approaches which can be applied to any business.

If you have the time to refocus the business or restructure it, you might start by working through the 14 principles of high growth businesses which I have documented in my book, *Winning Ventures*. Even small changes to products or target customers can have a positive effect on sales productivity and margins. However, once the nature of the business strategy is stable, you need to follow a strategy to increase sustainable profits and growth.

Firstly, simply focus on getting rid of significant wastage. I don't mean to imply that your business might be frivolous when it comes to expense control but you would be amazed how much can be saved with a different perspective. So get rid of obsolete inventory and equipment and review how you use warehouse and office space. Ask the hard questions about your use of travel, marketing and entertaining expenses. Simply adjust your lenses to saving money – you will be surprised what can be achieved.

Now list all your expenses, largest first down to the smallest. Start with the largest. What can be achieved over a 12 to 18 month period if you concentrate some effort on negotiating new agreements, improving productivity or paying more attention? Small reductions in large expenses add up to some sizeable cost reductions over time.

Now find out what you do well and what can be improved. Join a benchmarking program for your industry or subscribe to some benchmarking results. What are you doing which is better than the industry average? What are you doing which is clearly below par? Now look at the industry best practice. Find out how that can be achieved. Once you can isolate practices which can be improved, you might spend some time reading, attending seminars, talking to peers or hiring a consultant who can help you with improving aspects of your business which increase revenue or increase productivity.

For those parts of your business which are unique, consider introducing a continuous improvement process. The convention here is that – if you don't measure it, you can't improve it. The methodology behind this technique is to establish performance metrics so you can see what happens period on period. You can expect variation in performance and your task is to discover what creates improved performance. You may need help with implementation but at least you know where the problems are.

Improving profits over time so that you can benefit from a higher valuation is not that difficult but to be sustainable, those changes need to be done in a systematic manner which can be demonstrated to produce reliable long term improvements.

Any premium paid above conventional value for a business is recognizing the unrealized potential in the business. The reason why this is not already built into the value of the business is that it will require the buyer to exploit this potential. That is, the potential will only be realized by the buyer and not by the current owner. The essence of this argument is that the buyer will need to bring something new to the business, such as new funds, energy, knowledge and/or synergistic relationships and so on, in order for the potential to be realized. If this is the case, why would the buyer pay for something which only they can realize?

Almost without exception, professional advisors will tell you that buyers will not pay for what they bring to the enterprise. At best, they are only willing to pay a fair value for what the business, as a going concern, can produce. Look at this from the buyer's viewpoint. Let us imagine that I am smarter than you and I have worked out how to increase the growth rate of your business to

double what you, the vendor, are currently achieving. I should be able to buy your business on the basis of your growth rate, make the changes and then benefit from the increased rate of growth which I can achieve. Any subsequent increase in value surely must be mine since you, the vendor, were not able to do this previously. Without a doubt, this latter position will be heavily supported by knowledgeable buyers.

If I as the vendor were unaware of how to extract future potential out of the business, I would certainly not expect any buyer to pay above the conventional going rate. But what if I knew exactly how the business could be exploited and therefore knew that the business would be worth a lot more in the hands of the right buyer. My challenge would be to try to extract part of that future value for myself. The critical point here is that, if they don't buy, the buyer does not get the opportunity to extract the additional value. Thus, what I need to do is to hold off selling until the offer price goes up or get the business into a competitive bid so that the buyers are forced to bid up the price in order to be the successful acquirer.

The smart vendor works out how the business could best be exploited and lays the foundation for that prior to sale. They then identify those potential buyers who can best exploit the potential in the business and bring to their notice the possibilities which might accrue to the successful buyer. Finally, they put the business into a competitive bid to ensure that the buyers have to compete for the opportunity to gain the additional value. While it is unrealistic to expect that all the potential will be passed back to the vendor, sufficient will to result in a premium on sale.

Selling to a strategic buyer

Just after I started my last business in the USA in 1995, a company called Red Pepper was purchased by Peoplesoft for 25 times revenue. Since then I have seen numerous examples of such deals in the internet space and in biotechnology. Every time I mention these deals to friends I get the same response 'luck and timing' and these things happen only in the internet and biotech sector.

So if told you that I assisted a small sports travel business to achieve 40 times EBIT you would start to question this view of the world. The fact is that any

business which has the potential to enable a large corporation to exploit a large scale revenue opportunity can gain a significant premium on sale.

However, very few people understand how to set up such a deal. We have spent most of our lives believing that our businesses are worth some meager multiple of EBIT. In fact, if you talk to most professional advisors, investment bankers and business brokers they will focus their analysis of your business on what profit you are achieving now and what your likely revenue and profit growth will be in the near term future. I will freely admit that such analysis makes good sense when you are dealing with conventional businesses where the only value they contribute is the generation of revenue and profits through their own resources but what of the business which can enable a large corporation to exploit a national or global opportunity?

Most private business are heavily constrained through lack of finance, limited capacity, poor access to large distribution channels, lack of skills and so on. The inhibitors to growth often prevent them from exploiting their underlying potential. In the hands of a better resourced and more capable buyer, the underlying potential can be more quickly achieved. Even so, most companies can only generate reasonable increments of growth due to the competitive nature of the market they are in. But what if you had a world class product or service which had a clear competitive advantage? Could you find a large corporation which could exploit this advantage on a national or global scale to achieve 50 or 100 times your revenue in a relatively short period? This is the basis of a strategic value sale.

The fuel for such an opportunity lies in the assets and capabilities which a large corporation can exploit, usually within an existing large customer base. The process of setting up such a deal starts with an examination of your own assets and capabilities. What do you have or do which could provide the basis for resolving a serious threat or enabling a large scale revenue opportunity for a large corporation? Often these are things which currently provide your competitive advantage but they may also be things which you are not exploiting in your own business but which some other business could. Next, you need to determine whether you can provide the buyer with some reasonable period within which they can exploit the asset or capability without it being copied, eroded or negated by an aggressive competitor. Something that can be easily

acquired, assembled, developed or negated is of little interest to a large corporation.

Next you need to identify which large corporations can exploit the opportunity. Now you have the basis for setting up a deal where you potentially could achieve a sale price of many times EBIT or revenue.

These different stages of the strategic sale will be examined in greater detail in subsequent chapters.

Focus on strategic sales

You have already seen that generating a reasonable return in a financial sale requires the investee firm to develop a successful business capable of generating increasing revenue and profits in its own right. On the other hand, a business targeted at a strategic buyer has a very limited objective, simply develop an asset or capability which a large corporation can exploit.

Remember, that in the case of the strategic sale, it is the business concept of the buyer which is key to execution, not that of the business being sold. As you will see from the table below, basically you have a 12 times greater chance of a successful outcome since you will be targeted by a buyer who already can deliver on the rest of the attributes needed for success.

But it can be better than that. If you set out to invest only in ventures which have already developed the key strategic asset or capability, your probability of success will increase. What is really critical to the Angel or VC investor is that, even if the business is a financial failure, this will not by itself prevent a successful strategic exit. My own sale of Distinction Software to Peoplesoft clearly demonstrates that point. I will also be showing how such sales can dramatically reduce the period of the investment. It should also be obvious at this time that the risks of execution in a strategic sale are significantly less than those involved in financial sales or IPOs.

In the next few chapters I will examine in greater detail how a business is selected and prepared for a strategic exit. I will not be returning to the preparation of a business for a financial sale or an IPO.

If we use the 14 principles of the high growth business as a metric, you can see how dramatically different this hurdle is.

Individual Attribute	Financial Sale	Strategic Sale
Right place, right time	80%	80%
The compelling need to buy	80%	80%
The right customer	80%	100%
Channels to market	80%	100%
Innovation as the driver	80%	100%
A Competitive advantage	80%	80%
Sustainability	80%	100%
Scalability	80%	80%
A clear vision	80%	100%
A long term strategy	80%	100%
Robust margins	80%	100%
Management of risk	80%	100%
A capable management team	80%	100%
Profitable	80%	100%
<i>Combined probability of success</i>	4%	51%

In the case of a strategic sale, the buyer completes the business concept. The buyer already has the distribution channel, the management resources, the operational discipline, the ability to scale the product or service and so on. Thus the task of venture development is significantly reduced.

Basically, strategic ventures are easier to exit with a premium, often involve less business development and the sale can usually be achieved in a relatively short period from the time of initial investment.

Multiple Exits

There is the possibility that a single venture can throw off more than one exit. This can happen where the firm has developed IP across multiple markets which solve quite different problems. It may be worth separating the business into distinct product/market ventures and preparing each for an exit.

Another possibility is that a single venture may have quite different activities each of which could be directed towards their own sale, perhaps with some being financial sales and others being strategic sales. This can happen, for example, where IP underpins a product sale but is then followed by maintenance or service activity. The IP may appeal to a global corporation but they may have no interest in the local services business. In such a case, it may be worthwhile splitting the business and selling the different parts to different buyers.

5 Threats and Opportunities

A major task in setting up a strategic exit is to identify a large corporation who needs our assets or capabilities to solve an urgent problem or to open up a large new revenue opportunity.

The nature of strategic value is that it directly impacts on the ability of a large corporation to achieve its strategic objectives. Thus any threat to its existing business needs to be countered with a solution. This is often acquired from outside the corporation if the price is less than the loss which would be incurred without the acquisition.

Large corporations don't just make acquisitions to solve problems, we should be alert to the fact that most large corporations buy in their revenue generating innovations. Thus a small company which can offer an innovation which enables a large corporation to generate significant new revenue would be an attractive acquisition as long as the investment provided a healthy return.

Note that in both these situations the strategic value of the acquisition is related to the problem or opportunity being addressed by the acquirer not the conventional financial value of the business being acquired. This is the key to extracting a premium on sale.

Finding Buyers with an Urgent Problem

One approach for finding the right strategic acquirer is to find a potential buyer who has a serious problem you can solve. This may seem simplistic but there are countless acquisitions that are made for exactly this reason. The task of the seller is to be proactive in seeking out corporations where the firm can take away a serious problem or threat. Those targeted potential acquirers that have a serious problem which can be resolved by the selling firm should offer a significant chance for the selling firm to achieve a premium on the sale of their business.

To better understand the circumstances that drive this type of acquisition, think of the 'problem' as a threat that might be solved, mitigated or reduced and where the threat is seen by the corporation as a potential or actual reduction in current or forecast revenue if no counter action were taken. Normal business life is littered with such threats stemming from price wars, introduction of new technology, new legislation, loss of a major distribution channel and so on. The 'problem solving' approach to making a strategic sale of a business is to be able to identify situations in which the firm's assets or capabilities can counter an existing or emerging threat for a corporation that has both the capacity and willingness to enter into an acquisition.

External threats occur when the corporation has no effective control over the event, however, it will impact on their ability to compete or execute if no counter action is taken. The other form of threat is from internal situations which disrupt the business, reduce capability or create a change in its future intentions.

External Threats: (examples)

- Major customer defaults
- Major supplier defaults
- A major supplier is likely to be purchased by a competitor
- New competitors enter the market

- A competitor introduces a more advanced product
- Current competitor becomes more effective
- Change in legislation
- Disaster (natural or terrorist)
- Loss of major contract
- Loss of distribution channel
- Changing customer buying patterns

Internal Threats: (examples)

- Loss of key employee
- Lack of funding
- Major delays on product development
- Serious personal health or family issues of senior executives
- Urgent need to buy out investor or partner
- Need to liquidate to retire

Here are some detailed examples that demonstrate the situation.

PIONEER COMPUTER SYSTEMS acquired a supplier to gain control over a strategic component of their product development infrastructure.

Example: (Author's italics)

In 1984 Pioneer Computer Group (PCS) utilized a 4th generation language from North County Computer Services (NCCS) in Escondido, California. At the time the language, USER11, ran on the RESTS/E operating system on the Digital Equipment Corporation's PDP 11/70. With the introduction of

the VAX series of computers, the USER 11 product was ported over to the VAX to provide an identical programming and end user environment. However, this failed to use any of the new features inherent in the VAX and thus PCS faced a decline in its market acceptance. NCCS were determined to stay with a transparent interface thus threatening the survival of the PCS applications written in USER 11. ***To solve the problem PCS raised \$1.5 million in venture capital, acquired NCCS and rewrote the USER 11 product to utilize the advanced features of the VAX.***

Source: Dr. Tom McKaskill, Former CEO, Pioneer Computer Systems

AGERE SYSTEMS acquired Massana rather than let their initial investment be lost.

Example: (Author's italics)

Agere Systems announced Monday the acquisition of an Irish semiconductor-maker that designs broadband network chips that are 10 times faster than current technology.

The startup has only produced a prototype, which several companies are sampling, including possibly Cisco Systems and Apple. The privately held company has not turned a profit. It has received about \$30 million from U.S. and overseas venture capital firms. Agere will have to inject cash to cover research and employee salaries, without revenue coming in immediately. It will assume a small amount of debt.

The Dublin company is a startup venture founded in 1996 that began as a provider of engineering services. It has collaborated with Agere for the last year on developing gigabit Ethernet chips used in high-speed broadband networks. Agere produces chips for slower speed Ethernet connections.

Massana was on track to fulfill its contract, **but Agere decided it wanted more control over the project so it decided to buy the company**, said Sohail Khan, executive vice president of Agere's Infrastructure Systems.

Source: <http://www.mcall.com/business/> accessed 7th September 2003

CHINADOTCOM acquired Ross Systems Inc., a supplier of ERP systems. Ross Systems had a history of poor management which made them vulnerable to takeover. Chinadotcom may have decided to acquire rather than let them pass into a competitor's hands.

Example: (Author's italics)

ATLANTA (Dow Jones)—Chinadotcom Corp.'s CDC Software unit signed a definitive agreement to **acquire Ross Systems Inc.** (NasdaqNM:ROSS- NEWS) for \$5 in cash and \$14 worth of chinadotcom common shares.

In addition, CDC Software has been a master distributor of Ross Systems' enterprise business solution, iRenaissance suite, in the Greater China region.

Source: <http://www.rosssystems.com/> accessed 6th September 2003

PEOPLESOFT acquired Distinction Software as a counter to the announcement by SAP of a suite of supply chain optimization products.

Example:

In early 1998 SAP announced a suite of supply chain optimization products replacing their alliances with a number of small software companies. Within a few months their major competitors including Peoplesoft, J D Edwards, Oracle and Baan all made similar announcements. However, these were mostly development initiatives and not completed products. Peoplesoft took the opportunity in late 1998 to acquire a

small software house, Distinction Software Inc. which had a complete suite of products in order to counter the move by SAP.

Source: Dr. Tom McKaskill, former CEO, Distinction Software Inc.

Solving a serious problem, negating a threat, overcoming an obstacle, or removing a constraint are ways in which the selling firm can offer strategic value to the acquirer. The buyer needs to see value beyond that which is represented by the earnings on the seller's income statement. It is by creating this additional or 'strategic' value that the seller can achieve a premium on the sale of the business.

Most business owners know their industry and understand their own competitive position. Within their business they will have assets or capabilities which provide them with a competitive advantage. We can think of these as 'things we own' and 'things we do'. The process of seeking out strategic buyers based on solving a problem is to think of how other businesses would use the competitive assets or capabilities of the firm. Those businesses that could use these assets or capabilities to overcome a problem or threat are target acquirers.

Example:

In 1990 the owners of Pioneer Computer Group (PCG) decided to sell their software firm. They had 160 staff over three locations; Northampton and London in England and San Diego in California. They developed 4th generation languages for the PDP/11 and VAX computers and then used these languages to develop ERP systems for discrete and process manufactures. After investigating the UK for potential buyers, they were disappointed in the low valuations and turned their attention to the USA. There they found Ross Systems Inc. that was also using the VAX computer but using a 3rd generation language and only selling corporate financial systems. Ross recognized that their future looked bleak unless they could compete with new software technology and gain access to

a larger market. PCG's successful approach to Ross was to show how they could provide ROSS with a new development capability and enable them to enter a growth market in the manufacturing sector. The sale was 200% higher than the valuation they could have achieved in the UK.

Source: Dr. Tom McKaskill, former CEO, Pioneer Computer Group

Finding the strategic buyer can take some time. The buyer must have both the need and the capability to buy. Often external circumstances provide the impetus for such a need. In the 'problem solving' scenario, it requires a search for corporations that need what the firm has which could overcome a problem or threat, however, few corporations publicize their threats. A well networked industry executive may be able to spot opportunities but generally it requires some systematic approach to cultivating relationships where such situations are discussed. Sometimes it just requires boldness to initiate discussions with industry firms to discover where a strategic fit might occur. Generally it is only by participating in industry and professional networks that a firm will find out about a corporation with a problem which they can eliminate or reduce.

Finding Buyers with a Huge Opportunity

Most acquisitions are made to take advantage of synergies that can be leveraged through combining the businesses. The most attractive of these scenarios is where the acquiring corporation can leverage the acquired assets or capabilities to open up new markets and/or generate significant new revenue.

A business is faced with an opportunity when a favorable set of circumstances is presented in which they are able to achieve an increase in revenue. Opportunities are often situation and time specific. An opportunity for one firm may not be open to another due to the knowledge possessed or the assets or capabilities needed to execute to deliver the benefits. Opportunities are almost always driven by a change in some aspect of the external environment. It is the business which can exploit that change which will generate new revenues.

Opportunities:

- Changing needs of customers
- New legislation
- Failure of competitor
- Disaster (natural or terrorist)
- New solutions to old problems
- Dramatic improvement in product utility or functionality
- Significant reduction in cost of a product or service

Often large corporations see external opportunities but do not have the assets or capabilities to take advantage of them. This is fertile ground for small companies who have products or services which can be used by large corporations to pursue such opportunities.

The reward for the acquiring company is to take advantage of an opportunity by utilizing the acquired assets or capabilities. The objective of the selling firm is to identify the match between what they have or do with the capabilities and capacities of a large corporation in order to identify which corporations can clearly exploit one of these opportunities through an acquisition. To the extent that the selling firm is more able to provide the solution (better fit, more timely, less problems in the acquisition), or more able to enhance the opportunity (fit, scalability, less problems in the acquisition), the better the price that can be negotiated.

Opportunities can often be very large in potential returns if circumstances permit. Here the key to the price the buyer may be willing to bid is scalability of the opportunity and rarity of the solution. The more the activity can be scaled, the greater the potential financial reward to the buyer. The seller is in a more powerful negotiating position if theirs is the only possible solution. This may be a factor of location, timing, size, culture, technology and so on.

Opportunities can be described using the business development matrix:

Market Development Strategy	Existing Markets	New Markets
New or Enhanced Products	Increase Frequency Increase Margins Cross Sell	New Business Creation
Existing Products	Increase Frequency Increase Margins Cross Sell	Expand Markets New Customers

The challenge for the seller is to show how their assets and /or capabilities can leverage additional business in one or more of these market development areas.

Enhancing Existing Products/Markets

The seller may provide the capability for the corporation to reduce costs and/or enhance the sales value of their existing products thereby increasing margins. This may be through technology, better processes or capabilities in sales or marketing. Additional benefits may come from combining operations to gain lower cost through economies of scale or learning curve effects.

Increased customer penetration or frequency of use may come from finding additional uses of an existing product by incorporating new components, replacing components, changing packaging or changing the marketing messages. The seller may be able to show how their technologies, processes or knowledge may enhance existing products to create new business within existing markets.

Example: (Author's italics)

San Jose, CA, July 8, 2003 -- Pericom Semiconductor Corporation (Nasdaq National Market:PSEM) today announced that it has signed a definitive purchase option agreement to acquire the net assets of privately held SaRonix LLC of Menlo Park, CA., subject to the completion of due diligence and customary closing conditions. SaRonix and Pericom are executing joint marketing and product development initiatives for crystal based products including clock recovery, frequency translator and timing modules.

The acquisition will add to our core competencies by enabling technologies for new products, enhancing customer service and streamlining value added solutions for the combined customer base. Both Pericom and SaRonix focus on the computer, networking, telecom and storage markets, have many common major customers and complementary geographic strengths

Source:<http://www.pericom/corporate/> accessed 8th September 2003

A very common reason for an acquisition is to reduce costs through new technologies or to build additional differentiation or competitive advantage into existing product offerings.

Example:

Inight acquires Information extraction technology nright Software, a leading provider of software solutions for accessing and using unstructured data, announced that it has acquired the technology assets of WhizBang! Labs, of Provo, Utah.

The strategic acquisition, the first following the company's

recent \$22 million investment round, extends the company's text analysis, classification and retrieval capabilities.

"This technology acquisition demonstrates our commitment to providing the most powerful solutions for accessing and understanding corporate data assets" says John C. Laing, Inxight's president and CEO.

"Combining the acquired functionality with our existing technology enables us to better serve customers, expand our market share and serve notice to the Unstructured Data Management market that Inxight truly is determined to dominate."

Source:<http://content-wire.com/taxonomies/index.cfm?ccs=82&cs=2328> Accessed 18th February 2006

Example:

The potential acquisitions are targeted on the basis that they should bring synergies to ComOps' existing businesses, both in terms of cost savings and, more importantly, in revenue opportunities created by enhancing our product offerings to our already long list of quality clients together with new customers.

Source: http://www.comops.com.au/client_images/330102.pdf
Accessed 22nd April 2008

New Products to Existing Customers

Many acquisitions are made by corporations to acquire products which they are able to sell through their current distribution channels to their existing customers. Expanding the portfolio of products can be very cost effective as relationships with customers are already in place or their brand is already known. Creating differentiated products through an expanded solution set may be a very effective hedge to competition. Alternatively, adding complimentary products may allow corporations to increase their penetration into existing market sectors.

Example: (Author's italics)

South African industrial services group Bidvest (BVT) will continue to look for ***acquisitions in South Africa and abroad to expand its service offerings.***

Executive Chairman Brian Joffe said on Monday that Bidvest remains acquisitive by nature and committed to expanding its distribution, services and trading strategy.

“Bidvest uses acquisitions not to achieve breakthrough, but rather to accelerate momentum. Finding the right acquisitions at the right price and at the right time requires skill and patience.

Source: <http://www.bday.co.za/bday/content/direct/> accessed 7th September 2003

Example:

“This acquisition is a significant investment which reinforces and expands our emphasis in security related products,” said HPIC’s Chairman/CEO, Kim Kelley. “Keeper adds cargo management capabilities to our collection of branded, high value, easy-to-use security hardware and related accessory products for the home, vehicle and workplace. In the first year alone, Keeper’s sales will represent about one-third of Hampton’s overall sales.”

Source: <http://www.theautochannel.com/news/2006/01/23/208192.html> Accessed 18th February 2006

Current Products to New Customers

The selling firm may have access to a customer base where the buyer has none or little presence. This could be a new geographical area or a new sector. Often firms buy their competitors for this reason. They can then switch the customer solution across to their own products providing economies of scale benefits as well as taking out a competitor.

This strategy is also used to increase coverage within a sector, especially for expansion overseas where the buyer will be acquiring a presence in a market and thus access local knowledge, local capability, a distribution channel and achieve critical mass. This strategy can be especially effective where the selling firm has a very large customer base but few products. A corporation that has a wide range of products that can be sold to an acquired customer base is effectively buying a readily developed channel to market.

Another form of expansion is to find a new mission for existing products by selling into a different sector where the product might be used differently. Often with this type of acquisition, the buyer is seeking to acquire knowledge of the sector. Every market has its own ways of doing business. Acquiring a firm, for example, that undertakes government contracts, would allow a firm to acquire deep knowledge of how to secure new business in that sector.

Example:

Lion Nathan's \$10 million acquisition of its third brewery in China earlier this month confirms its plans to expand in the world's largest beer market despite \$230 million of cumulative losses. The acquisition which will make Lion the largest brewer in the town of Changzhou.

Situated between Nanjing and its existing brewery in Wuxi, the Hua Xia brewery in Changzhou is Lion's latest move in a strategy of expanding its foothold in the rich Yangtze River Delta region.

It will not only give Lion access to some 22 million litres of capacity in the city, where the brewery markets the Linkman beer, but will make it easier to sell its other China brands in the region. The China business is on the look out for more acquisitions in the Yangtze River Delta.

Lion Nathan bought a brewery in Wuxi, 120km northeast of Shanghai in 1994 after a two-year search for an acquisition in China. Lion Nathan access to the biggest beer brand in the city, called Taihushui.

Lion Nathan is now looking for more acquisitions like the Changzhou deal which will give it access to more markets in the region.

Buying a local brewery is as much about buying access to the local beer market which is often fiercely protected by local business and political interests.

Lion wants to continue to expand volumes and seek the market dominance that brings more control over pricing.

Source: The Australian, 31st December 2003, page 19, Great Creep Forward for Brewer, by Glenda Korporaal

Example:

‘Moreover, etalk’s customer base of over 1,500 contact centres and 35 of the Fortune 100 companies will gain access to the world’s leading technology, offering them a competitive edge over any other solution, based on Autonomy’s unique ability to understand the content of the call.’

Source:http://www.cambridgenetwork.co.uk/pooled/articles/BF_NEWSART/view.asp?Q=BF_NEWSART_156736 Accessed 18th February 2006

Cross Selling of Products to Both Customer Bases

The selling firm may have a set of products that can be sold into the existing distribution channels of the acquiring corporation. At same time, the buying corporation may have products that are able to be sold back into the customer base of the firm being acquired. Such an acquisition is especially attractive where little additional resources have to be expended to introduce the new products into the existing distribution channels. In these situations, the return on investment for the acquirer can be especially high and the payback on their investment relatively short. The selling firm that can clearly articulate this opportunity is well positioned for an acquisition.

This strategy can also used to effect an entry into a new market where local knowledge and local products can be readily enhanced with the corporation's own set of products. At the same time, the acquired products can be brought back to benefit the corporations existing distribution channels.

Example:

San Jose, CA, July 8, 2003 -- Pericom Semiconductor Corporation (Nasdaq National Market:PSEM) today announced that it has signed a definitive purchase option agreement to acquire the net assets of privately held SaRonix LLC of Menlo Park, CA., subject to the completion of due diligence and customary closing conditions. The transaction is expected to

Both Pericom and SaRonix focus on the computer, networking, telecom and storage markets, **have many common major customers** and complementary geographic strengths

Source: <http://www.pericom.com/corporate/> accessed 8th September 2003

Example: (Author's italics)

Software mergers are notoriously difficult to pull off, from both technology-integration and go-to-market perspectives. PeopleSoft certainly said all the right things: its products and customers seldom overlap, its sales force is in training and is ready to go, it will realize more than \$200 million in merger-related cost savings and some of the most popular products will be integrated by year's end.

Even if the truth is a little less optimistic, a stream of PeopleSoft executives made a compelling case for a successful integration. Indeed, PeopleSoft focuses mainly on sales to large companies while J.D. Edwards' expertise is in the mid-market, or companies with \$1 billion or less in revenue. According to Phil Wilmington, executive vice president of PeopleSoft's Americas business, that means more cross-sell and up-sell opportunities. "More products mean more revenue," he says.

Michael Gregoire, head of services at PeopleSoft, says "JD Edwards looks like PeopleSoft did three years go." He says only one-quarter of JD Edwards sales come from existing customers. "This is too small. They need to upgrade."

Surce:<http://forbes/2003/09/05/> accessed 7th September 2003

While merged businesses may have their own niche markets, they can often have parts of their operations which are similar. These areas would provide cost synergies in addition to the revenue opportunities of cross-selling.

Example: (Author's italics)

Also buying their way deeper into EBPP are IntelliData and

Avolent. The former announced earlier this month that it is acquiring Home Account Holdings Inc., of Emeryville, Calif., its Home Account Network Inc. subsidiary and its suite of Unix-based Internet banking and EBPP products.

InteliData, of Reston, Va., already offers remote banking services to financial institutions. The deal **gives the company a broader customer base**—including credit card issuers—and a fast handle on Home Account’s current client roster, including some of the country’s top financial institutions, such as Bank of America Corp., Citigroup Inc. and First United Corp.

Source: Acquisitions help spur EBPP ,By Renee Boucher Ferguson January 22, 2001,<http://eweek.com/> accessed 6th September 2003

Example: (Author’s italics)

For instance, Gupta said, by the fourth quarter, J.D. Edwards’ real-estate management tools **will be available to PeopleSoft customers**. The latter, as a group, own more than 5 billion square feet of real estate, said Gupta. “Talk about an opportunity,” he added.

Conversely, Gupta said J.D. Edwards users will soon have access to PeopleSoft’s supplier-relationship-management tools. Gupta said J.D. Edwards customers spend more than \$50 billion annually on procurement.

Source: <http://www.internetweek.com/breakingnews/> accessed 7th September 2003

New Products to New Customers or New Market Entry

This type of acquisition is an expansion strategy where the firm desires to break into a new sector but requires a new capability to do so. This could be in a related sector where there is some commonality in market approach or could be in a very different sector where the firm has no synergy to leverage. This

strategy is often used by firms aggressively seeking growth or by companies trapped in declining sectors and needing to find new sources of revenue.

Example: (Author's italics)

eTime Capital Inc., IntelliData Technologies Corp. and Avolent Inc. are acquiring companies to jump-start their respective EBPP offerings, while iPlanet E-Commerce Solutions and MetraTech Corp. have announced EBPP additions to their applications.

EBPP lets companies send bills over the Internet to business and consumer customers and allows those customers to pay online.

eTime Capital, which provides transaction reconciliation and settlement services, will announce this week its acquisition of Dynamic Transactions Inc. The purchase of DTI, best known for its PayPlace service, which settles payments between online buyers and sellers, ***will propel eTime Capital into the EBPP space and shave months off product development time***, according to officials of the Sunnyvale, Calif., company. For its part, San Francisco-based Avolent last week said it had completed the acquisition of Solant Inc., which has expertise in business-to-business electronic bill payment, reporting and analysis.

Source: Acquisitions help spur EBPP ,By Renee Boucher Ferguson January 22, 2001,<http://eweek.com/> accessed 6th September 2003

Many companies pursue a build out policy to offer more products to existing customers as well as to break into new markets.

Example:

SenseStream's acquisition is the first by Adamind since its flotation in February 2005 and marks a major strategic move by the Company to expand into mainland China, Hong Kong and Taiwan as large amount of monies are being invested in

telecommunications infrastructure to cope with demand in the run up to the Olympics in 2008 and beyond. The acquisition is highly complementary with Adamind's footprint in the region with recent wins in Australia, Philippines and Singapore. It will enable the Company to accelerate its penetration into one of the world's fastest growing and largest mobile markets, namely, China, Taiwan and Hong Kong.

Source: http://www.adamind.com/press_02_08_06.php/ Accessed 18th February 2006

Example:

Satyam Computer Services Limited announced the strategic acquisition of Citisoft, a specialist business and systems consulting firm for the investment management community. The deal was for \$23.2 million, with an additional performance-based payment of up to 15.5 million to be paid over three years. Yet the acquisition highlights a pattern that has begun to form, in which offshore firms, once viewed as outsiders, are acquiring companies with more established local presences in the markets they serve.

Source: <http://www.a1technology.com/blog/2005/10/satyam-computer-services-limited.htm> Accessed 18th February 2006

Current Products and New Product Potential

The selling firm may have products that the corporation can utilize immediately within its existing distribution channel. This alone may be sufficient to justify the acquisition. A firm that, in addition, has products under development that can open up new markets or technology that can be used over a longer period to enhance existing products from either company, can offer very attractive long term benefits to the acquirer. While the selling firm may not be able to extract a premium for longer term potential, the acquisition may gain greater favour with

the corporation thus ensuring a greater commitment to get a deal completed.

A solution that offers new products to existing customers while opening up new customer sectors can be very rewarding to an acquiring firm. The initial investment can be recovered quickly by selling into the existing customer base while the new customer base is being evaluated and a strategy to penetrate it put into place.

Threat and Opportunity Synergy Acquisitions

The best position for the seller to be in is to have solutions that play to multiple needs, especially that of reducing a threat while offering access to new markets. The threat places time pressure on the buyer while the rewards of new products or new markets allow them to more easily justify a premium price. Threat solutions can sometimes be resented as the buyer may feel compelled to complete the acquisition but may feel no upside in the deal. Reward deals are more easily negotiated with a premium as the buyer can demonstrate how the investment can be recovered through increased sales.

Find the Match

The key to a strategic deal is to find the match between what the investee firm has or can do with a set of large corporations that either need or can greatly exploit what they have. In order to optimize this match and determine where the highest sale price can be secured, you need a very good understanding of how to identify strategic assets or capabilities and also an understanding of how to identify the best strategic buyers. We will examine how to identify strategic assets and capabilities in the next chapter.

6 Identifying Strategic Value

Experienced Angels and VC investors acknowledge that strategic deals are not only possible but desirable, however, they have no formal methodology for identifying which firms lend themselves to strategic sales. Nor do they have the methodologies to help them identify which assets or capabilities inside those firms could be used to leverage a strategic sale. This problem is compounded by our training in business valuation where we see only profit generation within the existing business as a measure of worth.

To move to a strategic value based valuation, we have to completely break away from conventional valuation norms. Furthermore, we have to be willing to go on a discovery mission to look inside a target investee business to find what they have or do which can leverage such deals. The fact that the investee firm may not be using it to generate their own revenue, or may not even be aware of its existence or may be incorrectly applying it, simply makes the task harder.

Strategic value is found in an asset or competency within the acquired firm which a large corporation can leverage to solve a major problem or generate a significant revenue opportunity. The problem of identifying the target asset or capability is complicated by the fact that the seller may not be exploiting it, or may not even be aware

of its potential. To understand its potential we need to look inside the buyer's organization to see how it might be exploited. But, if we don't know who the buyer might be because we have yet to identify the strategic value we are at an impasse.

The strategic potential to a buyer is only relevant within the context of the buyer's organization and marketplace. If the investee firm is working in a different marketplace or does not have the capability to exploit its underlying assets and capabilities, then it may be harder to work out which asset or capability is the one to leverage into a strategic deal. We should never assume that the asset or capability being used by the investee firm is the one which will generate the highest exit value. To be brutal, they may simply not have the capability to exploit it, might be in the wrong marketplace or simply using it to solve different problems. Of course, there will also be those investee firms where the strategic value is obvious and they have already made significant progress to prepare the business for a strategic sale but need assistance to see the process to a conclusion.

Whatever the situation, it is worth taking the time to review the investee firm's business to ascertain whether they have correctly identified their strategic value. In 90% of the situations I examine, I have been able to find much greater strategic value potential.

What we need to do is to go back to basics and build a model of a strategic asset or capability and then look inside our target investee firm to see what we can find. We can do this with a set of metrics around what creates high strategic value. This may end up confirming what we already know, but it has the strong probability of uncovering additional potential.

Strategic assets in this context are those things which a business **has** which can eliminate threats or provide opportunities for the buyer.

Examples are:

- Intellectual property (patents, trademarks, brands)
- Customer base
- Distribution channel

- Technology or a technical process
- Documented or codified knowledge
- Agreements or contracts
- Physical property, equipment and inventory
- Locations
- Advisors, Directors, managers and employees
- Access to specific institutions and organizations
- Licenses, membership status, authorizations
- Social, government or business networks

Strategic competencies or capabilities are things that the firm ***does*** especially well that can be leveraged or can solve a problem for the acquirer. Competencies are based on the knowledge and skill of the people employed. Thus, while an asset might possibly be sold in isolation, competencies go with the people.

Examples of strategic competencies are:

- Marketing and promotion
- Product development
- Product design and manufacturability
- Sales and after sales support
- Procurement and quality control
- Networking
- Managing distributors
- Managing large complex projects

With any potential strategic asset or competency, the key is to think in terms of how this might be used by a potential buyer. Often firms don't appreciate what they do well. Very often the most valuable skill is part of an overall process but not the most obvious. Firms often focus on their sales results or their bottom line without recognizing what they do well to get there. Their most valuable skill might be product design rather than sales. In the hands of a strong marketing and sales company, such a skill might be used to leverage considerable revenue.

An asset or competence that the firm has may not necessarily be contributing to the existing business. The key question here is, not whether it is a key asset or competence within the business being sold, but whether it would be strategic to the buyer. Often a smaller business simply does not have the resources to exploit all the assets and knowledge that it has. There may be patents registered but not used in the business. There may be offices, warehouses or factories underutilised or in excellent locations that could be better exploited in a different business.

Even a business that is running smoothly, operating at a profit and providing the owner with a comfortable salary, may not be extracting the maximum value from its resources. In the hands of a different owner, underused and unexploited assets and capabilities might generate significant revenue. The acquirer may be able to bring new energy, increased funding, new distribution channels and complementary skills to the situation thus releasing untapped potential.

We need to have a way of isolating the strategic potential of the underlying assets or capabilities, often in isolation of what the current business is doing with them.

One exercise which is worth doing is simply to look inside the company and list all the things that the firm has or does that could be leveraged into creating significant value for a potential acquirer. Try asking these questions:

If we didn't have that asset or capability, where would we be competitively and financially?

What do we have, or do, that some other firm would find attractive or that another firm could leverage much more than us?

What constraints do we have on our ability to grow that another firm in our sector does not have? How could they develop our potential if that constraint were removed?

Strategic acquisitions are undertaken to leverage off an asset or capability of the seller. This would normally imply some level of scalability of the activity

associated with the strategic asset or capability. If you can foresee this as a likely path, how easy will it be for the buyer to exploit that potential?

Assume you were given the resources to generate 10 times the revenue from your products or services. What would you have to do to build the capacity to support that level of activity? What resources would you have to put in place to get started? Would you be able to clearly articulate what would need to be done if that opportunity were to present itself? Now which corporation already have the capability and capacity to provide the environment to quickly reach that target? When you start to look at what constrains your business, you can see what a possible buyer could do to release the potential.

If you had the resources to grow faster, which products or services would you choose to concentrate on?

What you are looking for are products or services that can generate significant revenue. Why did you choose those specific ones? What was there about them which encouraged you to choose them rather than others?

Another technique you can use is to review a conventional list of intellectual property or intellectual capital to identify what exists within the target investee firm. That list will include patents, brands, copyrights, licenses, rights, trademarks and other registered IP as well as areas of deep expertise or competence.

When you are examining the various forms of assets and competencies of the investee firm, think about how these might be leveraged by a large corporation.

Access rights, licenses, patents or brand names

Corporations can sometimes be frustrated in expansion plans within a sector through the lack of intellectual property. This might be a license to operate, a recognized brand or access to technology which is protected by patents. A lack of such rights when competitors have rights or acceptable alternatives can be a threat to future revenues.

In areas of emerging knowledge, the number of experts or specialists with deep technical expertise or specialist knowledge is often limited. If competitors have such expertise and are leveraging it to gain market share, a corporation is threatened unless they can also acquire such expertise. Sometimes the only way for a critical mass to be acquired quickly is to buy a firm which already employs such people or has developed such capability.

Example:

“Eastman Kodak Co. Monday announced plans to buy two companies that make digital printing systems and said the acquisitions would reduce its 2004 earnings. For Kodak, whose shares were down 3.6 percent in early trading, the deals are part of a drive to invest more in digital imaging. The company has been hurt by the waning film market”

Source: <http://www.forbes.com/newswire/2004/03/08/rtr1290006.html>. Accessed 7th April 2004

Gateway capacity or technology

Often in a specific sector, the ability to compete may depend on owning a share of a channel or access path. If, for example, capacity within a channel is only able to grow at a limited rate, the corporation that has control over part or all of that capacity has considerable influence over market share. The same logic would apply to a market where existing suppliers have effective control over the market due to high switching costs to their customers of moving to a new entrant.

Example:

‘As part of its expansion plans and strategy to enter the Internet business, Kuoni Travel Group India has acquired Resnet from Traveljini.com, which is an investee company of ICICI Venture, for an undisclosed sum.

The acquisition of Resnet from Traveljini.-com is the first and

primary initiative in the overall Internet strategy of Kuoni India, the company said in a release.

Resnet is an on-line booking engine and a comprehensive reservations solutions provider to the hospitality industry and represents various hoteliers on the GDS and Web platforms.”

Source:http://www.financialexpress.com/fe_full_story.php?content_id=56473. Accessed 7th April 2004

Example:

“U.S. RealTel, Inc. (OTCBB: USRT), a national broadband services holding company operating primarily through its wholly owned subsidiary, Cypress Communications, Inc., today reported its consolidated operating and financial results for its fourth quarter and fiscal year ended December 31, 2003.

The acquisitions of Cypress Communications and WorldCom’s Intermedia Advanced Building Networks (ABN) unit in 2002 provided a platform from which to launch a strategy ultimately designed to increase shareholder value.”

Source: <http://www.tmcnet.com/usubmit/2004/Mar/1027229.html>. Accessed 7th April 2004

High profile customers or hard to acquire customers

Entry into a market or expansion beyond a certain point may require the corporation to secure the business of certain key accounts. If these are already being serviced by another firm, the only way forward may be to acquire the existing supplier.

Key locations or launching pad for expansion

The costs of entering a new market from scratch may be prohibitively high in terms of time and/or investment. Existing businesses may, however,

have built sufficient critical mass and infrastructure that they can provide a launching pad for further expansion into the market.

Example:

“Axon Group plc, the business transformation consultancy, announced that it has agreed to acquire the entire issued share capital of MyDruid Services SDN. BHD, an offshore services partner based in Kuala Lumpur

Axon says the acquisition supports its strategy in two key areas. Firstly, it provides a beachhead into Asia, from which Axon intends to grow the local client base, focused initially in Malaysia, Singapore, China and Korea. Secondly, the Applications Management centre in Malaysia will become Axon’s off-shore and on-shore capability centre for the region, providing resource to support both local and global clients. The acquisition will not have a material effect on the Group in 2004.”

Source: http://www.consultant-news.com/article_Display.asp?ID=1420. Accessed 7th April 2004

Products which can fill out a portfolio

In markets where the number of products is large, channel members try to limit their administration load by working with partners that can offer a wide range of complementary products. A firm may be faced with erosion in its market if competitors can offer wider ranges of products. Thus acquiring a firm which can complement a product line and counter competitor pressure may be a successful method of retaining existing business.

A similar argument can be applied to integrated solutions in engineering and software. The success of the large ERP vendors such as SAP and Oracle has come from their wide portfolio of products. Such firms often make acquisitions to provide a more comprehensive solution to customer’s

needs. Thus they may be forced to seek an acquisition to counter a product development at a competitor.

Highly networked or well known industry leaders

A corporation threatened with a loss of contracts may seek to acquire a firm with highly networked management or high profile individuals who can secure them a place on tender processes.

Experienced management team

A corporation with a poor performing business unit or a situation which requires unusual expertise might seek to acquire a smaller firm just to be able to acquire a fully operational management team.

Reduce risk

Example:

“Malaysian conglomerate Sime Darby has agreed to buy a controlling stake in three companies involved in auto distribution and parts manufacturing as part of moves to expand its motor vehicle business.

It said the proposed acquisitions were expected to give its motor vehicle business a boost as Hyundai was one of the best-selling and fastest growing brands in Malaysia.

Sime Darby chief executive Nik Mohamed Yakcop said the proposed acquisitions would provide a more balanced portfolio of marques and reduce its exposure to the euro.”

Source: http://www.channelnewsasia.com/stories/afp_asispacific_business/view/78679/1/.html. Accessed 7th April 2004

Example:

In 1987, Userware International, a distributor of the COMMAND ERP solution, was the preferred supplier to a nationwide mattress manufacturer that sought to replace its existing

systems across 26 plants. Finally, however, the manufacture acquired a competing software firm. They argued that the risks of such a large project justified the cost of buying the software firm and dedicating their staff to the implementation which was expected to take 3 years.

Source: Dr. Tom McKaskill, President, Userware International

Example:

While on the surface these types of moves appear particularly strategic for the acquirer, Dan Houlihan, Citisofts managing director of US operations, said the deal held advantages for the acquired as well. Prior to the acquisition talks, Citisoft had identified outsourcing as one of the specific threats to its business. Many investment management clients have outsourced key functions, and much of the work we do onsite could be done elsewhere, he said. Through the merger, he added, the two firms could provide very complementary services, pairing Citisofts expertise from its on-site consulting experience with Satyams technology and offshore capabilities.

Source: <http://www.a1technology.com/blog/2005/10/satyam-computer-services-limited.html>. Accessed 18th February 2006

The examples shown above demonstrate that acquisitions are often made to resolve a difficulty or to exploit an opportunity, or both. The selling firm's task is to take control of that process by being proactive – by seeking out corporations where they can add strategic value. By doing so, they can secure a premium for the business, sometimes many times greater than their conventional EBIT based valuation.

While every asset or capability you review might have some value to a large corporation, we are really trying to isolate those which have the potential to leverage a strategic sale. For that we need to screen for those which can generate high growth in the hands of the buyer.

High Growth Criteria

The end game is to find something which a large corporation can leverage either to solve a threat or to create a large revenue opportunity. Generally speaking, a higher strategic premium can be gained where the buyer generates new revenue rather than solves a problem. Thus focusing on what the target investee firm has which can drive significant revenue over a short time period inside a large corporation will most likely identify the best strategic assets or capabilities.

High growth potential assets and capabilities tend to have certain attributes. These are:

- They target a well defined customer who is able and willing to pay
- The market size is significant and often global
- The problem being solved or the need being met is of a high compelling nature
- The product or service has a high, sustainable competitive advantage
- The customer is not price sensitive in this specific application
- The product or service must be scalable or easily replicated.

What we are seeking are those assets or capabilities which have the potential to generate high velocity in sales. When you have a product or service with these attributes, you have the following outcome:

- Short sales cycle
- Insensitive to price
- High referral rates

This scenario is especially effective when you are targeting a large well identified niche market which has the capacity and willingness to buy at the price you wish to sell the product or service.

Given that you are anticipating that the large acquiring corporation will have the capacity and capability to fully resource the sales, operational and service needs of the marketplace, you have the underpinnings of a very high growth revenue situation. In this situation, sales will experience a lower per unit selling and marketing cost and high referral rates.

These are the key attributes which need to be well understood if they are to be used as the screening criteria to identify strategic assets or capabilities. It is therefore worth spending a little more time examining them.

The compelling need to buy

Achieving high growth is about gaining momentum in the chosen market. Think of this as a freeway. You are really looking for a smooth uninterrupted path. You either want an empty lane or one where the traffic is travelling at an even pace. You will notice that when traffic is interrupted, it starts to backup and ultimately creates a roadblock, often for no obvious reason. The same thing can happen to growth momentum. If it slows down, then resistance builds up along the supply chain which ultimately results in bottle necks and disruptions, which in turn stalls growth.

The greatest source of friction in the growth curve is the decision making process of the target customer. To the extent that the prospect can choose not to buy, choose to delay the purchase or choose alternative products, the growth rate will be sporadic and slow. When external events such as economic cycles, man made and natural disasters and business interruptions impact the willingness to proceed to buy, the rate of sales will be unpredictable and the momentum needed to support growth investment will be lost.

When a product or service is being offered for sale, it has a value proposition to the customer. The value proposition can be composed of many elements of which utility is the one most people focus on but this may not be the one that triggers a specific purchase. In the case where there are close alternatives, other factors such as design, smell, taste, image, ease of purchase, risk in use, after sales help, environmental impact, an association with causes or celebrities, availability, warranties and so on, can influence the purchase.

Few people understand just how hard it is to build a value proposition which compels a customer to buy. Most products are chosen on a whim, can be readily deferred or have many alternatives and substitutes.

For each of your products or services, test their growth potential with these questions.

- *What problem are you solving? How important is it that the customer solves that problem?*
- *Are you satisfying a need or a desire?*
- *What degree of compliance (penalty or cost) results from not buying?*
- *What happens if the customer does not buy?*
- *What alternative to your product or service could they buy?*
- *Who is required to solve the problem? What happens if they don't?*

Clearly the most desirable position for any firm to be in is for their product to be needed desperately by a set of customers. This does not mean something they desire or would like to have, or even something they want to have. This refers to something they must have and, better still, must have now! You might well argue that few products can ever be so compelling but, in fact, many basic products would fit that need. Each person has a need for food and water, basic accommodation and security. Without electricity, water and sewage services, life in urban areas would be impossible. This is possibly the major reason why these services were initially provided by state owned enterprises and are often regulated. Food is of course satisfying a basic need although there are many alternatives. But the compelling need is still there.

Some conditions do create compelling needs. Virtually all regulations have compliance requirements and associated penalties for non-compliance. Thus a product or service that stops you from being fined or going to jail has a high compelling need to buy. Products and services that neutralize or reduce physical or psychological pain and suffering easily fall into the class of products which have a compelling need to buy.

Potential customers are not always aware that they have a need for a specific product. Many products come onto the market through the use of fear

marketing. For example, they inform you of the millions of bacteria lurking on your tongue or millions of germs hiding in your toilet. Having now made you aware of the danger to your health, they immediately offer to solve the problem with their latest product – which of course will kill all those nasty bugs.

Within the software industry we had the FUD factor (fear, uncertainty and doubt). The sales pitch was to show the customer how much money they were losing by not solving a specific problem and then of course offer the solution. The best products of course uncovered a long forgotten regulation which had severe penalties for non-compliance. My favorite software sector was always payroll as the penalties and disruptions for not getting it right were severe.

In many sectors there are quite severe penalties around health and safety in the working environment. Products which are known to reduce risks are often mandated under specific working conditions. Many factory environments have quality control requirements specified under regulations. Failure to comply can be severe, even to closing down the facility.

It is very difficult to gain growth momentum if the problem you are solving is not serious enough to justify immediate attention. To the extent that the customer is willing to live with the problem or is willing to delay solving the problem, the sales pressure is severely weakened. This was the case in the applications software industry. Basically the essential processes were being undertaken manually or with basic transactions software. However, when value added tax was introduced; these systems all had to be replaced. The customer had no choice but to upgrade or to purchase a new system. Then they were locked into continual upgrades as the regulations changed.

Products that have many close substitutes have real problems creating sales pressure. Almost all basic food and beverage products exist within this class. There are simply countless products on offer to satisfy basic food and drink needs. In these markets, the sales message has to move beyond utility to appeal to other factors of value creation. Alternatively, the vendors need to package the product for a specific market – non-spill, high energy, lactose free, etc. The marketing objective has to identify a market with a higher need and to move away from markets with alternative or substitute products. This is where competitive advantage plays its role. We will look at that issue next.

For many businesses, the task is not to drop the product; it is to find the right problem to solve. The task of the producer is to find the customer with the most compelling need where the product or service will be truly appreciated. The ideal situation is also where there are no alternatives or close substitutes.

With a high compelling need, the decision time is normally greatly reduced, the sale is not sensitive to price and the customer will be willing to refer you to others with the same need. Often a potential investee will have the potential of a much better target customer and much better product fit with a compelling need but may not have the capacity and capability to pursue that market or may be unaware of its existence.

New technologies often find themselves in a situation where they can be used to develop products to solve serious problems which have not been addressed previously. This is one of the reasons why breakthrough inventions are often found in rapid growth firms. What you have is pent up demand, no alternatives, a compelling need and short decision times. Many biotechnology discoveries have spawned global products by solving medical problems which have defied medical science for generations. At the time of discovery, they are normally the only solution available. With such a background high growth rates are almost guaranteed.

What if you have a product that has low utility. It can still drive high growth sales if it satisfies a psychological need. Clearly if the need is not in the utility of the product itself, the value or need can still exist through intrinsic or perceived value. This is the marketplace of designer brands. They create need through an association with an image of self or with high profile celebrities. Need can be associated with self image, ego, peer group pressure, a need to 'belong' or a need to be admired, respected or envied by being in possession of a specific brand. In industrial products or services, the need might be satisfied through an association with an admired and/or leading business customer or through being an 'approved' supplier of choice to a much admired corporation.

Even if a product does not satisfy a compelling need, it can still achieve a high rate of sales if it can be closely associated with one that does. Multiple products can be pulled into a sale by being complementary to a product that solves a

compelling need. The sale opportunity is created by having one component of the sale satisfy a compelling need but the sale process itself takes the opportunity of presenting other complementary products. Thus an applications software vendor might open the door with a payroll, tax reporting or OH&S reporting system but sell an entire system on the back of it. Consulting firms have compliance audit services that gain them access to clients and then sell general consulting services in cross sell opportunities.

A compelling need reduces the costs of selling as there is little selling effort required. This in turn helps create higher velocity in the business. However, where there are close competitors, this advantage can be readily lost and deals will ultimately be won on lowest price. The ideal position to be in for any business is to have a product that satisfies a compelling need in a medium to large growing market, has no close competitors and is able to protect its competitive advantage for some period of time.

Compelling Need Check List:

- How important is it that the target customer solves the problem you have identified?
- How readily is the customer willing to defer the purchase?
- What alternative products or services can the customer purchase to solve the same problem?
- What is the impact on the customer if they don't buy?
- Are there penalties for delay or non-purchase?
- Will the customer suffer mentally or physically by delaying or not purchasing?
- Will the problem get worse during the period of non-purchase?
- How well does the customer understand the impact of non-purchase?
- Can the effect of non-purchase be measured in terms of future expense, lost revenue, penalties or disruption?
- Is there a shortage of supply?

- Is demand increasing relative to available supply?
- Are there local, regional, state or national regulations that are violated through non-purchase?
- How important is image or status in having the product or using the service?
- Can celebrity endorsement increase the value of the product?

Strong competitive advantage

While it would be an advantage to have a rapidly growing market in which even the poorest of the competitors could find space to grow, few markets offer this situation. Most businesses compete in either mature markets or markets with slow growth. Yet, even within mature markets, some companies manage to carve out a place and grow rapidly. This was certainly the case with Starbucks, Office Depot, Walmart, Aussie Home Loans, Virgin Records, Virgin Blue, and Bendigo Community banks. They all found a way to compete which resulted in a significant shift in market share. Yet look at the products they sold, all well established products which had been around for some time. All these companies found a new business concept or process which dramatically increased customer value compared to their competitors.

It is easy to see how an invention can provide a competitive advantage. A major change in functionality, a new attribute of performance or a major reduction in cost will clearly unseat established firms. Innovation in product characteristics which taps into an unmet need can provide massive growth opportunities. At the same time, a major development in process innovation can lead to a raft of new products that can provide a first mover advantage which might give the business time to seize a leadership position in an emerging market.

Some competitive advantages are in fact monopolistic and provided under statutes or regulations. For example:

- Patents
- Trademarks
- Registered brands
- Copyright
- Licenses
- Legislated rights (forestry, mining, fishing and so on.)
- Regulated approval to sell (TGA, FDA)

While these vary in the degree of protection offered, they all provide some level of exclusive use and thus a competitive advantage.

However, if you have a product or service in a marketplace which is simply littered with comparable offerings, you have very little hope that your venture is going to gain the traction needed to support any significant level of growth. The market place is crowded with 'me-too' products. With little to differentiate them, customers will buy on a whim or simply treat them as a commodity and buy the one that is the most convenient or the cheapest. In these markets, shelf space and price are the dominant competitive dimensions. Unless you can control the shelf space or ensure you are the lowest price, your ability to forecast and control sales is limited.

The answer is to identify a niche market where your products and services better match the needs of the target market than your competitors. However, if everything you do to be different can be readily copied with little effort, clearly you are in a business with little chance of substantial growth.

Competitive advantage arises from having a superior position on one or more attributes which your target market values. In the case of customer value attributes, that superior position needs to be not only obvious to the prospective customer, but they must value it to the point where it is the major factor in their choice between competitive offerings. If the difference is strong enough and important enough for the customer, it is also the attribute that can drive a

premium price position. In the case of internal operations, the attribute must result in a significant cost advantage that results in superior profit performance.

Few markets have customer utility and customer buying experience around a single dimension. Consider these aspects of the customer interface:

Utility:

- **Functionality** – How well does it do the job (specifications)?
- **Safety** – Some products are safer to use than others
- **Fun and Image** – Interesting colours, design, style and brand
- **Environmental** – Does it impact the environment and has this been taken into account in the design?
- **Convenience** – How easy is it to put away, carry and use?
- **Simplicity** – How simple is it to operate?

Purchase:

- **Availability** – How easy is it to find and buy?
- **Information** – How easy is to find out about the product and have questions answered?
- **Delivery** – What is involved in getting it delivered and picked up?
- **Supplements** – What after sales help, warranty, training etc can you access?
- **Ease of use** – How easy is the product to use?
- **Disposal** – How do you get rid of it when you don't want it any more?
- **Maintenance** – How easy and expensive is it to be maintained?
- **Divisibility** – How easy is it to try before you buy?

While many of these attributes refer to physical products, equivalent attributes exist with service offerings. Thus the quality of the experience itself is

a dimension of many participant services. Customer service in terms of quality, consistency, friendliness, level of helpfulness, knowledge, and so on, can be used to differentiate different types of experiences. Atmosphere, ambience, noise level, security, the type of other participants, duration and mementoes, all alter the feeling during and after an experience. The key to service experiences is to work out how the customer expects to react and then to offer an exceptional experience along a dimension that the customer values and remembers.

Within any market there will be sets of customers that place different weights on the various attributes of the utility and the buying experience. In the end, you may have to make a choice between different attributes which are mutually exclusive or that compromise each other. Thus portability may have to be sacrificed for greater productivity.

One dimension may be sufficient for you to create a niche market. Thus vibrant colors may not appeal to mainstream buyers but a fringe market may exist that appreciates unusual style and color. There may be a niche market in a rugged version of the product for use in difficult environmental situations like building sites or uninhabited regions.

Another dimension of competitive advantage can come from specialist information. Thus many firms have developed expertise in bidding on government contracts or in consortium tenders. Others have developed deep expertise in a specific application. Some recruitment firms specialize in one type of business or one type of professional executive. Package travel providers often specialize in one region or one type of experience.

Many businesses have grown substantial market presence by solving an especially difficult problem. For example, this could be in servicing jet engines or putting safety systems into mines. The key to this advantage is to solve a complex problem which requires unusual expertise and perhaps specialized equipment. Often these markets are not large enough to attract large corporations. Also, the expertise gained in such environments often cannot be used elsewhere.

There have been many situations in the past where competitors have fought for market share along a single dimension. This has normally been in product specifications, such things as capacity, power consumption, weight, pixels, size,

accessories, or speed. In their race to be first to market on the next dimension of competition, they often forget that customers have many other attributes of value and that substantial niche markets evolve around those. Thus a product which has average performance but has unbeatable customer service will gather loyal customers and grow market share providing enough customers value customer service over other product attributes.

Only by finding a strong point of difference along an attribute that the target customer values will your products or services carve out a segment of the market. Clearly the most desirable position to be in is to have a product which not only fully meets the needs of the target customers but has no competitor or near substitute.

Unless the business has a strong cost advantage, growth will only be generated by products or services which are differentiated from the competitors. Typically this differentiation will be based on some level of innovation in product, process or business concept. The innovation itself needs to be difficult to match over a reasonable period of time for the business to gain a leadership position within its target market.

Growth businesses only maintain their position by staying ahead of their competitors. Thus they are very sensitive to what their competitors are doing and how they are positioning themselves within the market. A superior position can be readily lost if a competitor is able to match or exceed your position on the attribute you have chosen to compete on.

The smart business is proactive in delivering increasing value to customers. Within their chosen market sectors, the most successful firms seek out the most demanding customers and work closely with them to provide an on-going stream of added value. These key accounts are often the reference point for other customers within the sector and their purchase decisions will highly influence others in the same market.

By staying close to the key customers and by working with them to establish where products and services need to evolve, the firm has a direct connection to customer value leadership. The market notes the buying preferences of the

leaders and thus marketing is more by referral than persuasive marketing. This in turn can lead to greater marketing budget productivity.

Growth businesses carry out continual competitive analysis to ensure their market is not being eroded by developments in other firms. This analysis needs to be matched with the target segment needs to ensure that the firm's products and services continue to provide better value than the competitors. The competitive analysis needs to be able to show very clearly why the firm's products are preferred in some market segments to other offerings and to be able to offer reasonable proof of that assertion.

For a competitive advantage to be meaningful, it needs to be periodically validated by actual or potential customers. The difference must be meaningful and sufficiently important to the target customers that they have a clearly expressed preference for the product or service you are offering. Validation is also needed to ensure that the other companies which do have product offerings in the general market in which you are dealing do not have a close alternative.

What we are looking for is a situation where the acquirer has a period of time to exploit the competitive advantage offered by the seller's strategic asset or capability. The strategic value flows directly from the buyer's ability to create much greater revenue than the seller. With the right level of competitive advantage, the buyer can put the seller's product or service into a large distribution channel and with adequate marketing support, the buyer can achieve revenue many times more than the seller would have been capable of. More particularly, the buyer will be able to generate that large revenue gain rapidly because all the other parts of the business concept are already in place. However, this opportunity only exists if the buyer is given enough time to exploit the opportunity and that requires some period of competitive advantage.

A product or capability which can be readily copied, easily assembled or quickly negated by competitor retaliation has little or no strategic value. Thus an essential characteristic of strategic value must be some period of strong competitive advantage.

Registered intellectual property typically provides this as does deep intellectual capital. However, strategic value may still accrue even where

competitive advantage does not exist within a wider public market. A large company which can sell a new product or service back into a protected customer base can achieve a large revenue gain. A new product might be added to an already dominant product suite and be swept along in a sales situation. The acquirer may be able to make additional marginal revenue simply by adding a complementary product to an existing suite of products. The competitive advantage still exists but it is accessed by living in the shadow of other offerings which are winning the business.

Competitive Advantage Check List:

- What patents have been filed or could be filed?
- What trademarks or brands are well established?
- What copyright exists?
- What regulated licenses or rights do they hold?
- What complex problems do they solve?
- What are the strengths and weaknesses vs. the competitors?
- What is the biggest problem their customers have that they could resolve?
- What compliance problem could the firm solve?

Target an identified and accessible niche market

Successful high growth businesses have a very clear definition of their target customer. They know exactly what problem their targeted customers have and they know how and where to deliver a sales message to the customer in a way that will create a positive situation for closing a sale. Above all else, the sales process is proactive. They go out and touch the target customer; they don't wait for them to find out about the firm and its products or to come and find them to buy the product.

You see businesses all the time that reach out to the general public in the hope that they will buy. A retail store, a restaurant and the internet marketing firm are all hoping they can attract customers. But they have little influence over the buying cycle. When I walk down most main shopping streets I am constantly amazed at the number of shops which are closing or opening. I wonder what happened to the ones that failed? However, it isn't hard to guess what went wrong with most of them. They set up the business using the 'hope' strategy.

They put up a sign or develop a web site and then think:

I hope people bother to stop and read about my products.

I hope they are interested enough to enquire and I hope that they have enough money to buy and are willing to do so.

Then I hope they will tell all their friends.

This does not create a high growth business. The high growth business targets a specific customer who has a problem which they can solve. The customer is either publicly identified by name and address, such as a corporation or a professional service provider, or is available through a mailing list or is a member of a club or association which is willing to support a marketing approach to its members. The size of the market being addressed is sufficient to provide the growth projections of the firm for some years to come.

Alternatively, the customer can be readily reached through an established, or readily built distribution channel. This might be through a subscription magazine, a credit card member directory, a specific specialty store or a web site. The aim of the firm is to gain easy access to the specific customer who has a high likelihood of having the problem that is being addressed by the firm's products or services.

In order to generate the growth rate needed, the firm must be able to project the rate of sales of its product or services. To the extent that it can estimate the number of potential customers it can reach with its sales message, it has a much better chance of estimating its sales closure rate. The marketing program needs to have a very good estimate of the number of potential customers hearing its message in order to be able to estimate interested customers. With a tight customer profile, a readily identified method of reaching them individually

and a clear understanding of the sales triggers, a proactive approach can be mounted to generate the level of sales activity that the firm can support.

The more successful firms solve a very specific problem that has a compelling need to be resolved. Where these problems are experienced by highly targeted and readily identified customers who are able and willing to pay a reasonable price to satisfy the need, the firm has a much easier marketing task. Highly specific problems also normally have readily obvious decision processes with which the firm can work. Thus specific information can be provided to demonstrate how the product or service can readily solve the problem.

A great number of businesses target 16 – 25 year olds, time poor executives, free thinkers or people with a desire to feel young at heart. The problem with this type of approach is that it is difficult to be proactive, to actually reach out and connect directly with the target customer. These businesses are highly dependent on the passing traffic for business. They typically advertise to the general public through newspapers, popular journals and TV. But they can't be sure that they are getting to their intended audience. They are reliant on their target customers seeing them in passing. Since most of us are now highly resistant to advertising, much of the marketing spend is wasted.

Alternatively, highly targeted marketing to a named individual or to a tightly defined readership of a specialty journal or to a mailing list of a special interest group, is going to have a higher rate of contact. The marketing spend per contact is likely to be much lower and the conversion rate higher, especially if the problem being addressed has a high compelling need. Thus marketing productivity in high growth firms tends to be much higher.

Often the product or service can be aligned to a problem which is already the focus of attention of an interested group. Thus providing a solution to a new tax compliance issue may find receptive clients through an accountant's journal which has been addressing the need for some time. A plant soil additive which absorbs and slowly releases water that can be spread in a field in climates with erratic rainfall might be of interest to a farmers association or be picked up in a farmer's journal or a specific TV program.

Sometimes a firm can use an existing distribution channel to gain access to a target audience. Thus an existing supplier might be willing to bring a new product to the notice of their own customers if they see that it might enhance their own customer relationships. This is often the case with strategic partnerships.

Multiple businesses might agree to work together to promote each other's products to the ultimate benefit of a joint customer. This was often the case in the computer hardware industry. The marketing challenge of the computer hardware manufacturer was that they did not directly solve business problems. These were solved by software vendors and implementation consultants. Thus in order to sell the hardware, they would identify the problem to be solved, find the right software solution and then present the prospect with a package of products and services from multiple strategic partners. The strategic partners would spend much less on marketing as the hardware vendor was searching out the right prospects for them.

The potential customer needs to be reachable for the firm to proactively impact the sale. A reachable customer is one that you can get in front of with your product or service message. Potential customers must be identified with a location or place where you can deliver your message. This also needs to be cost effective, thus a TV advertisement aimed at registered dentists does not make a lot of sense when a trade journal, a dentist conference or direct sales visit to a registered dental surgery, would have a higher conversion rate.

For business to business sales, the sales process also needs to deal with complex multi-tiered decision processes. The person with the problem may not be the person making the buy recommendation or the person with the power to make the purchase. Sales processes need to understand the level of influence, the authority and the politics of the customer environment to close a sale.

An important attribute of the target market must be that they have the willingness and the ability to spend on the product or service. A potential user with no budget or authority may only be able to recommend the product or service, but the criteria for the buy decision may be made on other attributes of the product or vendor. The marketing and sales process needs to take these aspects into account when marketing and selling the product or service.

Clearly a high growth venture also needs to have prospective customers in sufficient numbers so that the business can make enough revenue and profit to be a viable and growing entity. Many businesses limit themselves to one segment, geography or channel. For adequate growth to be achieved, the firm needs to project revenue over a number of years in its selected market segments. If these markets do not generate the necessary transaction volumes to support a target growth rate, the business needs to look at new geographies, new channels and/or new markets for growth.

Instead of seeking out or developing new products for new customers, the firm should first see if it can find more of the same customers that brought it success. A product which has a clear competitive advantage, solves a compelling need and has a well defined target customer, should be readily accepted in other geographies. Even if the firm is unwilling or unable to establish its own operations in those new territories, it may be able to find distributors with the capacity, knowledge and distribution channels to handle the product or service. This way the firm can continue to benefit from its existing capabilities before it needs to spread its resources across other products.

Target Customer Check List:

- Does the firm have a well defined description of the prospective customer?
- Are there sufficient numbers of the target customers to create a high growth market?
- Is the firm able to obtain names and addresses of target customers in a manner that would allow personal approaches?
- Do the target customers belong to a specific association or well defined entity that would allow targeted marketing?
- Is there a well defined buying process that is used by the target customers that can be incorporated into the sales process?
- Is the firm able to create a sales proposition that can be put in front of the intended customer which the customer is likely to notice and act upon?

- Are the targeted customers willing and able to buy the product or service at the price offered?
- Is the problem or need being addressed obvious to the intended customer?
- What other businesses are already servicing the target customer that might be interested in working with the firm?
- Are there other products or services that complement those of the firm which can create a better overall solution for the target customer?

Scalability is critical

If the value of any investment is related to the net present value of the free cash flow generated by the investment, it follows that the value of a strategic asset or capability is directly related to the size and growth rate of the gross margins it generates. Thus early revenue generation is more valuable than later generation. Obviously, high growth rates are more valuable than slow growth rates. The value of any acquisition is thus directly related to the speed with which the acquired products or services can generate revenue, the faster the better and the greater the better. Thus in selecting strategic assets for potential Angel or VC investment we need to look for assets and capabilities which are able to be rapidly scaled or replicated in the hands of the buyer and, obviously, the sooner the better.

In order to make the opportunity able to be exploited by a large corporation within a relatively short period, the selling firm must ensure that the buyer has the capability to replicate and scale the strategic asset or capability being acquired. If the seller is unable to create the preconditions to enable the buyer to exploit the asset or capability properly, the corporation may decide not to undertake the acquisition. Few large corporations are willing to take on products or processes that can only be used in a small part of their business.

Thus one of the key criteria in identifying investee firms for an effective strategic sale strategy is to find assets or capabilities which are able to be scaled rapidly. Part of the sale preparation is then to put in place the structure of people and resources which will enable the buyer to scale the asset or capability as

quickly as possible. This means that the buyer would need to have the ability to rapidly add capacity or be able to use spare capacity, to have knowledge well documented and/or have people available who are able to quickly train a larger number of staff in using the newly acquired products or processes.

So we need to find products or services which, by their very nature, are capable of driving high growth. Then we need to ensure that the growth which is being generated can be serviced by a highly scalable product or service. Clearly, for this to be effective, you need to start with assets and capabilities which, because of the way they have been designed and supported, are able to be scaled.

Scalability is the ultimate key to a strategic sale. What the potential buyer needs to see is a high growth market which they can secure through the assets or capabilities of the seller. An acquirer that sees the possibility of a considerable increase in revenue by selling back into their own large customer base or through a greatly expanded existing distribution channel, need not be that concerned about paying a premium for the deal.

Not all products or services can be scaled. There are many situations where the scalability is limited or inhibited. This is going to result in a low acquisition price or the deal not being consummated.

Location

A firm located in a region or section of a city that has difficult access or lacks good infrastructure and is unable to be relocated.

Tied to Culture

A product or service that is tightly tied to one limited culture.

Tied to Legislation

A product or service tightly coupled to local, state or national legislation that cannot be ported to another jurisdiction.

Locked in to One Customer

Products or services contracted to one customer or custom designed to suit one customer's specific requirements.

Un-codified Knowledge

Firms that do business out of their heads rather than using a documented, systematic procedure or process that can be readily passed on to new employees are limited in scope.

Highly Dependent on One or Few Individuals

This occurs where a small number of individuals are critical to making a business work and are linked closely to specific customer solutions. This can be difficult for the buyer as they face a risk of losing the capability if the key individuals left.

Incomplete Solutions

Scalability requires that the product or service be complete, tested and stabilized in customer reference sites.

Lack of Standardization

Firms that customize their solutions for every customer often require a high intellectual input. This requires high calibre staff with deep knowledge. The best situations for scalability are where the products are standardized and the level of intellect required to sell, install and support the product is relatively low.

When we seek out a potential buyer, we are looking for a corporation which has the ability to scale the strategic asset or capability rapidly. Clearly this provides the best outcome in terms of creating value on sale. For Angel or VC investments we need to be very selective in what we invest in. We need to concentrate on those products or services which are able to be scaled rapidly and also where we have the ability to put in place the foundations which will enable the buyer to do that.

Picking Winners

If you decide to invest where there is a high probability of a strategic sale, you need to have an evaluation process which helps you identify strategic assets or capabilities. One of the major problems in identifying potential investments is that the firm you are evaluating may not understand the concept of strategic value and scalability and so may not have ever thought of their products and services in that context. Also, they will often have been struggling to survive and thus may well be selling products and services which suit their own capability and capacity and these may be very different from the products and services they could offer with the resources of a large corporation behind them.

You might get lucky and have a situation where the strategic assets and capabilities are obvious and are already being developed by the target firm. Then it is simply a case of working out what you have to do to sell to a strategic buyer. At other times, the answers won't be obvious and you will need to do some digging. Remember that what you are interested in is what a large corporation would exploit and this may not be what the target firm is currently developing, selling and supporting. You are often trying to work out what they could do, what problems they could solve and which markets they could offer solutions in.

Usually the key to identifying the strategic assets or capabilities, if there are any, lies in what problems the firm is currently solving or could solve. Usually I start by identifying those problems which represent high compelling needs.

You can start by understanding what problems or needs the business is focused on currently. This may seem like a simple task but in fact can take some time and be exhausting for the investor and the venture management. Too often they see their business in terms of features and functions, products and services, customer and markets but not problems and needs. Once you have identified the problems and needs being addressed, you can rank these in terms of their market growth potential.

- *How quickly do they secure the business?*
- *What level of competition do they face?*
- *How price sensitive is the customer?*

- *What is their competitive advantage?*
- *How scalable is the solution?*

This is a useful starting point but remember that the business will be developed for sale and so some of these issues will be further addressed to improve their outcomes.

Now start to look at potential. That is, what could they do. What we are looking for is a set of problems or needs which they could address with the underlying intellectual property and intellectual capital they have. Remember it is not necessarily what they are doing but what problems and needs a large corporation could address with what they have. What additional or different problems could they solve within a short period given access to investment funds.

So, if they had the resources and market access:

- *Which problems could they solve with what they have now or could develop in a short period of time?*
- *Which customers have these problems and is the market large?*
- *Would these customers be willing to pay a premium for a solution?*
- *What level of protection can be built into the products or services to provide a reasonable period of high competitive advantage?*
- *Could these products or services be developed and validated in a relatively short period at a reasonable cost?*
- *Can the products or services be put into a form where a large corporation could rapidly scale or replicate them?*

Obviously the key here is whether a large corporation would be willing to acquire the firm to pursue the revenue opportunity, thus the identification of potential acquirers will be critical to the investment decision. But if you don't have existing products or services to work with or don't have the potential to develop them, there is little point in continuing the evaluation. Therefore, businesses which do not have existing products or services or do not have the potential to develop highly scalable strategic products or services should not be considered for potential investment.

7 Finding Strategic Buyers

The ultimate strategic buyer is the one which can best utilize the underlying assets and capabilities of the firm. Once the assets and competencies are identified, the search starts for those corporations that can best leverage them.

An investigation of historical strategic sales will show that very few were ever acquired for their revenue and profits. In virtually all situations, it was an underlying asset or capability which the acquirer was seeking and they justified the premium on the purchase price by showing the corporation could generate significant future value through the acquisition.

In many acquisition situations the acquirer is consolidating a number of similar businesses with the aim to build cumulative capacity in terms of revenue. The synergy in the consolidated business comes through economies of scale. In this situation, it is very difficult for a firm to achieve a premium on sale unless they are a key firm in the industry and their acquisition can convince others to join the consolidated entity. Alternatively, they may have some management processes which can take additional costs out of the combined entity. This is not where you will find the strategic deals.

What you need to find are corporations who can generate large new revenues through the acquisition. You need to start your search for potential strategic buyers by developing a screening technique to whittle down the list of potential buyers. In the end you want about 5 – 8 corporations which meet all your selection criteria. If it is not possible to identify that many, then you want those that have the best available fit. I usually start with a wide net and use a series of tests to exclude candidates.

Start with a set of questions which will generate an initial population of corporations which have something in common with the investee firm.

- *Who makes money when I make money?*
- *Who does not make money when I make money?*
- *Who can make more money than I can from my products?*
- *Who can remove a constraint on my business?*
- *Who has a problem I can fix?*
- *What threat can I reduce or eliminate?*
- *Who sells to the same customers I sell to?*
- *Who uses the same technology I use?*
- *Who needs my customer base?*
- *Who needs my technology or people?*

Who makes money when I make money?

The most common acquisition path is to sell to a partner. Where the firm is jointly selling into a customer, each taking a part of the profit, the larger firm will often want to be in better control of the sales process and the account future. Also a supplier generally makes money when the firm makes a sale and may wish to integrate forward to control the channel and to scale the business. A distributor also makes money when they sell the firm's products. They may wish to integrate backwards to scale the opportunity by increasing capacity, increasing R&D or providing greater coverage.

Who does not make money when I make money?

If one firm wins a contract, it generally means that another has lost it. Buying a competitor may provide multiple benefits to the acquirer. It may increase the customer base for existing products, reduce pressure on price, make the sales process more effective by eliminating a competitor and acquire some new product capabilities. The acquirer may wish to upgrade their products, integrate some of the products into theirs, cross sell new products to existing customers, acquire technology or R&D capability or acquire a customer base.

Who can make more money than I can from my products?

The selling firm should look far and wide to find a firm with the capacity to scale their products into larger markets. A buyer that can readily introduce the products into existing customers and/or existing distribution channels is an ideal target. A buyer that has the capacity to rapidly expand the products into a sector that they are not currently in, but have the muscle to expand into that sector, is also a good target.

Who can remove a constraint on my business?

If you wished to scale your business by 5 to 10 times – what is the factor constraining your ability to do so? This could be location, distribution channel, export capability, finance and so on. If the constraint could be removed, how much more revenue and profit could be achieved. The strategic buyer is the one that can overcome the constraint.

Who has a problem I can fix?

Often firms lack the capability or capacity in a new area, new technology or new process. Sometimes the quickest way to solve this problem is to acquire it. Alternatively, the firm may be faced with legislative changes, changing market conditions or the loss of key staff. A firm that can solve the problem may be an ideal acquisition.

What threat can I reduce or eliminate?

A threat occurs when a firm is faced with a potential or actual decline in current revenue. This would often come from an existing or new

competitor. The firm may not have the luxury of time to create a competitive product and so acquiring already available products may help to eliminate, or reduce the threat. A threat may also occur where the competitors are anticipated to undertake some action. Being first off the block may counter the advantage they otherwise would achieve.

A threat may also come with loss of a key distribution agreement, key account or key capability. Loss of key staff may create a gap in capability in any part of the firm. An acquisition may be used to resolve the problem as well as provide increased capability.

Forward integration is sometimes used to reduce the threat of loss of distribution capability. A key distributor might be acquired by a competitor or the distributor may be financially unstable. Rather than risk loss of the distribution capability, the firm may buy it out.

Alternatively, the firm may be facing a risk with a supplier. The supplier might be acquired by a competitor thus locking out a source of supply or they may be financially unstable. A supplier that is not developing products in line with a firm's strategy may also be acquired in order to own the capability.

Who sells to the same customers I sell to?

Scanning customers to find another company that sells to them will often indicate a potential buyer who can capitalize on knowledge of that customer sector. They may be able to cross sell products or utilize their own distribution channel to move new products.

Who uses the same technology I use?

If a key ingredient to the success of the firm is the use of a specific technology which is expensive or difficult or time consuming to acquire, then another firm that uses that technology may wish to acquire the firm to increase capacity or enter new markets. For example, in software technology, many firms which merged used the same underlying language or database technology.

Who needs my customer base?

The customer base can often be a very valuable asset, especially if it provides opportunities for the acquirer to sell additional products or to break into a new sector.

Who needs my technology or people?

A specialized technology, especially if protected with patents, or specialized staff with deep knowledge, can often provide a buyer with scalable opportunities.

What we need to arrive at are those corporations who have the capability and capacity to fully and quickly exploit the strategic assets and capabilities of the investee firm. You want the potential buyer to quickly see the benefits of an acquisition and to recognize that they have the capability to drive the revenue potential out of it.

You don't want acquisition beginners or corporations wanting to enter a new market (unless that is their core competence). To be really pragmatic, you are seeking a potential buyer who thinks it will be easy to achieve the benefits of the acquisition because they understand it very well, have the capacity and capability to roll out the new product or service and already have experience in the target market.

Reviewing Markets and Products

Ideally, what you are seeking is a very large corporation which can bring your products to market quickly, has the customer base and/or distribution channels already in place and has the resources to do the job efficiently and quickly. If you can structure your company so that your strategic asset or capability can be rapidly scaled or replicated, which corporation has the best chance of taking it to market and generating the most revenue from it?

What you are hoping to find is a corporation which can take on the strategic asset or capability and quickly generate revenue from it by selling it into an existing marketplace where they already have access.

In order to tease out possibilities, I often take the ideal product/market scenario and look at who will make money out of it if it is hugely successful. This could be the retailer, wholesaler, manufacturer, supplier, installer and so on. This will often help you identify who has the greatest interest in the solution becoming widely available. Another test is to work out who has the best capability of a large rollout. This will often identify the corporation who is best able to undertake the task.

As we have seen from our earlier look at net present value, early revenue is worth a lot more than later revenue. For example, lets say you have two possible buyers, each can generate \$10 million in gross margin in the first two years. The better one is the one which can generate the revenue earlier. Using a 50% discount factor we get the following NPV on acquisition.

	<i>Year One Revenue</i>	<i>Year Two Revenue</i>	<i>NPV</i>
<i>Buyer One</i>	2	8	4.8
<i>Buyer Two</i>	4	6	5.3

In scenario Buyer Two, the acquisition is worth 10% more to the buyer.

Many large corporations have an acquisition criteria of achieving a payback in the first two years of the acquisition. Thus the maximum value they are willing to pay is the discounted gross margin achieved in the first two years of the acquisition. Any delay in scaling up revenue will severely punish the seller.

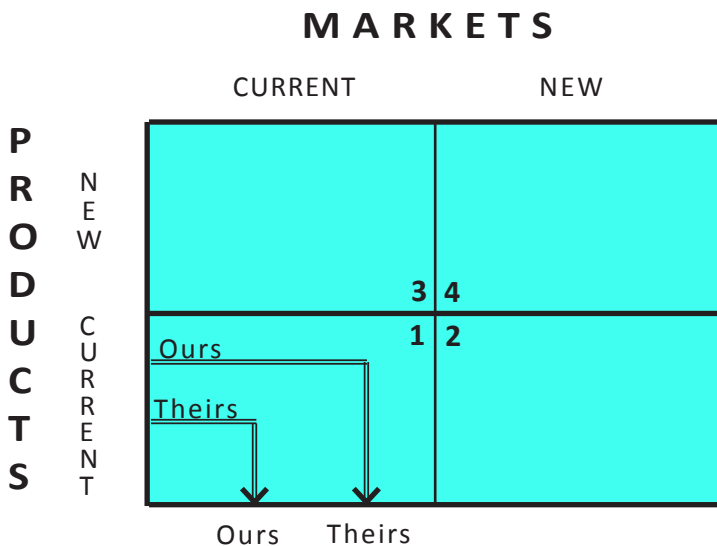
Another consideration for the buyer is the level of uncertainty associated with achieving revenue. Products which can be sold without further development and can be sold to existing customers represent a considerable reduction in risk to the buyer. The buyer will be interested in longer term revenue possibilities and this will make the acquisition more attractive, but clearly the focus of the seller should be on short term revenue at the least risk to the buyer.

QUADRANT ONE: Existing products into existing markets

Look for situations where the acquired products or services can be sold into a large established customer base or through well established distribution channels. Ideally, what you would like to see is that the buyer already has the distribution channels and the customer relationships in place to quickly sell the products.

Alternatively, look for situations where the acquired firm has a large customer base which can quickly absorb the products of the acquirer. In some cases there are opportunities for a cross selling situation.

In this situation, the buyer faces very low risks as products are already fully developed and markets already exist and are being serviced by the corporation. Early revenue, possibly well within the initial two year target is highly likely.

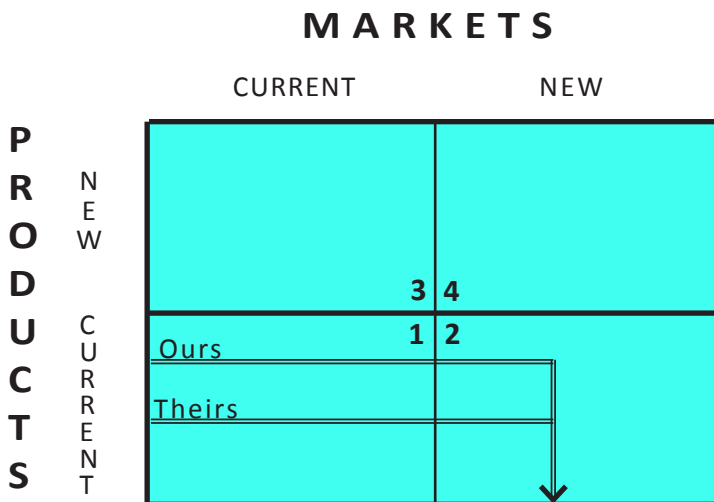


QUADRANT TWO: Existing products into new markets

Most firms know where they would expand their reach if they had the capacity to do so. Thus a company selling into legal offices might expand into auditing firms. A firm selling in the eastern states might expand into the center of the country or open up markets in the western states.

While there is some market risk, the products are already well established, are not being altered and already have a reasonable chance of success in the new markets.

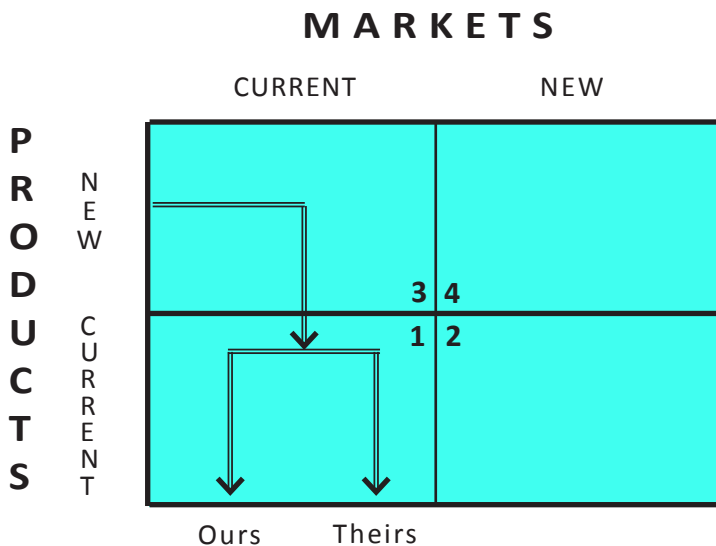
In this scenario there is a market risk but no product risk. Chances are that an aggressive roll out campaign could secure some new revenue within the two year target window. Longer term revenue is certainly able to be achieved in this quadrant.



QUADRANT THREE: Enhanced products into existing markets

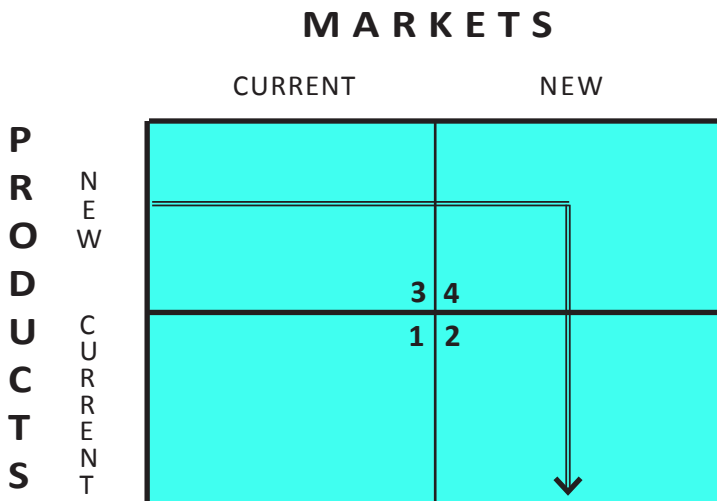
Most firms know where they would enhance or develop their products to provide more functionality or features for their existing customers and hopefully secure more sales or sales at higher price points by doing so.

In this scenario, the corporation is facing some level of product risk but has no market risk. Few product developments happen without delays and cost overruns and so there is some risk, especially in time to market, for this scenario. Even so, there may be some new revenue achieved within the two year window. Longer term revenue will be achieved through this scenario.



QUADRANT FOUR: New products into new markets

The acquiring corporation will have a much longer planning horizon than the selling firm. The buyer will be interested in the long term possibilities of developing the products and services and opening up new markets for penetration. However, it is unlikely that this will occur within the two year window and thus it should not be expected to contribute to the sale value, however, it will make the acquisition more attractive to the buyer.



With this new insight into when revenue will be generated and what risks will be faced by the buyer, the investor can be much more selective in the choice of potential buyers. Those with large early revenue possibilities should be much more attractive as potential buyers.

The issue of early revenue and low risk is critical in the choice of potential buyers. However, there are still many factors to consider apart from product and market fit, there is also the consideration of how quickly the buyer can ramp up to get product out the door. Some of these issues will be addressed in

the next chapter on enabling the buyer but some problems the seller cannot resolve.

Take for instance the problem of putting in place high volume manufacturing or large scale recruitment of service delivery and support personnel. There is only so much that can be done within a limited time period. If process lines need to be re-engineered, if new office accommodation needs to be sourced, if salespeople need to be retrained or specialised equipment acquired, all this takes time and delays the ramp up of revenue generation. What the seller has to do is anticipate these issues and either select potential buyers who don't have these problems or work to find a short term solution which can be implemented while the buyer is putting in place their own capability.

Further Considerations in Selecting the Buyer

There is little point in being acquired if you don't achieve your priority objectives. Thus if harvesting the value in your business is the primary objective, selling out for shares in a privately held business where you are a minority shareholder is not an effective exit. This makes the publicly listed corporation a much more attractive target. Once the listed shares are held past the lock down period, they are normally able to be freely traded, although if some of the former shareholders continue to work for the acquirer, they may be subject to some restrictions.

Your selection criteria for the buyer should also look at their experience in acquisitions, whether they have dedicated staff to handle the negotiations and integration and whether you think they will be a willing rather than a reluctant buyer. You don't want to spend your time educating the buyer on how to do an acquisition nor do you want to be dependent on them making it work where you have some possibility of a claw back or potential litigation if they fail.

Normally you would want to exclude any corporation which does not have a healthy business in terms of potential growth and reasonable profits. You need to be assured they have the capacity to execute on the deal and won't be wavering when something else goes wrong with their existing operations.

While it might look attractive to squeeze the last drop out of your buyer, you should try to avoid the naive buyer. There are some very good reasons why you might want to limit your selection of potential buyers to those companies with a good track record of successful acquisition.

There is now considerable research available on acquisitions and their impact on the acquiring corporation. A 1999 study by KPMG found that 83% of mergers failed to unlock value. A 2004 study by Bain & Company of 790 deals made by US based companies from 1995 to 2001 confirmed prior research that “70% of all deals fail to create meaningful shareholder value”. It would seem that the likelihood of success in a merger or acquisition is against the acquirer. However, a more recent Bain & Company study of seventeen hundred large public companies in six industrialized nations spanning the time period of 1986 to 2001 did uncover corporations which were consistently successful in their M&A activities.

Bain found that the successful corporations had several characteristics in common:

- They were frequent acquirers. That is, they had an M&A program that undertook regular acquisitions;
- They typically started with small deals and gradually became more expert at acquisitions and then progressed to larger deals;
- The size of the deals was generally small – often less than 15% of the parent company’s capitalized worth;
- A clear return on investment case was made for the acquisition and they were prepared to walk away if their criteria was not met;
- A comprehensive due diligence was undertaken of the potential target with a strong emphasis on the integration effort. This included a serious consideration of the culture match between the two businesses;
- Frequent acquirers set up benchmarks so they know that the integration effort is on track and have processes to deal with under-achievement; and

- Successful acquirers have an acquisition strategy which targets potential firms that offer value to their core business and builds relationships with them prior to formal discussions.

Basically you want smart acquirers. They know whether they can make it work and you want a buyer that can. Because they know what they are doing, they won't waste your time and they will quickly recognize the strategic value if it works for them. They know the right questions to ask and will understand how much effort you have put into to make it successful for them. Acquirers who overpay, who don't know what they are doing or mess up are your nightmare. They will send their lawyers after you to get their money back.

There are some other good reasons why you might want to look for competent and successful acquirers. Generally they have been there before and understand what to look for, thus their due diligence will be thorough. If they find a serious problem they will request it be fixed, make an allowance to fix it or walk away. That means that there are unlikely to be hidden rocks which can catch you out later on.

The last thing you want is for the buyer to sue you over something that could have been discovered during the due diligence process. You also want a successful integration of your business into the buyer's and you want them to achieve the benefits of the acquisition. A buyer that is making lots of money from an acquisition is less likely to worry about a few problems that they uncover. But always keep in mind that a deal that goes sour will find the buyer going over every inch of the business trying to find how they can litigate to recover their investment.

Clearly successful acquirers rarely overpay for their acquisitions and so it would appear that your chance of generating a premium on the sale of your business would be minimal. However, it is clear that successful acquirers also look for strategic value and are generally prepared to pay above fair market value to gain such a strategic uplift. They are interested in acquiring firms which can clearly add to their core business through extending the scope of their offerings or their ability to scale the size of their business through distribution capacity or customer base. The firm which can show how their products,

processes or capabilities can be leveraged by the acquirer should be a good acquisition target.

Your proposition to a potential acquirer should show the buyer how they can exploit the potential of your business. Most private firms are constrained by limited resources, lack of funding, an inability to recruit the best people due to their size, a limited distribution channel or small customer base. Often these elements are exactly what the larger corporations have in abundance. This presents a great opportunity for the acquirer to release unrealized revenue from the underlying products, processes or capabilities of the smaller firm. The key is to find the right buyer that can do that. If you can show how significant revenue can be generated, then it is certainly possible to extract a premium on sale of the business.

The successful acquirer that pays a premium on the deal is also less likely to terminate your employees. They acquire the business because they see potential in it. It is most likely that the potential needs to be supported by your previous employees, thus you are also taking care of your loyal employees by finding the right buyer. Successful acquirers also understand how to go about the integration effort and are also less likely to lose good people through a lack of understanding of the degree of change they are being put through.

Frequent acquirers will almost certainly have a formal process of evaluation, due diligence and integration. They will have learnt from their mistakes and built up an accumulated knowledge of what works and what does not. This should mean that they won't waste your time while they figure out how to do the deal. They also might be willing to share some or all of that information with you in a friendly deal so that the final outcome is better for both parties.

The experienced acquirer will have a senior member of their executive team who has primary responsibility for assessing potential acquisitions. This also makes your task easier as there is a name for you to contact. Since that person performs only by making acquisitions, they need to have a pipeline of possible acquisitions. Their job includes setting up relationships with potential targets and thus you are helping them achieve their objectives by approaching them with a possible future deal. This makes your task easier as they may assist you in

setting up other contacts within their firm so you can better understand where the strategic value might best be utilized.

If they have a formal process, you might be able to review it to see if you fit their acquisition and return on investment (ROI) criteria. Again this helps you weed out potential acquirers where you are not able to meet a critical requirement. However, where you clearly meet their conditions, this helps you gain more attention during the relationship building phase.

Frequent acquirers know the importance of undertaking friendly acquisitions. Companies that have been through hostile takeovers understand the levels of stress placed on both organizations, the loss of staff during the process and the difficulty of later integration. Where they can, acquirers would rather build a mutual case where both parties are comfortable with the acquisition. By undertaking this over a period of time, both parties can sort out the most appropriate integration level and use the time to convince the best people to stay with the merged business.

Culture is seen to be critical in most acquisitions. Only where there is almost no integration can unlike cultures co-exist. The more integrated the planned combined operations will be, the more critical it is that pre-acquisition cultures are compatible. The seller needs to have a good feeling of the match between cultures. Spending some time with the other party pre-acquisition is essential to avoid a disaster. It is in the best interest of the seller for the acquisition to be successful, even several years after the deal is done. Where there is a choice between potential acquirers, the seller should give the culture match serious thought.

If the potential buyer has made prior acquisitions, part of your due diligence on them should be to examine the success or failure of their previous acquisitions. Serious acquirers understand this and should be willing for you to interview the founders and some of the former executives who stayed with the merged business and perhaps some of those who left.

Your objective is always to produce a deal that works for the buyer while allowing you to achieve a premium on sale, so in reviewing the prior acquisitions,

you can see if they have a track record of making deals successful for the sellers as well as for themselves.

- Were the sellers happy with their deals?
- Were any of them sued after the event?
- Did any of them stay with the merged company – what was their experience?
- How did the earn-out conditions work out?

Example:

Hampton was equally optimistic about the synergy coming from the acquisition. “Our combined companies are already producing innovative ideas,” said Kelley. “During the courting phase, our two R&D teams worked together to develop several new products, including a revolutionary bungee cord with a built-in carabiner style hook. It was introduced at the Automotive Aftermarket Products Expo (AAPEX) in Las Vegas last November and is already generating excitement with the company’s key customers.” Together, Hampton Automotive Group and Keeper plan to launch over 200 new and proprietary towing, towing security, cargo management products and merchandising concepts “to meet the needs of a changing marketplace,” he added.

Source: [http:// www.theautochannel.com/news/2006/01/23/208192.html](http://www.theautochannel.com/news/2006/01/23/208192.html). Accessed 18th February 2006

Many strategic acquisitions occur where there has been a prior relationship between the companies

Example:

In Satyam-Citisofts case, the two firms were introduced through mutual clients of Citisoft and Satyams Financial Services Group, the division into which Citisoft will now be included, and Bear Stearns Asset Management was a mutual

client quoted in the release announcing the acquisition.

Source: <http://www.a1technology.com/blog/2005/10/satyam-computer-services-limited.htm>. Accessed 18th February 2006

Connections between buyer and seller are often related to mutual customers, suppliers and strategic partners.

Do I have to sell the whole business?

Many business owners only think of selling the whole business without considering whether it could be sold off in parts. In fact, the total sale proceeds may be significantly more if the business is sold in stages, perhaps to different buyers. Not only will selling off over time potentially make more money for the shareholders, it can be a very useful way of restructuring or refocusing the business.

Many businesses grow in an unstructured manner. Investments are often made over time to suit the personal interests of the owners or to solve temporary problems. Often those investments end up with a life of their own and develop into significant parts of the business. Many family businesses grow this way and end up spread across a range of activities which are sometimes only loosely integrated. In fact, when it comes to deciding what makes the most sense or the most money, there are often parts of the business which should be sold off.

One harvesting strategy is to prepare one part of the business for sale at a time. Where there are different parts of the business operating in different markets and with different products or services, this should be relatively easy. The objective is to repackage each business unit as a separate stand-alone business and then prepare it for new ownership. This is often easier to resource and certainly easier to manage if there are very different buyers for the different activities. Proceeds from each sale can either be channeled back into the core business or given to the shareholders. Alternatively, the business can be restructured to allow some shareholders to cash out thus providing a way of concentrating the shareholding or providing flexibility to bring in new shareholders.

Often when I investigate a firm to prepare a sale strategy, I uncover a variety of underlying assets and capabilities which will appeal to two or more very different buyers. In order to optimize the overall sale price, I will recommend that the firm be split up with each part being specifically targeted for a selected set of potential buyers. This process takes time and money and thus a phased approach is often the most sensible strategy. Of course, it is also true that a complex business is often hard to sell because it may not have an obvious buyer. I have also seen situations where one part of the business is worth more by itself than the value which was originally assigned to the whole firm. The sum of the parts is often worth more than the whole.

Final Selection

From the information you have gathered and your own understanding of the market, develop a final selection criteria and use this to screen the remaining candidates. I develop a list of ideal buyer attributes and use those to screen potential buyers. This could extend to 12-15 attributes covering size, location, markets, acquisition history, culture and so on. If this list produces 5 – 8 ideal candidates, you would stop there as that is sufficient to develop the sale process.

If there are not sufficient ideal candidates, you do need to source further potential buyers. Almost without exception, not all potential buyers will be able to act on the opportunity at the time you wish to sell thus you need a set of possible buyers. At the same time, a long list is unworkable. You simply won't have the time and energy to work on the relationships to bring them to the table at the right time.

If you are unsure of the worth of some of the potential buyers, you can simply approach them with details of what you have and ask for an expression of interest. This will help cut down the number as some will exclude themselves.

Once you have the list of potential buyers, you need to work out what you have to do to make a compelling case for them. A major part of the preparation is to ensure that the buyer can quickly exploit the strategic assets or capabilities. I call this 'enabling the opportunity' which I will cover in the next chapter.

8 Enabling the Opportunity

Creating the strategic value for the buyer to exploit is not sufficient for you to maximize the sale value of your business. You also need to structure the business in a way which will assist the buyer to quickly execute on the opportunity. This may require you to build a launch platform, identify strategic partners, set out a plan for scaling capacity and change your business to reduce integration issues.

The value which you will receive for your business is directly related to the level and timing of the revenue and profit which the buyer can extract from your strategic value. The longer it takes for the buyer to exploit that value, the less it is worth to them.

The more distant the expected benefits and the higher the degree of uncertainty that the benefits will be achieved, the less pressure you can create to get the deal signed. Future benefits are discounted back to the present to arrive at the NPV of the opportunity. The higher the NPV, the more you can offer as value you bring to the buyer. The more distant the benefits and the longer it takes the buyer to exploit the opportunity, the lower the NPV and the less the value of your business is to them.

Looking at this from the opposite viewpoint, the quicker the buyer can exploit the benefits, the more certain the projected profits and the sooner the revenue and profits are earned, the higher the NPV and therefore the greater potential sale value of the business. Your objective, therefore, must be to create a set of conditions that enable the rapid integration of your business into the buyer's and a roll out of the program to exploit the opportunity.

The basic questions you should be asking yourself are:

What does my business need to look like at the time of sale?

What can I do to allow the buyer to more easily exploit the opportunity?

What can I do to enable the buyer to generate new revenues earlier?

Reducing Integration Time and Costs

Once you have identified potential buyers, you can start reviewing your own business to identify how your business might be more rapidly integrated into that of the buyer.

One of my workshop attendees put it like this;

"The more I look like the buyer, the easier it will be for them to buy me."

In essence, what he was saying is that, where there are fewer differences in culture, remuneration, entitlements, processes and so on, the easier it is for the buyer to integrate the new subsidiary. While this is an ideal, there may be a number of things which you can do to reduce the time, cost and stress of integration.

Old products

Are there any products or services which you are currently offering that would not be of interest to the buyer or would distract the focus of the potential buyer away from the main opportunity? Old products tend to come with customer obligations, perhaps dedicated staff, equipment, inventory and so on. Perhaps these could be sold off prior to the sale of the core business.

Parts of the business that are not relevant

Are there parts of the business which are not relevant to the value being acquired? It might be better to carve these off into a separate company and keep this out of the deal or sell it off in advance. For example, you might be able to do a management buyout of those parts of the business not relevant to the opportunity for the buyer. This would have the effect of speeding up due diligence, reduce the time to integrate the operations and reduce the cost to the buyer of having to deal with redundant capabilities.

Adherence to standards

Are there standards which you should be using relating to areas such as design, manufacturing, packaging and so on, which the buyer will want to implement prior to rolling out the new products or services? Can these be implemented prior to the sale?

Product interfaces

Are there interfaces or interface capabilities that would need to be incorporated into products or services before they can be rolled out? Are these able to be incorporated prior to the sale or could you make changes to the products or services to ease the work required to implement them?

Customer, supplier and partnership agreements

If you can see that some or all of your agreements will need to be changed to allow you to sell the business and transfer capability to the buyer, these changes should be implemented in advance. If the agreements need to be modified to bring them into line with the buyer's standard agreements, you should investigate how you can assist with these changes by making them prior to the sale or by getting advance agreement with your customers, suppliers and partners to the changes prior to the sale of the business.

Information system interfaces

It is almost certainly the case that your internal financial reporting and other application systems will need to be replaced by those of the buyer or they will need to interface with them. You should investigate the

capabilities within your own systems to ensure that you have as much interface capability as possible. To the extent that you can anticipate the requirement and plan for it, the integration and handover task is eased.

Remuneration and entitlement alignment

There are always problems when businesses merge where remuneration packages and entitlements to vacations, public holidays, bonuses and so on, are different. You might want to investigate these arrangements in your potential buyers to see what possible misalignment might occur. It might be worth offering a special bonus on sale to your employees to cancel or alter any existing entitlements so that the buyer has the flexibility to implement their own compensation packages.

Succession plan

The buyer will be concerned at the number of people leaving the business at the time of sale or shortly after. They will want to be assured that the key people are retained within the business and that the management capability to operate the business is in place post sale. It is to be expected that a number of senior executives will wish to leave within a short period after the sale. Most senior executives in small firms prefer to work at a senior level and may be uncomfortable working at a lower level in a large corporation. As well, these individuals, who are most likely cashed up from the sale, will want to use their newly acquired wealth to pursue other interests.

It is important to ensure that the knowledge and capabilities within the business is adequately protected. This could be secured by ensuring that successors are in place for senior executives, key employees are paid a retention bonus for staying on with the buyer and that information within the business is well documented. You need to be able to assure the buyer that they will be able to effectively transition the business knowledge to their own employees.

Transition arrangements

The firm should be sensitive to ensuring that the buyer is supported throughout the transition period. Thus it may be worth considering

retaining senior executives under a consulting arrangement for a limited period of time to assist the buyer to transition the business across to new management. Rather than allow the buyer to imagine risks in the transition, the firm can address these issues in advance and offer solutions. The more that perceived risks can be addressed with acceptable solutions, the more willing the buyer will be to go forward with the deal. This solution also offers greater flexibility for the buyer to encourage senior executives to stay if they need them, but ensures that the risk of them leaving is addressed. It also means they could terminate them earlier if necessary.

Cancellation of external relationships

In some cases the buyer will have a capability which will replace an existing arrangement with an external supplier or distributor and they will wish to terminate the seller's existing arrangements. The buyer may also have their own preferred agreements which they wish to apply after the sale. In anticipation of such a possibility, the firm should have agreements in place which allow for termination. The firm should also have in place arrangements which allow the transfer of any rights under agreements to the buyer. Of course, the opposite might also apply. An arrangement might be cancelled by a supplier on the sale of the business and the firm will need to have alternative arrangements in place.

Exploiting the Opportunity

Many acquired businesses are not able to be scaled because the knowledge that the business uses to generate revenue is locked up inside the heads of the founders or key employees. For the business to expand other people need to acquire the knowledge or the knowledge needs to be codified and/or de-skilled. When the buyer is reviewing the potential of the business, they are going to want to estimate the time and cost of putting the business on a growth footing. If they have to extract company intelligence first, it may look problematic as there is always a danger of getting it wrong and/or losing the people who have the knowledge.

An essential part of the value proposition to the potential buyer is to show them how they can easily exploit the revenue potential. If the systems are

already in place to do this, the risk to the buyer reduces and the time to payback on the investment may well reduce. Both these elements lend themselves to adding more to the price you can extract at time of sale.

Clearly the opportunity is worth more to the buyer if the benefits can be received earlier and the risks of exploiting the opportunity can be reduced. Thus the firm needs to put itself into the position of the buyer and think through the activities which the buyer will have to undertake to rapidly exploit the opportunity. Perhaps this is best understood by making some assumptions about the rollout program.

Assume that the buyer:

- *Wants to launch the new product or service as quickly as possible;*
- *Is willing to provide the necessary funds to undertake the program;*
- *Will allocate the necessary management capability inside the corporation to support the activity;*
- *Will deploy the new capability as widely and as quickly as possible if the costs of doing so can be quickly recovered by new revenue, and*
- *Wants to minimize possible risks.*

A good rule of thumb for any acquisition is to set a target of breakeven or into profit within two years. Generally speaking corporations are prepared to fund new projects or programs where they can clearly see a positive return on the investment inside two years. However, the sooner your program can be cash positive, the more positive the buyer's interest.

There are two considerations arising from this approach. For the seller, they must be aware that the size of the gross margin achieved from new revenue in the first two years is probably the limit on what the value of the acquisition is to the buyer. Anything which can be done by the seller to assist in higher and earlier revenue will directly impact on the sale price of their business.

For the buyer, an acquisition which has a quick payback is going to be much more attractive. Whatever they are likely to offer as a purchase price will be strongly influenced by the likely gross margin generated by the new revenue in

the first two years. The more they can earn in this period, the more they will be willing to bid to be the successful buyer.

Working out how best to deploy a new capability to maximize revenue within two years of the sale of the firm and how to bring it into profit early, is part of the planning that the firm should do in order to articulate the opportunity to the potential buyer. If you think through the process which will need to be undertaken by the buyer to scale the activity, you will have a better appreciation of what the buyer will need to do to exploit the opportunity.

What can you do now and over the period before the business is sold to make that activity more effective?

I normally work on a two year preparation program prior to the date of anticipated sale of the firm. That is:

What can I do over the next two years to put in place a platform from which the buyer can launch a program to exploit the opportunity?

Even though this may require an investment by the seller during that two year period, the more revenue the buyer can generate in the two years after the sale, the higher the potential sale value of the firm. Since you don't know when you will need to sell the business or receive an offer to sell the business, you really can't afford to delay this preparation. So assume you will sell the business in two years and then, if you delay the sale, at least you will be well prepared when you do.

Given an objective of rapid deployment after the sale;

What can you do over the next two years prior to the sale to enable that to happen?

Are you able to go to the potential buyer and say;

"I can make this work for you because we have built a capability and put in place a set of circumstances and activities that will support your rapid rollout of this opportunity".

Put yourself in the position of the buyer and try to work out what problems they would need to solve to enable this opportunity.

To what extent can you resolve these problems in advance?

The key to a premium on sale is to create a platform from which the acquirer can rapidly achieve the benefits they seek in the acquisition. A strategic buyer will be interested in the rate at which the strategic asset or capability can be replicated or scaled. The anticipated speed of execution impacts the value of the business to the buyer and greatly influences the price which the seller will receive.

Documentation

It is likely that many more people will need to become involved in order to scale up the program. Are you able to provide the necessary documentation of the product, process, systems, implementation activities and so on, to support rapid deployment? Knowledge cannot be in the heads of the current employees if many more people are going to be involved.

Support for a scaled activity

If you were asked to support an activity, 10, 50 or 100 times what you are doing right now:

- *What would the product or service need to look like and what supporting activities would this need?*
- *Are you able to put the underlying support structure in place to enable the buyer to quickly move to those levels?*
- *If you were asked, for example, to train sales staff, product demonstrators, implementation and support staff in large numbers, how would you prepare for such an activity?*
- *What would you need to have in place to quickly move to a much higher level of activity?*

Arranging capacity

Some products and services require additional specialized capacity to support a higher level of activity. This might be a manufacturing capability or a help desk, implementation or support capability. You may need to ensure you have access to adequate supplies of components, ingredients or supplies to support a scaled up operation. While the buyer might have their own plans on how to do this, you might be in a better position to assess the needs. You might screen potential suppliers or you might wish to identify potential sources of manufacturing capacity or manpower and have an option which the buyer can take up to gain resources, or have a letter of intent which the buyer can activate in order to speed up the launch capability.

If the buyer needs to implement new internal systems, processes or capabilities in order to undertake the release of a new product, you might be able to source external capability to allow an earlier launch with a gradual transition to in-house capabilities. Whatever you can do to ensure an earlier generation of revenue you should do.

Building strategic partnerships

Some products or services require complementary skills or resources in order for them to be delivered. If you are able to define these requirements in advance of a scaled up operation, could you also identify, screen and gain agreements for such services.

For example, say you had a business which would be very attractive to a multi-national software corporation. You have an application which could be sold to global end-users but you need a consulting organization to implement it which your potential buyer does not have. Assume that the savings to the global end-user are significant and the earlier they are delivered the more the end-user saves. You could identify a global consulting service which could implement the solution and you could work out an agreement for the deployment of consulting services, a program of staff training and a support desk capability which they would implement to support the program. Your presentation to your potential

buyer can now show how the product could be delivered to end-users with minimal delay.

Creating immediate revenue opportunities

The ultimate opportunity might be enhanced if you were able to deliver to the buyer a large scale customer project. While you might not have the capability of delivering on the project yourself, the buyer might see this as a way of bringing the acquisition into positive cash flow very quickly. It also demonstrates the credibility and capability of the long term potential of the business.

Implementing reference sites

A large scale rollout, especially across multiple geographies, may require a small number of reference sites to demonstrate the key features of the product or service. This might be the case, for example, where the product needs to demonstrate multiple language capability, the ability to handle certain types of transactions or solve specific problems. References might be achieved for certain types of consumer products by having them associated with high profile personalities. Having the product in the right places, with the right people or being used for the right applications, will assist a more rapid ramp up of sales for the buyer.

Localization

Products which you intend to scale internationally might need to have some localization changes or support. This could be local language, local reference customers, packaging requirements, technical standards and/or support for specialized transactions such as tax or payment methods. While it may be expensive to do every one which will be needed, you might make underlying changes in the product to enable these to be done more quickly and more cost effectively. It would be sensible to implement in your products those changes which would be required for the largest markets in order to speed up time to market in those markets. Where customers are skeptical of the capabilities, you might wish to implement reference sites in those sectors or geographies.

Building market awareness and reputation

In most sales situations, there is a lag between introducing a product into a market and general awareness of the product and acceptance of its benefits. To the extent that you can reduce time to market for the buyer by building awareness in the buyer's target markets prior to the sale of the business, you will increase short term market acceptance and build credibility for the acquisition with shareholder's and market analysts. Market awareness might be achieved through trade exhibitions, selective advertising, public relations and by briefing industry market analysts.

Building a prospect pipeline

In a situation where your value on sale is related to the level of revenue generated by the buyer in the first two years of the acquisition, it may help in the sale negotiations to have a database of prospects. These can be handed over for the buyer to act on. The better qualified the prospects are, the more valuable they are to the buyer.

Acquiring licenses, rights, approvals, registrations, etc

Some products and services will require the product or the seller to have certain approvals, registrations, rights or licenses to practice or to undertake product sales. To the extent that these are already in place, the time to market is reduced. In any situation where these are difficult to obtain, time consuming or costly, resolving this prior to the sale makes the acquisition more valuable.

Put Yourself into the Buyer's Shoes

Few people think beyond the sale of their business to see what the buyer would need to do to fully exploit the business potential. They see that the buyer has the resources or the distribution channel to absorb their product or service but they don't take into account what the buyer would need to do to bring the product to market inside a large corporation across a large geography. They fail to appreciate that the ability of the buyer to rapidly deploy their product or service directly impacts the current value of the revenue opportunity facing the

buyer. Clearly, the more it is worth to the buyer, the more the buyer should be willing to pay to acquire it.

Nor do they consider how they could enable the buyer to maximize the opportunity. They fail to consider how much effort, time and cost the buyer will need to expend to scale the business to support a much larger marketplace.

Clearly, the greater the effort required, the more additional resources are needed and the greater expenses incurred, the longer it is going to take. The longer it takes, the lower the NPV of the opportunity. Yet, without a great deal of effort or expense, the seller may be able to create the capability which could dramatically reduce the time, cost and resources needed. The seller may be able to work with external agencies, suppliers, customers and the media to speed up market penetration through such elements as reference sites, icon users, public relations and so on.

Another critical aspect of the buyer's rollout is that the acquired firm will need to provide resources to the buyer's program while continuing to run their existing business. Few buyers are prepared to undermine an on-going business by stripping out key capabilities to support a large scale rollout. Instead, rollout will be delayed until additional capabilities can be recruited and trained. So a key question a firm needs to ask of itself is,

"How can I build a capability that I can release to support a buyer's program while continuing to operate the current business?"

This additional capability may need to be built and staffed in advance of the sale and then immediately dedicated to the buyer to allow the buyer to launch a large scale program.

You need to build a scenario for how the buyer would exploit your strategic value. Assuming the funds and internal support are not constraints, how would a buyer best scale a program to maximize the revenue? Now work out what the buyer would need to have in place to launch such a program. Working back from there, build a program of activities that will create as much of the launch platform as you can.

I typically work on a two year program, but if you already have much of the capability in place, you might be able to complete the list earlier.

What you should be aiming to do is build a compelling case for the buyer to move forward with the deal. You want to show them that the resources and activities required to exploit your strategic value have been thoroughly examined and that you have built a capability and an environment that will allow rapid exploitation at minimal risk and delay. In crude terms – you want them to be able to taste success. You should be able to say to the potential buyer that you have removed as many possible impediments and constraints to scaling the opportunity that you could and that you are delivering to them a highly probable large scale revenue and profit opportunity which can show benefits quickly.

Creating Additional Strategic Value

Whether you have existing products, services or processes that can be scaled or would be attractive to the potential buyers, there is a good case for using the time available until you sell the business to create new forms of value for the buyer.

One way you can do this is by changing your products, services and processes so that they become more compatible with those of the potential buyer. For example, can your products be redesigned to better complement the current range of the buyer's product portfolio. Are there features you could add which would be of benefit to the buyer's customers. Whatever you can do to make yourself or your products and services more attractive to the buyer will improve your value.

You might also look at where your potential buyer can use your current products, services or technology to open new revenue opportunities and to create new products, services or processes which they can exploit. What else could you do to enhance those opportunities? Another possibility is to find ways in which you can increase productivity or reduce expenses in your operations which can be exploited by the buyer across a much larger organization. Firms that basically sell commodity products can generate value by developing

management applications or better business processes that can bring cost savings to a larger organization.

Some businesses can create platforms for revenue generation even though they are not able to exploit it themselves. Thus developing IP and registering new patents may create potential value. Acquiring new rights through agreements, licenses, registrations, purchase options or outright purchase may also create potential value for an acquirer.

The Business Concept

The value that the potential buyer places on your business will relate to what they are going to do with the strategic asset or capability, which may not be the same as what you are currently doing.. The value to them will relate to their market and their capability rather than yours. Thus their investment will be set against their revenue and profit from the acquisition not your revenue and profit. Even if you were to enhance your profitability, it may make no difference to the value of the acquisition to them and may have no effect on the ultimate price they are willing to pay.

In many strategic acquisitions, the asset or capability being acquired will be leveraged through the corporation's existing distribution channel. In these situations, it may be quite irrelevant as to whether the acquired business is making a profit or a loss. In fact, the size of the business itself may be irrelevant to some extent.

The major consideration of the potential buyer will be whether the acquired firm has the underlying capability to support the exploitation of the strategic asset or capability being acquired. Many firms with strategic value make the mistake of putting their effort into growth in revenue and profit when, in fact, this is not the basis on which they will achieve their maximum sale value. In practice, seeking growth may, in some cases, reduce their strategic value because the acquirer then has to deal with legacy customers and staff they may not want.

The key consideration in a strategic sale strategy is to grow the firm only to the level of revenue and profit that is necessary to provide the critical size that

would allow the acquirer to properly exploit the potential. Once that size is reached, additional surplus funds should be put into enhancing resilience and developing additional strategic value for a potential buyer.

While the pursuit of additional profit may not impact the ultimate sales price, some profit is useful to ensure survival and resilience. The firm must still generate cash to build out its strategic assets and capabilities and needs to have something in reserve to avoid mistakes. Also, it is not possible to predict when the sale might occur, thus the firm needs to plan to stay in business until a sale can be negotiated.

Since strategic value is coupled to an asset or capability, enhancing the underlying assets or capabilities may add more value to the sale price than additional revenue and profit. So instead of pushing the business to achieve higher levels of revenue and profit, you should be investigating how you can enhance the strategic value.

This logic flies in the face of conventional wisdom which says that valuation is based on revenue and profit. But if the maximum sale price is unaffected by revenue at the margin, you are far better to reduce risks in the business and concentrate on building resilience so that you can last long enough to be acquired at a hefty premium.

Instead of funding more growth, the business may be better off selling off parts of the business and concentrating on further developing its strategic assets and capabilities.

IN MY CASE, I sold a 30 person software business which, at the time, was facing insolvency due to a sudden shift in the market and was making a one million dollar loss. The business was sold to Peoplesoft for six times revenue. What was clear was that the value to Peoplesoft was generated by their ability to sell my software products directly into over 1,000 of their existing customers. At about \$500,000 per sale, this represented a very large revenue opportunity. The key to this deal was that our software products were well suited to exploiting this opportunity within their customer base. Furthermore, there was really no other

alternatives available to them within the near term. If they didn't step up to acquiring our business, they would walk away from the revenue opportunity and they might be allowing a competitor to acquire us.

While profitability, customer base and growth may not be important to a strategic deal, size may matter. In order to deliver a platform from which the opportunity can be launched, the business needs to have the capability and capacity to provide the launch platform.

The asset or capability which is destined to provide the source of the revenue opportunity to the buyer must be in a form or structure which will enable the buyer to achieve the acquisition objectives. If the business is too small, or the asset or capability has not been structured for scalability or replication, the business may not be worth acquiring. Thus size matters to the extent that it allows the buyer to exploit the opportunity. However, beyond that point it may in fact reduce the value of the business. If the buyer has to discard parts of the business or close parts down, there may be costs, delays and risks in doing so.

9 Reducing Risks to the Buyer

One objective you need to keep in mind throughout the exit process is to 'make it work for the buyer'. One of the major tasks of the seller is to reduce risks to the buyer. This will include anything that exposes the buyer to potential liabilities as well as situations that cause the buyer to expend funds, time and effort to put the business into an effective and efficient situation.

The buyer will be interested in evaluating three aspects of the business before they decide to go ahead with a purchase:

- *What are the inherent risks in the business being acquired?*
- *What issues will they have to deal with in the change of ownership?*
- *What costs, delays, problems and stresses will they experience in achieving the acquisition objectives.*

The smart seller anticipates these aspects of the buyer's evaluation and puts in place a program to reduce, eliminate or mitigate risks. They set out to ensure that the change of ownership process is smooth and set the business up in such a way that it provides the best platform for the buyer to achieve their acquisition objectives.

Most large companies that have undertaken a number of acquisitions will have experienced acquisition disasters. These are often things that they knew about going into the deal, but agreed to accept as part of the transaction. More often, however, there are things that are uncovered after the deal has been consummated and turn up progressively over time. The smart ones learn from their mistakes and have a rigorous due diligence process which they undertake prior to finalizing the deal. They also have legal remedies and a project control system following the acquisition to manage surprises.

For the buyer, risks in the deal are anything that will cause delays in exploiting the opportunity. This includes anything that creates costs, reduces effectiveness or impacts on time to integrate the acquisition or to take advantage of the assets and capabilities acquired. Additional risks for the buyer are those things that required further investigation but were not able to be undertaken prior to the deal closing. Risks are both things that can be seen and things that cannot be seen. For example, an employee intellectual property (IP) agreement may show that the firm owns all inventions from its employees. Missing signed IP agreements from past employees may however create a potential claim later on.

Observed Risks:

- Non standard customer contracts
- Non standard supplier agreements
- Harsh lease conditions
- Loose IP agreements
- Overly generous reward and remuneration systems
- Generous options schemes
- Generous health or vacations benefits
- Poor reporting systems
- Harsh compliance requirements
- Out of date equipment or poor quality products

Missing information:

- Lack of clear IP ownership
- Lack of documented processes, procedures or instructions
- Unclear customer obligations
- Missing performance information
- Successes and failures not understood
- Information on cost structures or recurring revenue
- Data about sales process, sales cycles, closure rates
- Intentions of key employees

The acquiring firm undertakes the transaction to solve their problem (threat) or to execute on an opportunity. To the extent that uncovered risks reduce their probable outcome or delays their time to execute, the value of the potential acquisition declines. In some cases the threat will go away or be reduced in potential impact through external events or because they uncover an alternative solution. Opportunities may decline with time or they may find another way of undertaking it. In almost all cases, the expiration of time is at the expense of the selling firm. Either the price will drop or the deal will go away. Therefore, understanding potential risks to the buyer and resolving them prior to an acquisition deal is the best way of preparing a business for sale.

Due Diligence

Once the parties have agreed the business terms of the acquisition, the potential acquirer will proceed to a full analysis of the investment opportunity. At this point analysts, lawyers and accountants acting on behalf of the acquirer will undertake a due diligence investigation.

The buyer will incur considerable costs in this investigation and they will want to ensure that the selling firm is acting in good faith during this period. To protect themselves, the buyer may request that the seller execute an exclusivity agreement where the seller agrees not to proceed with acquisition discussions with any other party during the due diligence period. A penalty may be agreed for a breach of this condition. Alternatively, in a competitive bidding process,

there may be a shortlist of parties that undertake the due diligence assessment concurrently.

One objective of the due diligence process is to investigate the firm to see if the business itself has any major problems which have not been identified in the information already provided to the acquirer. The due diligence process will undertake a validation of all aspects of the existing business as presented in the documents supplied (information memorandum, business plan, prior financial reports and so on). This investigation would include most of the following (dependent on a share or asset sale):

- Background checks on the key executives and key employees (subject to privacy laws);
- Review of all corporate documents including Board minutes;
- An examination of all shareholder information including share classes, rights, obligations, options, warrants, covenants and minority interests;
- All material agreements with external parties, especially those that impact revenue or expenses or that involve guarantees or restrictions on trade;
- Any employee agreements including management contracts, option schemes, remuneration arrangements, pension arrangements, commission and bonus payments;
- Review of all financial information and additional investigations where necessary to validate key numbers in financial reports and budgets;
- Inspection of all key contracts including leases, mortgages and debentures;
- Review of all compliance requirements;
- Review of all taxation filings and liabilities;
- Review of any current and potential litigation;
- Review of all insurance and any outstanding claims;
- Validation of all intellectual property ownership;

- Examination and verification of all real property ownership;
- Interviews with major customers, suppliers and distributors;
- Verification of costs, expense levels and purchase commitments;
- Assessment of plant and equipment and capital expenditure requirements;
- Review of intellectual property rights, including patents;
- Assessment of key employees;
- Review of inventory holdings including ageing.

This process will check the integrity and honesty of the firm as well as provide a view on how well the business is managed and on the adequacy and accuracy of the information which is being used in the business. It will also uncover how well the key executives understand their own business and the ease with which they are able to access and provide additional details necessary to the analysis.

A key part of the due diligence process is for the buyer to identify anything that would incur additional costs, create delays or expose the buyer to actual or potential liabilities that are not identified in the information provided to the buyer. This may lead to price adjustment or additional clauses in the sale document. Items that frequently create problems include:

- Non standard customer contracts;
- Non standard supplier agreements;
- Harsh lease conditions;
- Loose IP agreements;
- Overly generous reward and remuneration systems;
- Generous health or vacations benefits;
- Poor reporting systems;
- Out of date equipment or evidence of poor quality outputs;

- Use of company funds or resources for personal use;
- Pre-existing obligations, rights, commitments or restrictions;
- Unusual shareholders rights, legal structures, joint ventures, option schemes or anti-dilution arrangements.
- Punitive rights of existing debt holders;
- Excess inventory;
- Overvalued assets;
- Understated provisions.

A business that is effectively and efficiently run, has good customer, distributor and supplier relationships and has good internal reporting systems that monitor performance, ensure adherence to compliance regulations and protect the business from mistakes should have few problems in satisfying the buyer.

After the firm has satisfied the buyer with regard to its current operations, the buyer will turn their attention to an examination of those aspects of the future potential of the business that are critical to achieving the integration synergy and/or exploitation of opportunities presented by the acquisition.

For example, they may wish to validate the business projections and other planned targets and milestones that underpin the seller's business plan. Or they may wish to validate the size and viability of the opportunity to generate new revenue based on the acquired assets and capabilities of the seller's business. If achieving these targets is critical to meeting the ROI conditions of the investment, this is the area that exposes the buyer to the greatest risks. This investigation will review the following:

- The identification of the prospective customer and the quality of the benefits the customer gains from the product or service;
- The size and growth rate of the prospective market;
- The size, strength and strategies of current and potential competitors;
- The quality of the intellectual property underpinning the projections;

- The quality of the sales, marketing and distribution strategies proposed;
- The likely ability of the management team to be able to execute the plan;
- Availability of executive and specialized staff needed to deliver on the plan;
- A detailed review of the likely cash flow over the expected investment period.

As the business gets older and more complex, the data needed to support a full due diligence becomes more extensive and probably harder to uncover. Few early stage businesses have the filing disciplines to keep adequate records or to file them in a manner which allows ready retrieval many years later. Smaller businesses may not take the trouble to document management or board decisions and then later find that they cannot find the authorities that allowed them to make significant decisions that may have affected stakeholder rights. This opens up the door for possible litigation from minority shareholders or other vested interests.

The best path for the potential seller is to undertake a vendor due diligence. This is a due diligence activity that is undertaken by professional advisors on behalf of the seller but from the viewpoint of a potential buyer. The outcome should be an action plan for the seller on what they need to do to bring their business up to date and in a position where they could meet the due diligence requirements of a potential acquirer. So rather than be surprised or penalized in the acquisition process, the seller who is prepared for due diligence has everything ready for the due diligence investigation.

It is unlikely that any firm can submit to the due diligence inspection without there being some issues that need to be resolved. Firms that have not considered due diligence and have let compliance slide, are late with meeting new regulations or have inadequate internal information systems, may have a lot of work to do to bring themselves up to the mark. Thus it could easily take 18 months to 2 years just to put in all the performance and compliance monitoring systems to ensure that these aspects of the business will be ready for a due diligence review. Since these systems should be there anyway, this is money well spent and should be done whether the business was being prepared for sale or not.

When you undertake a due diligence review of your business you will inevitably uncover numerous items that need attention. Some activities may simply be to bring files up to date and make information about company operations available in a more accessible and understandable format. Other items will require the implementation of new compliance reporting and monitoring systems, installation of new financial recording and analysis systems, restructuring of roles and responsibilities and so on. These are aspects of your business that will have immediate payback in the current business but will also produce a more effective and efficient business for the new owner.

The acquisition may be based on some level of integration of the seller's business with the acquirer's existing business. The buyer due diligence process will need to identify where integration needs to occur, the likely priority and timing of such an integration and the capability and willingness of the respective staff to make it happen. Included in that review will be issues such as:

- The need to open or close new offices, warehouses and manufacturing locations;
- The extent to which staff will be relocated, reassigned or have conditions of employment, remuneration, health benefits, entitlements, responsibilities or reporting lines changed;
- The extent to which information systems need to be integrated, merged or interfaced;
- The extent to which the cultures of those units which need to be integrated are alike;
- Whether suppliers, agents and distributors will continue and what costs and disruptions will occur if they are not.

Integration will take time, utilize senior executive time and require funding. These costs and delays need to be factored into the investment evaluation.

To the extent that uncovered risks reduce the probability of achieving the desired outcome or delay the time to execute, the value of the potential investment declines. In some cases, the problems can be overcome by installing additional controls, renegotiating agreements and putting in place alternative strategies. However, these may result in additional costs or delays in executing

the plan. To the extent that problems cannot be easily resolved or structural changes are difficult to implement, the investment will incur greater risks. At some point the buyer will decide that the risks are too great and will decide not to make the investment.

You need to see the integration process as a cost to the acquirer and whatever the cost it will be deducted from the potential gain from the acquisition. The more you can reduce the costs, time and stress of integration, the higher the potential value that can be assigned to your business.

Aspects of integration which you can influence in advance of a sale include:

- Moving customers and suppliers over to new relationships and systems, perhaps rewriting contracts, agreements and trading arrangements;
- Shifting business from some distributors and suppliers to those which have pre-existing arrangements with the acquirer;
- Closing down duplicate offices, warehouses and manufacturing facilities. This might include redundancies or relocating staff;
- Shifting financial reporting systems and transaction systems across to a common administrative system;
- Realigning remuneration, health, pension, vacation and other entitlements;
- Replacing staff who have left;
- Changing job descriptions, responsibilities and reporting lines;
- Re-branding products and services and re-designing sales collateral.

Ask yourself how you can help streamline any of these processes with your target acquirers. For example, do you have termination and/or change of ownership clauses in your contracts? Are you using industry standard terms of trade? Are your products based on common industry interface standards and use common industry components?

Take a good hard look at your business and ask yourself if everything you are doing makes sense and if it is contributing to adding value to a potential buyer.

It need not generate more revenue or even reduce costs for your business right now but consider the impact on the buyer. Whatever you can do to make the business easier to manage, increase the productivity, or allow the buyer to focus on exploiting the potential can increase the value proposition.

Remember that your buyer may have other firms to look at. All other things being equal, the one that is the least effort to exploit is going to be the preferred deal.

If the investigation results in an agreement to proceed with the investment, the buyer will incur the costs of the due diligence plus the legal fees associated with the preparation or review of the investment agreement. These will be factored into the final price paid to the seller. Thus the more due diligence work needs to be undertaken, the lower the final price to the seller.

The more prepared the seller is for due diligence, the lower the costs of the task, the shorter the time it will take and the more likely the buyer will go through with the deal. Thus, it is in the seller's best interest to fully understand the due diligence process and undertake as much of the preparation work in advance.

The advantage that accrues to the prepared firm is that this level of preparation indicates to the buyer that the seller understands how to manage its compliance and operating risks. Since these are often where the greatest risks for the buyer lie, this is good news to the buyer and should speed up the acquisition process. Where the buyer has a choice of acquisitions, the better managed one is more likely to also allow the buyer to more quickly execute on the opportunity. It becomes the preferred purchase.

The firm that is better prepared for a due diligence inspection also presents itself as being well managed. Firms which are seen to be efficient will find it easier to secure the support of champions in the purchaser's organization and that will help get the deal done. Also never forget that the task of the seller is to collapse the time to get an agreement. Being efficient and well prepared creates the best chance of getting the deal done quickly and of preserving value for the seller's shareholders.

Creating value is partly psychological. Buyers go into a deal anticipating problems and all their experience suggests that they can expect them. They should be delighted when they find a business that operates efficiently and satisfies their due diligence investigation. Don't forget that professional advisors who carry out due diligence projects have to justify their fees and are looking for ways to reduce the price paid by the buyer. If you can create a clean business, the buyer is likely to reduce the scope of the due diligence work. They won't be willing to keep paying professional services fees if the service providers are not finding anything to justify further work.

Always keep in mind the golden rule of selling – the shorter the time it takes to get the due diligence complete, the higher the price you can expect and the more likely you will be to get the deal done.

Confidentiality

If you are talking to potential buyers about selling the firm, this can lead to some unfortunate results if handled incorrectly. Competitors can use this information against you, key employees might decide to leave, staff can be stressed due to uncertainty and become less productive, suppliers might want early payment and so on. How can this be handled with both external and internal parties?

External Parties

Probably there is no one right answer and it may well depend on your own position within an industry. The norms in each industry vary. It may also depend on how good your existing relationships are with customers, suppliers and partners.

Open Intention:

Some industries, such as the software applications and systems market, accept that everyone is for sale. Since they are for sale, discussions are always taking place between parties as to mergers and acquisitions. Generally, acquisitions take place because a larger party can better scale the operations and therefore customers are reasonably well protected.

Strategic Investor:

Many firms are looking for investment to help them develop their business. These can often turn into acquisitions. Providing the firm is open about looking for a partner, it may not be a surprise if that turns into a sale.

Longer Term Objectives:

Many owners are quite open about wanting to retire at some time, or being open to an offer if the offer is a good one. Providing this is not a secret, the firm is reasonably well protected from rumours.

Private Negotiation:

Some customer deals may be quite sensitive to a possible takeover. However, provided this is dealt with confidentially and the reasons are beneficial to the prospective customer, it may be better to declare this privately to the prospect. If they then hear it from another source, at least it was not kept from them.

Partnership Deal:

A discussion of a possible acquisition can be portrayed as a partnership or alliance arrangement. A larger corporation which is looking to distribute your products or enter into a joint venture may wish to carry out extensive due diligence to protect themselves. Another way in which this can be explained is through a licensing arrangement. Again, much of the discussions are similar to those undertaken in an acquisition process but this public declaration allows the firm to proceed without declaring that they are going through an acquisition discussion.

If you don't have to do a deal, you can always simply entertain the possibility and portray in that light. That is, "if the right deal comes along – of course we would be foolish not to investigate it". This is something that any reasonable business owner would say and should not convey the impression of a firm in trouble or desperate to do a deal.

If on the other hand, you are desperate to do a deal, the best way to do it is quickly. The longer the market sees you in trouble, the greater the impact on

your business. Competitors will be quick to seize the opportunity of undermining your sales efforts.

The only way to execute a deal quickly and yet still come out with a premium price, is to be proactive and prepare for a sale. Providing that you know who the potential buyers are and have established the type of relationship that you can leverage to get a deal done quickly, you should prevent any major negative effects on the business.

Consider using a Non Disclosure Agreement to ensure that the other party understands the seriousness of the information you are sharing with them.

Internal Parties

Employees are naturally going to be concerned about any possible major change in ownership. They will have heard stories of other firms going through the process and know of redundancies, relocation, changes in work practices, remuneration, benefits and so on. No doubt some of that will happen when your firm is sold. So how can you best deal with that?

Make it strategic for employees:

When you seek a company that can scale your operations, overcome your limitations and provide a larger market for your products and services, employees are often better off. You should be conveying the message that you would always be interested in a strategic sale where the employees may have better career prospects.

Involve Managers and key employees:

Some staff are required to make the transaction possible. They will be providing data to the potential buyer as part of the due diligence. They need to be informed about what is going on and be counselled about the implications for their jobs. Where there are potential negative impacts on them, these need to be discussed and a plan put together for mitigating the effect on them personally. This could be a lump sum payout, redundancy payment, a longer notice period and so on.

Provide incentives:

If employees have an incentive to make the transition work, they will tend to support it more. The incentives could be in the form of shares, options, bonuses and so on. There needs to be an alignment of the interests of the shareholders, managers, employees and the new owners.

Employment agreements:

As part of a review of general employment conditions, consider incorporating a bonus at the time of the sale of the business, special termination conditions if the business is sold and/or special retention bonuses for key employees. This change can be incorporated into standard employment conditions along with other updates on health benefits, maternity leave and so on, perhaps based on an external professional review.

Post Sale Scenarios

It is possible to put yourself into the position of the prospective buyer and work out what is likely to happen to the business. If you can anticipate issues, problems or changes which the buyer will experience, can you reduce the impact of these and improve your attractiveness to the buyer? By working through after sale scenarios, the firm can predict where problems might be encountered. As these are likely to cause problems in the negotiation, you may be able to fix these in advance or have solutions which the buyer can implement. By working through how these might be resolved, the firm can take the initiative and reduce potential negotiation problems.

Acquiring firms, especially those which have experience in M&A, assume they will have many issues to deal with after the acquisition. These are generally associated with the integration of the two firms as well as securing the best use of the strategic asset or competency they acquire. In considering the likely situation after the sale, consider the following questions:

- *Where will the merged firm (yours) be located?*
- *What will happen to existing facilities, plants, warehouses, offices which are not required?*

- *Which positions are duplicated and therefore which staff will be made redundant?*
- *Which employees are key to the buyer's benefits being realized? How are those staff to be retained?*
- *What will the new terms of conditions of employment be?*
- *What happens to employee options and any share purchase scheme?*
- *How will health insurance, vacation entitlements and existing bonus systems be translated?*
- *How is the buyer to leverage the new acquisition?*
- *What will happen to existing customers, suppliers and distributors?*
- *Which partnerships, alliances and joint ventures need to be terminated or protected?*
- *What are the owner/managers going to do in the merged company?*
- *What if they don't want some, or all, of the senior management?*
- *What potential litigation will you have outstanding that will need to be resolved?*

The key to a successful negotiation is to have thought through these questions in advance of any detailed discussion with the potential buyer. To the extent that these issues can be resolved in advance or options can be presented, the negotiations will proceed more smoothly.

Generally speaking, it is easier to merge a firm which has standard conditions throughout its operations. So industry standard contracts with suppliers, customers, distributors and employees should normally not present a problem. Overly generous terms of employment (salaries, benefits, bonuses, options, health cover, etc) can seriously damage a potential sale. Since the buyer will most often have to integrate new employees with their own, any marked differences where the new employees are better off, will be a serious impediment. It is always better to have a situation where employees gain through the merger rather than lose. Discretionary bonuses and rewards can be used prior to a sale to provide motivation without any guarantee that these will be continued in the future. Alternatively, terms of employment can be agreed where aspects can be

subject to review on a periodic basis. These can then be removed prior to a sale or shortly after.

A firm intending to be sold should also look at the costs of terminating its various agreements. Since the situation after the sale cannot be predicted, having options in agreements which allow termination on change of control, or by putting a formulae or price on termination, allows the firm to estimate the costs of withdrawal. It also prevents a possible legal claim for damages.

The key question here is – how can you make this work for the buyer?

Put yourself in their shoes. What would the ideal scenario be for the buyer? How close can you get to that scenario? The closer you can get, the easier the negotiation will be. The buyer will be pleasantly surprised with the homework you have done and will see that you understand what they have to do to make the deal work. The fact that you have resolved many of the problems, allows them to see that you are flexible and will do what you can to resolve potential problems during the process of negotiation.

Install a Board of Directors

In preparing the business for sale, you should give serious consideration to installing a Board of Directors as part of your sale preparation process.

You may feel that you alone know enough to adequately manage the business and that the costs and time involved in supporting a Board of Directors is a waste. You would not be alone in that opinion as most small, medium and family business owners feel the same way. But running your business is not the same as positioning it for a sale. In setting a business up for sale, we need to consider the viewpoint of the buyer and what the buyer would find attractive in the business. Our objective is to take away from the buyer any hesitations about the operation of the business as well as reducing the anticipated costs and delays of changing the ownership of the business.

The buyer will be concerned about inherent risks in the business. If the selling business has systems and processes for reporting to an independent board, it will indicate to the buyer that the owner is prepared to be accountable for performance and is prepared to review the business operations with external

parties. If the process is done properly, the buyer can be confident that the underlying systems and reporting processes will enable an easier transition to new ownership. If the Board reporting pack includes operational as well as financial performance measures, the buyer will have more confidence in the quality of the business being acquired.

One of the biggest concerns of any buyer is the fear that the business rests on the personal knowledge and contacts of the owner. To the extent that this exists, the buyer takes the risk that the goodwill and corporate intelligence will be lost with the departure of the owner. To the extent that the business has a knowledgeable and independent Board of Directors, the buyer can have some confidence that the underlying systems are in place to monitor business operations and that some of the corporate intelligence is shared among the Board. Thus the buyer has the option of keeping some of the Board members for a period of time after the purchase to ensure that knowledge is transitioned to new management.

Perhaps the greatest benefit of having a Board in place prior to the sale is that it indicates to the buyer that governance is seen to be important in the business. It also shows that there are disciplines in place for longer term planning, risk assessment and accountability, all very good signs of a well run business. This will all help to give comfort to the buyer and hopefully speed up the sale process as well as increase the sales value.

Prevent the Loss of Key Employees

In the pressure to sell a business, the entrepreneur often forgets that it is a team sport. While the business owner might be overjoyed to see keen buyers banging at the door, the rest of the employees may not be so excited. Not only do they face a change of boss but they will be rightly concerned about their future employment, their job responsibilities and even whether their desk will continue to have a window view. If the entrepreneur is to realize the full value of the business, he or she needs to have the full support of the key employees throughout the sale process and beyond into the new ownership.

As a business owner or investor, you need to put aside traditional views of valuation based on EBIT multiples which reflect what you achieved in the

business and embrace a more realistic view that the value of the business is what it can achieve for the new owner. Everything we buy, including a business, only has value for what we anticipate we can harvest from it, whether that be an experience or a good return on our investment. Thus preparing a business for sale is simply about anticipating how we can maximize the future value for the new owner. Much of that value may be tied up in the active and positive participation of the current employees in the business under new owners. So what can we do to ensure that the new owner has the full support of those key employees who will help maximize that future productivity?

We need to examine three areas of concern for the new owner; what problems, risks and liabilities are inherent in the existing business; how easy will it be to transfer ownership and, lastly, how confident will the new owner be that he or she will be able to exploit the potential of the business post-sale. Firstly, our current employees can help put the business onto a low risk, profitable and resilient basis. For that to occur we will need their active co-operation. What we don't want is for them to be antagonistic or hostile to the new owners, or to be disruptive or to undermine the sale process. Certainly we don't want them to leave because they are concerned about their future with the business. What we need to do is to involve them in the sale preparation and due diligence process and give them an incentive to work towards a common goal of selling the business successfully.

The next stage involves the transition to new ownership. We need to be confident that the key employees will transition the core knowledge in the business. To do this successfully there should be incentives involved to encourage them to stay around in order for the transition to occur.

Lastly, we want the new owner to have the highest chance of successfully running the business and, possibly, developing it to generate greater revenue and profit. We need to consider how we can structure the business to provide the best platform for that to occur. Again, this may mean some incentives for the key employees to stay with the new business to give it time to settle down under new ownership.

The buyer needs to have time to transition the inherent business knowledge to employees who are likely to be employed longer term with the acquirer. Since

most resignations of newly acquired staff are likely to occur during the first year of the acquisition, putting in place incentives for key acquired employees to stay during the transition period can significantly reduce buyer concerns. Where the vendor has arranged this prior to the sale discussions, the buyer has some assurance that a major risk can be averted. This not only places the vendor in a more positive light but can positively influence the value of the business being sold.

To do this right, it will require you to allocate some of the sale proceeds to encourage and compensate key employees. By preparing the business properly for the new owner, you are going to significantly increase the price you achieve for your business. Your investment in your employees will be more than compensated by the higher sale price.

Within the sale preparation process, the senior managers will play a key role. The major stages are preparation, negotiation, due diligence, integration and on-going post acquisition operations. Within most of these stages, the current management are actively involved and they can either help make it work or scuttle it. Getting their support is, therefore, absolutely necessary.

Many entrepreneurs incorrectly believe that they can carry this process off by themselves and continue to manage the business under new ownership. However, entrepreneurs typically make poor employees and most smart buyers know this and so they look to the management team to provide the transition to new ownership. This view from acquirers is not unreasonable. Entrepreneurs are used to being in charge, making decisions without justifying them, taking shortcuts and accepting risks. Thus they don't fit well into a bureaucratic structure where they have to report to a boss and take orders. In addition, they are most likely cashed up, want to take it easy or want to move onto their next big idea.

Similar logic can be applied to many in the senior management team. The CFO is unlikely to want to step down to being a branch accountant, the Sales Director to a Sales Manager or the Marketing Director to a Product Manager. If they are all used to being part of the strategic decision making process, they are likely to want to perform that role again. Furthermore, they may have done well out of the deal and want to move onto another venture. The bottom line

– few of the senior managers will go with the deal or stay long after the deal is completed. Smart buyers know this and therefore look to the second level management and key employees to make the transition successful.

The entrepreneur who wants the deal to be successful must find a way of gaining the support of second level management and key employees in both the preparation for sale and in the transition of knowledge across to new ownership. If the people who have to make the deal work are uncertain of their future or resent the business being sold, they may leave or work to undermine the process. The entrepreneur therefore needs to bring them into the process in such a way that they will actively support the sale preparation and will be willing to transition to the new ownership in order to provide the continuity needed by the buyer.

Incentives need to be provided to management and key employees to encourage them to work towards a sale. This means ensuring they have sufficient incentives in the form of shares, options or bonuses to do so. Those that will be made redundant need to be provided with a bonus in order to stay until the sale is completed and then provide them with a buffer to allow them to be retrained or look for new employment. Those key employees who need to be retained need to be provided with significant incentives to willingly stay on for, say, a year to transition the business to the new owners.

Business owners who fail to put these incentives in place risk buyers walking away from the deal or facing a significant drop in sale price.

Do It Quickly

The best scenario for all concerned is to have the deal done quickly. This then leaves little time for staff to become stressed by the whole affair. You need to prepare a contingency plan for the sale of the business so that it can be executed within a short period of time. The deal negotiation and closure process can be dramatically reduced through this preparation process which results in the business being less exposed and less disrupted than if the sale process was continued over a long period of time.

10 Setting up the Exit Deal

Unlike conventional sale strategies which prepare a business for sale by preparing an information memorandum and then advertising it for sale, the strategic sale needs a lot more preparation if the best result is to be achieved. Unlike a conventional process where the invitation to bid casts a wide net, normally through multiple private and public channels, the strategic sale focuses on a set of identified potential buyers. These potential buyers have been selected because they have the highest chance of exploiting the strategic value being sold.

Only a small number of potential buyers are explored, generally because each one requires some effort to bring into the process. Not only are they contacted in advance of the business being available for sale, but time is spent with each one to ensure that they fully understand the potential being developed and how that could translate into a strategic opportunity for the buyer. Because of the unusual nature of this process, the issues which the seller has to deal with are somewhat different to a conventional sale.

What is the best way of getting a strategic buyer interested?

If you have some underlying asset or capability which can leverage a very large revenue opportunity for a national or global corporation, it should not be difficult to get their attention. The uncertainty most

entrepreneurs experience in seeking out potential buyers is they don't know who the best buyers may be and are not sure how to get them interested. However, once you have identified the best potential buyers, the task becomes significantly easier.

The end game is to be acquired by a large corporation who can exploit your strategic value. Clearly, the highest price will be paid by those corporations who have the capability, capacity and product/market space which can best exploit the asset or capability. They will be even more interested in acquiring the business if you can structure your business to reduce risks in the acquisition, speed up the integration process and then provide a structure which can rapidly deploy your product or service. You simply need to let them know what a great fit you would be for their business.

It is very common for large corporations to acquire small emerging firms within their industry in order to secure new innovations or specialized processes or knowledge. This being the case, the vendor who wants to identify a strategic buyer need look no further than the large corporations within their own industry. Almost without exception, the best buyers will come from within your industry and will have similar customers and competing or complementary products or services – thus they aren't that difficult to identify.

The ideal strategic buyer will normally have complementary or similar products, sell into the same or similar customers, use similar marketing and sales processes and have a track record of undertaking acquisitions. To be a good strategic target, they should also have a similar culture and have a good track record of meeting their investment objectives from prior acquisitions. With this set of criteria, the entrepreneur can readily develop a list of preferred prospective buyers. Given that a large portion of acquisitions occur where there is a formal or informal relationship between the parties, the next task of the entrepreneur is to develop closer links to the prospective acquirers.

The first step is to get in front of them. You should always keep in mind that the best acquirers are also frequent acquirers and will have a unit within their organization whose task it is to identify, evaluate and acquire firms which can contribute to their corporate strategy. Therefore, there are people inside the

prospective buyers who are likely to want to talk to you. Your job is to make contact and encourage them to give you a meeting.

You can achieve this through a variety of channels. You could of course just contact them directly and ask for a meeting explaining that you have a firm which might be of interest to them at some time in the future and you simply want to understand their acquisition criteria and process. While this may not seem possible, it is surprising how effective this can be.

You can always approach their local subsidiary managers and explain what you want to do and get them to recommend you. If you are already in the same industry, you might well know someone who works for the target corporation. Contact them and ask for an introduction. You may also find out the names of their Directors and approach one of them either directly or through a contact. An approach might also be made through your professional service provider.

Most companies within your industry will attend a variety of trade events, exhibitions, conferences and industry charity functions. You can use these to make contact with a senior manager of a potential buyer and use that opportunity to find out how to approach the M&A group, CFO or CEO. If you find that the right person is always too busy, ask to meet them when they are attending one of the industry functions. They will normally respect the fact that you are making a lot of effort to meet them and will set some time aside for a meeting.

The purpose of the initial meeting is to simply get on their future acquisition radar. Once you have their interest, it will be easier to set up subsequent visits where you can spend more time explaining what you have which would interest them and how you are able to facilitate them making significant revenue out of an acquisition of your business.

The aim of the entrepreneur should be to educate the prospective buyer on the future potential of the firm as part of their acquisition strategy. You will also want to take the opportunity to suggest ways in which the prospective acquirer might exploit the firm's underlying assets or capabilities. Once the relationship is established, the major task of securing a future potential buyer has been achieved.

If you don't want to make the approach under the guise of selling your business, try making an approach to their business development executives explaining that you are looking to find a strategic partner to help exploit your innovations. Explain that you are making the approach to them because of the fit with their existing business and the fact that you are looking for a business which will have a vested interest in working with you, that is, they have much to gain out of the partnership. The business development staff will see the possibilities in an acquisition and alert their M&A department. You haven't offered your business for sale but you have achieved your objective of getting their attention.

I am not for sale!

If you fear that competitors will take advantage of the pre-sale time to raid your employees and customers, you need a strategy to counter that threat. Clearly at some point you will need to ratchet up the level of activity as you get closer to seriously engaging potential buyers and this will increase the danger. What you need to do is engage potential buyers while projecting the image that you are not for sale.

Many business owners have insufficient competitive advantage to withstand a determined attack from a close competitor. A small chink in the armour might be sufficient for an aggressive competitor to undermine the sales message or create uncertainty in the minds of employees.

A prospective customer evaluating alternative products might hesitate to buy from a business for sale as they may have concerns about continuing supply and support. As well, current employees might be concerned about their future with the company if they hear that there could be an ownership change. This is very fertile ground for a competitor seeking to poach good staff. The business owner is now trapped. Any move they make to sell their business could disrupt their business, reduce their current sales and profits and potentially damage their sale price.

The firm which has strategic value is in a somewhat better position than most as their value is not necessarily eroded by a reduction in growth or profit, however, they could still have their reputation damaged or lose good staff.

There are a number of possible approaches to this impasse. Firstly, the business owner should indicate consistently over time that they would always be willing to discuss the purchase of the business to a corporation that had the capability and capacity to develop the business more than the current owners. If the new owner could better support the customers and provide better career paths for the employees, then this would be a good solution for both customers and staff. Such a message is more likely to have a positive than a negative impact on the market.

Another approach is to develop relationships with all the major potential buyers so that an open discussion of the trading environment can take place. Companies working in the same market often have a lot of issues and challenges in common and these discussions can be used as a basis for sharing information. During these conversations, the business owner should take the opportunity to point out how and where their competitive advantage lies and in what way the businesses complement each other rather than compete. Where possible, the owner should seek opportunities to work together on joint bids to show how the combined entity gains revenue. What is being demonstrated is what the competitor or partner could gain through an acquisition.

While maintaining that the business is not for sale, the owner might also suggest other business or hobby ventures they might pursue or personal situations which are demanding more of their time. The objective of this strategy is to demonstrate how an acquisition would benefit the buyer as well as be received positively by the seller. While the offer can always be rejected, it is far better to have offers coming than to have to go cap in hand looking for a buyer.

How many potential buyers do I need?

It is very difficult to extract the maximum value on the sale of a business if you have only one potential buyer. Generally speaking, the only way you can do this is to be in a position where you don't need to sell but you are willing to so if your terms and conditions are fully met. Simply by being hard to get, by having a business which gives you satisfaction and not having any great desire to do anything else will provide a basis where you force the keen buyer to do all the running. However, if your business is in trouble and the only potential buyer can

afford to wait, you will almost certainly be a fire sale and lose much of the value of your business on sale.

So while one potential buyer is possible, common sense would suggest that several are much better. The question is, how many is likely to create an optimum exit? The real issue here is how well you have selected your potential buyers rather than how many. Many possible buyers where none have a burning desire or need for the acquisition is almost certainly worse than one keen buyer. Thus an important component of preparation for sale is to ferret out those companies which have the highest need for what you can offer but are also in a position where they have the willingness and capability to go through with the acquisition process.

There are some simple rules of thumb when it comes to identifying possible buyers. Most buyers are larger companies within the same industry; they typically have acquisition experience and deal with similar or complementary products. By doing some industry analysis and working with professional M&A advisors, it is not difficult to narrow down a list of possible suitors. The next stage would be to establish contact with them to ascertain their appetite for new acquisitions, especially for a business like your own.

In the end, you need at least two keen, active potential buyers, each of which has a clearly expressed need to acquire a business like yours. However, sometimes timing does not always work in your favour. At the time you wish to sell, they might be involved in other projects, fighting internal fires, be subject to external threats or have used up their acquisition funds. Thus you cannot really depend on just a couple of potential starters. What you really need is at least 6 to 8 active interested buyers. With a little bit of luck, you will be able to deal with most of them. In the worst case, you can be confident that you will have at least two left with which to negotiate. Your back up plan should be the ability to delay until circumstances bring more potential buyers into the process.

Also be very careful not to have too many potential buyers. The best ones may simply pull out or they may decide the costs of participating in the process are too high. In the end, it very much depends on your ability to help potential buyers understand what you bring to the table and in creating some level of competitive tension at deal time.

How do I protect company secrets?

Many entrepreneurs fear giving away company secrets during a due diligence process involved in selling their business only to find that the potential buyer has pulled out and then uses that information to compete against them. Since most firms don't have the luxury of unique, patented or protected assets or processes, this is a very reasonable position to take. Where you have strategic value, this is often based on IP or deep expertise which is usually more difficult to copy, even so, imagine how foolish you would feel if you gave away the very competitive advantage which had created the sale value. However, you still need to get through the due diligence process for the honest buyer.

What you need to do is to balance the need of the potential buyer to be able to assess the quality and impact of your confidential information with your desire not to give away the store to the dishonest scavenger. To do this you need to have a process which gets rid of the latter but keeps the former in play. Thus how much can you provide to satisfy the serious punter while protecting yourself against the dishonest or opportunistic competitor?

Of course this is not much of a problem when you have strong registered IP. While patent protection is said to be only worth what you are willing to spend to protect it, remember you will sell out to a large corporation. In the end what you have is a gorilla buying your IP. Nothing protects IP better than a gorilla sized corporation ready to defend it. I always let my potential buyers know that the ultimate buyer will be a gorilla and that they will do whatever it takes to protect the competitive advantage they are securing through the acquisition. In this situation, it is not worth the competitors wasting their time stealing your IP. However, not all IP and intellectual capital is well protected.

Your best protection against the theft of confidential information during the sale process is to be very well prepared for the due diligence investigation. This information can then be released in stages subject to your own due diligence on the potential buyer. You should be looking for commitment from the buyer at each stage of the investigation. Buyers who are only fishing will not want to spend much effort in the process and will soon fall away. You should balance their effort with your own. As they require meetings with management, you should request similar meetings with theirs. If they ask for more detailed information,

you should request similar data from them. If they are not prepared to share information, you can probably assume that they are not serious and terminate the discussions. You can also have them sign a non-disclosure document with damages for use of confidential information.

Your second level of protection is to withhold sensitive information but have it examined and verified by an independent and credible third party. You can cite performance data, market statistics and forecasts but hold back the detail. This data would then only be released to the successful bidder as a final condition of the sale but could be done in such a way that, if validated, the sale would be concluded.

Your best strategy against this type of invasion is to have pre-selected the potential buyers. If you have determined that the potential buyer has a real need for your business, is capable of funding the acquisition and has the capability and capacity to make it work, then you should be dealing with genuine buyers who would rather buy than copy. By ensuring you have several willing potential buyers and being well prepared for due diligence, you can also speed up the sale process and dramatically reduce the exposure period. In the end, you will have to take some level of risk to get the deal done, but with some investigation you can determine the ethical values of your potential buyers. Make sure you steer clear of the doubtful ones.

Prevent buyer delays eroding value

I know of many entrepreneurs who have lost value on the sale of their business when the buyer has strung them out through the negotiation and due diligence process. The disruption to the business due to due diligence activities and the distraction of focus caused by the tension in negotiations often leads to a fall in revenue and a lowering of profits. Only by recognizing this impact, whether deliberate on the part of the buyer or not, can the entrepreneur mitigate the damage.

Not all buyers are honest and scrupulous and not all are well prepared for the buying process. It is not uncommon for the sale process to be drawn out with a subsequent loss of focus on the business. This rarely works to the advantage

of the seller. In fact, it is not unknown for potential buyers to use such tactics to wear down the vendor in order to achieve a lower price.

While some delays are unavoidable and tension and distraction are a normal part of the process, the smart entrepreneur prepares in advance for this eventuality. There is no question that it is hard to go through the sale process without significantly using up senior executive time as there will be some elements of the negotiation and due diligence process which simply cannot be delegated. Knowing this in advance, the vendor should put in place a succession plan so that essential operations can be undertaken by other than the senior management team.

Preparation for due diligence is an obvious step in selling a business. The last thing you want to be doing is hunting through storage cabinets looking for old documents or compiling essential employment or financial data which is standard in a due diligence checklist. The vast bulk of due diligence information can be assembled in advance and kept up to date for when a deal is on the table. While the buyer is busy doing the analysis, you can be back running your business.

By far the best way to keep a deal in play and progressing is to ensure that you have multiple potential buyers. If you are well prepared, have good advisors and have done your homework to identify those potential buyers who would have the most to gain through an acquisition, you have much greater control over the timeline of a sale process. Those buyers who are not prepared themselves or not willing to meet the deadlines will simply drop out of the process, but you do need to have a number of potential buyers to play that hand.

If you can clearly see that a buyer is deliberately using delaying tactics to wear you down and reduce the price, you are almost certainly going to be better off by pulling out of the negotiation. That tactic alone may well bring them up to the mark. The greatest danger in any sale process is to be in a position where you have to sell, you are unprepared and you have only one potential buyer. Planning the sale well in advance, being prepared and having several potential buyers is the only way that you can really ensure you get the maximum value on sale.

Getting the strategic buyer to understand the potential

If you are a conventional business, you should be able to estimate what you can sell your business for using an EBIT multiple valuation. But what if you are seeking a strategic sale? The value that is placed on your business is what the buyer can achieve in terms of new incremental revenue and profits. To achieve the best price, you need them to undertake a thorough analysis of the potential worth of the opportunity. How do you get them to do this?

The key to a premium on sale is to have several prospective buyers bid for the opportunity of buying your business. In the ideal scenario, you want a group of prospective buyers who have a very clear understanding for how they can exploit your business to generate new revenue. If you approach them with no prior relationship and where they have never considered how they would exploit the acquisition, they have little time in the bidding process to ascertain exactly how they would utilise your assets or capabilities to generate new revenue. Where they have little opportunity to understand how they might take advantage of the acquisition, you will certainly not get the best price you can.

Prospective buyers need to have time to work out how to best exploit the opportunity and this may take them some time. They need to develop a scenario for scaling up the business, possibly develop new internal capabilities, open up new sales channels or interface new products with their existing offerings. What you want them to do before they come to the bargaining table is to work out just how much new revenue and profit they could gain if they were the successful bidder. If the numbers are very attractive, they may be willing to bid up the price to ensure they are the successful buyer and, of course, they would rather that their competitors were denied the opportunity.

Your challenge is to find a way of getting them to do this analysis before you put the business up for sale.

Most large corporations are always on the look out for ways to increase their revenue and improve their competitive advantage. If you have something which could do this, you might approach their business development group rather than their M&A group. Your approach to them will be to discuss how you might work together in a strategic partnership to pursue new revenue where you

provide the intellectual capital, asset or capability which is to be marketed and they contribute their marketing and distribution capability to make it happen. Your approach is, however, conditioned on the fact that, because of your limited capacity to support such a venture, you can only support one partner although you are interested in exploring this opportunity with a number of large corporations. You request each one to undertake an internal assessment of the opportunity and then provide you with a convincing argument as to why they should be the selected partner.

Also remember that large corporations often have an active M&A section who are always scanning for potential acquisitions. If you have already identified your potential buyers, it makes sense to get on their potential acquisition map where they will start to evaluate the attractiveness of acquiring you. Once you have made contact with them, you can start priming the pump by providing updated information about your business. You can also stimulate a conversation around how your strategic assets or capabilities could be exploited inside their business.

This process provides time for each potential partner to work though how they would best exploit the opportunity and to work out just how much additional revenue they could generate through the relationship. Soon they will discover that they can make significant market gains but that they will be limited by your capacity to support an aggressive rollout. When they try to convince you of their worthiness to be your partner, they will also have to show their hand. What you hope is that this will stimulate them to move the discussion to an acquisition conversation. You now have an idea of what you are worth to them but you also have several well informed potential buyers in the frame.

Example:

“It is our mission and strategy to get this company bigger in size and over a period of time, one of the biggest companies on the ASX,” Wallis said. “We always have a four or five acquisitions that we look at any point in time.”

Source: http://www.arnnet.com.au/article/200602/dws_makes_strategic_acquisition Accessed 22nd April 2008

If you do end up going direct to their M&A group, then ensure that you give them enough time and the supporting data to enable them to do the revenue calculations. There is little point in forcing the pace if it only results in them reducing their offer due to higher levels of uncertainty on their part.

Who does the deal?

I am a very strong advocate of the entrepreneur managing the relationship with the potential buyers and playing an active role in doing the deal to sell their business. Instead of handing the problem over to someone who does not really understand the intricacies of the business, the entrepreneur should take charge of the process of identifying buyers and negotiating the deal. It is the entrepreneur who best understands how the business works, what risks are inherent in the business and how value can be extracted by the buyer. Unless the buyer can fully appreciate how to exploit the potential in the business, the seller won't get anything like full value for the business. It is highly unlikely that an external party can fully represent the business potential in the same way that a knowledgeable entrepreneur can.

In a strategic investment, it is still the entrepreneur who is best positioned to identify strategic buyers, make contact with them and assist them to understand how best to exploit the opportunity. However, an investor who understands the strategic sale process well, can ensure that the process is systematically and exhaustively undertaken.

Unfortunately, not all entrepreneurs have the time, motivation or skill to undertake the process of identifying and contacting potential buyers and then negotiating the deal. This then becomes a team effort. How should the investor manage this process? It is important that all the stakeholders understand the process which they are going to undertake to set up a strategic sale. The sale team would include the key investors, the senior management team and the professional advisors. They should all understand the strategic selling process and the legal, financial and operational steps needed to be taken.

The most important factor in achieving a premium price for a business is the selection of the pool of potential buyers. If the owner does not feel competent or able to do that, this should be outsourced to a professional advisor, however,

the entrepreneur should clearly articulate to the advisor how potential in the business can be exploited. Rather than leave the process of recruiting buyers to chance once the business is put on the selling block, time should be spent identifying and contacting possible buyers. In the end, it is the ability of the buyer to understand how to extract value from the firm which determines how much they will pay. By educating possible buyers on how the potential in the firm can be exploited, the entrepreneur is creating a knowledgeable pool of possible buyers. The entrepreneur should develop a list of potential buyers in conjunction with the advisor. An advisor can then make contact with them and assist to build a relationship between the firm and the potential buyers.

Unless the benefits are obvious, there is still the problem of educating the potential buyers to the size of the opportunity and how they might exploit it. If the entrepreneur is unable or not suited to this task, the investor needs to find someone who can. This could be an external consultant, the investor, or one of the professional advisors. The selected person should have a thorough grounding in the strategic assets or capabilities, the work which the firm has undertaken to prepare it for a buyer and the manner in which a buyer could best exploit it.

When it comes to negotiating the deal, it is worth having experience on your side of the table. Most small firms with potential are purchased by large corporate entities. They will certainly have very experienced M&A advisors. Our advocacy system would suggest that they will work hard for the buyer to get the lowest price. You need your own knowledgeable advocates to work equally hard for you. Make sure your team fully understands the work you have done to prepare the firm and of the potential which could be extracted by the right buyer.

The best deals are done by knowledgeable and passionate entrepreneurs faced with keen and well informed buyers, each assisted by good professional advisors.

Reputation is important

Building a positive reputation can help with introductions to those corporations who may be potential acquires but will also help them gain approval from their own stakeholders and industry analysts.

Getting known within an industry is actually not that difficult. The majority of industries have their own industry association, conferences, education programs, charity events and trade journals. There are normally specialized magazines which focus on certain industries. By getting the firm's executives involved in the industry association and industry events, the business highlights itself in the public domain. Additional exposure can come through speaking engagements at industry events, writing articles or cases for industry and trade journals and magazines and competing in industry or national competitions.

In undertaking these activities, the entrepreneur has the objective of getting on the radar of acquiring executives and corporations. By saying what your business does which is unique, you can bring this to the attention of industry participants. Many larger corporations continually scan for potential acquisitions and you simply have to bring yourself to their attention so that they consider you. If they have an interest, they will start monitoring your activities and are likely to proceed to develop a relationship with the business, perhaps informally, but with the intention of finding out more about your products, markets and management team.

You should get to know the trade journalists and the market analysts in your sector or from the sector in which you expect the buyer to come. Getting publicity in the trade press may help open the door when you want to meet executives from potential buyers. Take advantage of industry functions in your own country and in the major markets to meet with M&A Managers and your equivalent in the potential buyer's business.

You might even use these situations to discuss the partnering or sale of your company and start building the connections for more detailed discussions. You might invite the most likely prospects to visit your firm to meet your management team. Providing there is no time pressure, this is a good way to build trust and present a story about how any synergy might work.

We need to keep in mind that most larger corporations grow through acquisitions and therefore are on a constant watch for acquisitions which fit into their longer term strategy. Those who take this activity seriously will have full time staff employed to undertake research into potential acquisitions and assist in the evaluation and integration of acquisitions. Your job is simply to get on their list. Whether you then wait for an approach or proactively take the initiative to stimulate one, the end result is a potential buyer. Keep in mind that a good reputation also helps an acquirer justify the purchase to their bankers, shareholders and Directors.

Prior relationships are important

It is much easier to set up a deal where there is an existing relationship, especially if you have taken the trouble to meet the key players. Within most sectors, the number of key executives is quite small and they can often be met at seminars or conferences. This applies even to competitor's executives. Also in most industries, there are people who have worked for several companies, thus the network is often well connected across companies.

In building your network you are not selling your company, you are simply getting to know people who might help you when it comes to getting the deal done. It may be that, when you are ready, there are people who will help you identify the best targets and help with introductions.

More formal relationships can also be useful in building bridges. There are a variety of ways in which formal relationships can be established. These could include:

Management and/or shareholder roles:

- Member of a Board of Advisors
- Member of the Board of Directors
- Minority shareholder
- Venture capital provider

Formal trading relationships:

- Distributor
- Alliance partner
- Joint venture partner
- Customer
- Supplier

Formal relationships have a high conversion rate to acquisitions. It is a 'try before you buy' transaction. The buyer has more of an inside view of products and management and has a better understanding of the fit of the two businesses and of the potential benefit of an acquisition.

What the firm has to avoid, however, is creating a situation where there is only one potential buyer or where a sale can be blocked or hindered due to an existing relationship. At the same time, a formal relationship is often quite easy to convert into a sale and so the firm does not have the stress of looking for a buyer. If the benefits to the buyer are sufficient, then a premium can still be achieved in passing control to the new owner.

Some formal relationships can be established with an acquisition in mind. The formula for an acquisition or a sale can be worked out in advance so that the negotiation takes place before the formal trading relationship is entered into rather than be at the whim of the buyer later. The relationship can also be entered into with an option to terminate if there is a change of ownership. Alternatively, the firm could build in an option to terminate the agreement with the trading partner in order to seek out a buyer. The key strategy here is to have thought through the implications of a sale to both the trading partner and to a non-trading partner before entering into the initial relationship.

When the owners need to sell, when they receive an attractive offer or wish to sell, these prior relationships will help ensure the right potential buyers are brought into the sales process.

An acquisition is a political process

Even if we think that the benefits to the potential buyer are obvious, it still needs to proceed through their own internal acquisition process. Even when that process includes a detailed evaluation of the merits of the acquisition, you need to remember that it is also a political process with different executives advancing their own agendas. There may only be a limited pool of funds for acquisitions and yours may be one of several possible candidates. Under that scenario, you will need some champions inside the organization to promote your case through the system.

It is not just within the buyer's organization where the investment needs to be sold, it is outside to analysts, shareholders and the public. Listed corporations are very sensitive to the information released to the public. An investment which is supported by the analysts will reflect positively on share price recommendations. Conversely, an investment which is somewhat unclear or has an uncertain outcome, could well be received with a negative evaluation by the shareholders and analysts and thus depress a share price.

Given that you need internal and external support for your case, you need to ensure there is a very good understanding within the corporation of the benefits of the acquisition. You should not be leaving it up to senior management to guess at the potential or how they might exploit the best value. By working with someone inside the corporation on the investment case, you can help ensure that all the work which you have put in to reduce risks, structure the business for scaled up operation and secure the revenue potential is documented. Remember that an investment case is composed of both potential rewards to the acquirer as well as potential risks. You can help make the case if you are well prepared for the discussion.

Your inside champion has to convince their own superiors first. Once that has been achieved, the CEO will have to take this to the Board for approval. Following approval, the corporation will make an announcement to the public. At that time the analysts and key shareholders will comment on it. It is critical at this point that the case is solid and the price paid indicates a healthy return on the investment. Clearly, the easier it is for the corporation to extract early revenue, the more positive the investment will be seen by external parties. Thus

early revenue, a well articulated ramp up of activities and an early payback on the investment, are all key elements of the investment case.

Basically, you need to plan this in advance. You want active support throughout your potential buyer organization and you need a positive public reception to the acquisition. The way in which you structure your business for sale and the manner in which you assist in the generation of early revenue will all heavily influence whether you get support for your deal in the potential buyer's organization. That in turn will be a deciding factor in whether you get the deal done.

What if the buyer requests an escrow?

We can't always choose the timing of the sale of a business and so there are often unresolved issues hanging which can materially affect the sale value. The business owner will not wish to discount the sale proceeds to provide a contingency for the worst possible outcome but, at the same time, the buyer does not want to be out of pocket for negative outcomes which may occur. In order to overcome this impasse, the purchase agreement might set aside an amount or a number of shares that are held awaiting the conclusion of outstanding items. This is an escrow provision.

Both parties need to arrive at a consensus as to which items are being provided for, the method by which compensations or adjustments are to be made and the timescale over which the escrow is to be in place. Escrows are problematic agreements as both parties are trying to protect themselves and yet the future outcome(s) might be uncertain. Too often the agreement ends up in dispute where some outcome was not anticipated. Then it is off to the lawyers.

I was involved in one sale where 10% of the sale price was put into escrow and held by a large bank as the escrow agent who would interpret the agreement to give back shares to the buyer or disperse the remaining shares to the seller at the end of the escrow agreement. A number of small items were easily and quickly settled which accounted for a small portion of the escrow shares. We then got into a dispute over a patent infringement that the buyer settled without the agree-

ment of the sellers. The resultant dispute over whether this was a valid claim went on for the next 10 years, well beyond the one year term of the escrow. It eventually wasted away when the shares, originally held at a nominal \$10.50 per share, were being traded for 6 cents on the public market. We decided we didn't want them back at that stage!

Sometimes an escrow can't be avoided where there are material issues outstanding, however, like earn-outs they are very difficult to construct to ensure the agreement is workable. Providing there are very clear cut alternative outcomes and the manner of adjustment is seen as fair to both parties, then it can be a useful tool to help close the sale. As a seller, perhaps the best way to approach an escrow is to write off the proceeds and just hope for a windfall gain if things fall your way. Alternatively, work hard to find a way of avoiding the escrow in the first place. There should be strong enough warranties and representations in the agreement anyway to protect the buyer. However, they may have to go back to the lawyers to enforce the adjustment.

Clearly the best solution is to resolve all outstanding issues before the sale. Good internal control and governance systems will help avoid most of the common problems. Then simply find a way of settling everything you can before the deal is signed.

Do you have evidence?

When you put your case to potential buyers, what evidence will you have to back up your claims of high growth potential? We need to put ourselves in a situation where we can answer any questions put to us by the potential buyer. Clearly, they are going to be most interested in whether the take up rate of our product or service can be validated. If we have made claims of customer interest, where is our evidence? If we have said that customers will buy it, where are the letters of intent?

Remember that your sale price will be determined by what the buyer can expect to generate in new revenue in the early years of the acquisition. They are going to make their own estimates of sales and margins, but what evidence do you have to help them with those scenarios.

Do you have market research, census data, existing sales and sales trends, data from competitors or from similar product launches in the past. If you have built revenue projections, what source data did you use and can the results be replicated by the buyer?

If we are going to make claims about a product or service, what data do we have to back up our claims? Do we need trial runs, engineering calculations, quality results, testimonials, reference sites, independent expert opinion and so on. How do we make it easy for the buyer to undertake an assessment of the potential of our products or services?

Don't leave this to chance and don't allow the buyer to make unsubstantiated assumptions which end up undermining your case. Provide them with the data which will enable them to validate the potential which you see.

11 Evaluating Potential Investments

STRATEGIC INVESTMENTS ARE DIFFERENT!

The traditional manner of assessing business plans, sitting through presentations, working out a valuation based on the revenue and profit being achieved and then setting up a deal simply won't work in 95% of the cases. What is very obvious from my work with entrepreneurs, Angels and VC investors is that few people understand how to identify strategic value and, even if they can, have little idea of how to execute a strategic sale.

When you couple this with the fact that most entrepreneurs will approach a request for investment from a traditional revenue and growth profit perspective, you are being presented with the wrong information from the outset. Basically, you will need to take time to work with the entrepreneur to assess their strategic value potential and then work with them to build a plan for a strategic sale.

Once you have engaged in a discussion of how a strategic sale might be achieved, you can no longer build an investment case based on conventional financial value. The EBIT multiple simply does not apply to the exit and therefore it is inappropriate for the investment valuation.

A business which has underlying assets and/or capabilities which a large corporation can exploit is a very different investment proposition to that of a traditional business. These are businesses based on patents, brands, copyright, trademarks and deep expertise. The exit valuation in their case is not based on what their business can generate in future profits but how much profit a buyer can generate by exploiting their underlying assets and capabilities.

Imagine a very large corporation which has a customer base one hundred times that of the potential investee and where their customers would be highly receptive to the investee product or service. The large corporation may be able to quickly sell these products or services into an existing customer base reaping ten times the investee's revenue, or greater, in the first year of the acquisition.

Therefore, what is the investee business worth to a large corporation which has a ready market for these products or services? The value of the investee business to the buyer is based on what the buyer can do with the investee business not what the investee can do with it. In fact, the investee's revenue, profits, customers and numbers of staff may be quite irrelevant in putting a value on their business.

There are some markets where strategic value is the norm in the sale of a business. If you look to the drug discovery sector, you often see small development companies which get a drug to a certain stage of development and then sell it off to a large pharmaceutical corporation for the next stage of commercialization. The value of the drug is related to its potential long term revenue and the risks associated with completing the development and approval stages. Many of these development firms have few staff, no customers and no revenue. However, within that market, there are established norms for valuing drugs at different stages of development.

Unfortunately, we do not have the same set of norms across a wide variety of sectors, so we need to be somewhat creative in how we approach the initial valuation problem. You can hardly engage in a discussion of a strategic exit with an entrepreneur, say, putting the potential exit at \$40 million in two years and then argue that, because they don't have any revenue, you value their business at \$200,000.

Working out a valuation based on strategic value is very difficult but not impossible. What you have to do is estimate the revenue and profits that the acquirer will generate from your business. If you have customers and some revenue and they have a customer base one hundred times yours, then it might be fair to say that the value is one hundred times your conventional valuation. Will you get that for your business? Probably not, but you will gain some portion of that value if you set the deal up correctly with the right potential buyers and ensure you have a competitive bid running when you come to sell.

It is somewhat more problematic when you have no revenue but there is a clear case for a strategic value sale. In this case, you might start by estimating what it would be worth to a large corporation and then discounting this back to arrive at a NPV for the investee business. This number then becomes the post money valuation.

However, estimating what the buyer could earn from the use of the strategic asset or capability is highly uncertain. Different buyers will have different opportunities and this might create a wide range of potential valuations. Also, you can't be certain how long it will take to get the deal done. A delay of even one year can make a large difference to the NPV.

Of course, you have no certainty that any deal will occur. In these ventures, you are often dealing with emerging technologies, uncertain future markets, competitors who are yet to appear and IP which is incomplete and yet to be registered. The potential might look outstanding, but it still comes with a level of uncertainty and risk.

Understanding the strategic value, identifying strategic buyers and working out some crude calculations of the revenue and profit to them are essential steps in putting a present value of the investee business.

Another way in which a valuation might be arrived at is to consider the alternatives to the strategic buyer. A corporation may be willing to pay a premium on an acquisition if they can enter a strategic market early by acquiring the right product, process, or intellectual capital. That is, what would it be worth to them in additional profit if they bought now rather than wait to develop their own solution?

Large corporations generally have very high R&D costs due to their overhead costs, bureaucratic processes and higher remuneration and benefit levels. The research shows also that they are not good at developing breakthrough technologies or processes. Small firms often bring new products to market faster and with more creativity than large corporations, offering the large corporation a possible supply of innovation. The small firm that can provide a proven solution, often developed at a fraction of the cost which a large company could do it for, can sometimes be acquired for less than the corporation would have to spend developing a comparable product.

At the same time, the corporation needs to consider the additional revenue they might achieve by bringing an acquired product to market early. With a much larger existing customer base and/or distribution channel, they might readily recoup an investment even if they pay considerably more than the development cost of the product.

It might be possible to arrive at an estimate of what it would cost a large corporation to develop a similar solution. You also need to estimate the time it would take them to begin introducing the new product or service to the market. Next you should estimate how much gross margin the corporation could generate in this gap between an acquisition now and when they could bring a product to market. If you discount this gross margin back to the present by a reasonable risk rate, you will have a NPV for your investee firm.

You might also consider what a buyer would lose by not acting early. Timing is always relative to the impact of a threat on the potential buyer. Where the prospective buyer has a choice to delay doing something about a threat or problem, the strategic value is reduced. However, where a threat exists, the impact of not doing something to counter or mitigate it may be very serious.

The time factor is most impacted by the resilience of the potential buyer to withstand the threat. The lower the damage forecast, the less the need to look for alternative courses of action. The longer the time available to seek an alternative or to manage the situation, the more likely the damage can be minimized. The size of the threat is another way to estimate the strategic value of the investee firm.

In assessing the value of a potential acquisition, the potential buyer also needs to consider the impact on their business if a competitor acquired the investee firm. If the selling firm has on offer some unique product or technology which is heavily protected by patents, the corporation which misses out being the acquirer may not be able to counter the competitive effect of another company aggressively marketing the products into their marketplace. By forgoing the opportunity to acquire the firm, they may hand to their competitor a weapon which will be used against them.

Some opportunities are very time and place dependant. It may well be that the timing of the strategic sale impacts on the value to the buyer. Timing is relative to the impact of the opportunity on the potential buyer and whether the opportunity will evaporate or decline if not acted upon. Where the potential buyer has a choice (such as whether to pursue an opportunity or not), the seller needs to be able to show that the opportunity will reduce if not acted upon. The opportunity cost, that is the cost of not doing something, might be high, but it may not reduce current revenue.

In essence, the more time the potential buyer has to find an alternative solution, the lower the strategic value of the acquisition. In turn, where corporations are forced to seek solutions externally to a potential opportunity and where time is short, the more likely they are to pay a premium on the acquisition.

A good rule of thumb for arriving at the maximum sale price of a strategic acquisition is to discount the first two years of gross margin on new revenue generated by the strategic asset or services. Alternatively, what is the discounted gross margin on current revenue which would be lost if there is no acquisition. If this calculation is undertaken for the top half dozen potential buyers, some idea of the potential of the investee can be arrived at.

Once you have a determined a potential exit value, you need to decide if you have the resources to secure the strategic sale. The quality of the management team then becomes of critical importance.

The Management Team

The literature in the venture capital area is dominated by the quest for the 'A team'. This is the super team. The 'A team' has done it all before and has the skills, capabilities and diversity to cope with anything under any conditions. Regrettably, they rarely exist and Angel and VC investors have to put up with business plan presentations from ordinary mortals.

However, that is not to say that their objective is wrong. It is simply that executives who have done it before have probably learnt from their successes and failures. They are well connected in the industry and are knowledgeable of other experienced executives and can easily recruit additional team members. For the investor, it is all about reducing risk. If they can invest in a well rounded team with experience, they have a greater chance of achieving their minimum targets.

The 'A' team also brings with them the following:

- A knowledge of the investor investment requirements
- Willingness to negotiate a realistic valuation
- Experience with an exit
- Not as emotionally attached to the 'product'
- Networks within the industry and with potential alliance partners

So for the investor, members of an experienced team are easier to deal with and have a good understanding of the funding process.

Although the venture capital market has been operating in Australia and New Zealand for over 20 years on a formal basis, there are still very few experienced management teams that have gone through a formal private equity investment and exit cycle more than once, unlike the US and European markets that have floating management teams that move from one investment with a Angel or VC firm though to exit and on to another investment.

Many of the deals brought to an investor for funding simply lack an experienced set of executives. There can be no question that the entrepreneur

brings the idea, the passion, the vision and the energy, but other people usually make it work.

When the investor looks over the business plan, they are working out what activities need to be executed to deliver the critical targets and to secure the strategic sale. This might be sales, marketing, product development, quality control, setting up relationships with strategic buyers, working with advisors and so on. For each of these activities, you want to know who on the team will deliver this operationally.

The real test to be applied here is operational. Given where the business is today, can the team execute, with reasonable confidence, the activities needed to get them to the exit conditions within the target period. In some cases, the investor will be making a judgement as to their own impact on the ability of the firm to achieve such results. So the fundamental question that the investor has about the management team is: 'Can the team and I together achieve the targets needed to exit?' Basically, this will be a strategic sale and the management team may not be needed beyond that event. Not all proposals need the 20 year veteran or the executives recently cashed out from their recent IPO. In fact, this may be the wrong team for a clearly defined strategic exit.

However, the business proposition still needs to show who is going to deliver on each of the major activities needed to reach the exit conditions. Any weakness in the team will need to be corrected or undertaken by the investor. This is a critical time for the entrepreneur, as they need to put together a team with a high probability of meeting the targets. Some of the founding shareholders may have to step aside and new executives recruited to meet the experience requirement. Where the management team is not complete, the investor will want to see an acknowledgement that the existing management recognizes this deficiency and accepts that new talent will need to be recruited to deliver on the business targets.

The management team can be supplemented with experience from a Board of Directors, a Board of Advisors and external consultants.

You also need to acknowledge that the whole notion of a short term strategic exit may not have been considered by the entrepreneur. The team which they

have assembled to grow the business may be the wrong team for an exit program. It may be that they will need to change direction completely. Instead of pursuing customers, they might need to spend more resources on product development. Instead of working to generate cash, they might be better off taking a larger investment to secure a short term strategic exit.

This entire discussion may be very confronting, even if exciting in possibilities. You may end up restructuring the business. Instead of a plan to grow the business over the next few years, you might be confronting them with a potential sale inside a year. This is going to take some discussion and planning. Once accepted, you still need to set up the investment deal.

It is unlikely that the investor will ever know as much about the product as the entrepreneur and his team. Even if the investor has a technical background, this can quickly be outdated and thus they are rarely in a position to adequately judge the quality of the product development systems or the realism of the timescales. This is, therefore, a high exposure area for the investor. So, on the one hand you have a very strong possibility of a high value exit and, on the other, a number of tasks which need to be done by the investee firm, some of which may have some uncertainty about its timing or outcome.

Before you take this too far, you need to ascertain what the entrepreneur wants to do. You can't assume that they will want to take their venture to an exit, especially over a short timescale. Effectively you would be asking them to drop everything they are doing, change direction and take it straight to a strategic sale. If they are in the middle of a longer term plan involving developing markets, growing a business and setting themselves up as a CEO of a growth venture, this is quite a change. Not everyone will want to go on a different path.

However, you might simply ask why they are doing it? What is their long term objective? Basically, as I often express it – 'what do they want to be when they grow up?' Usually an exit is somewhere in their plans but is some distance off because they see how much they still need to do to build out their business and establish a reasonable level of profit to justify a good exit price. When you present them with an strategic exit possibility, potentially many times what they thought their business could be worth, they generally change their mind

and come on board. But they do need to make that switch if you are to work together on a strategic exit.

Another important consideration for the investor is whether they have sufficient trust in the entrepreneur and the management team. Recall that it is the management team which will be using the investor's funds and it is they who will have to deliver on the exit strategy. Unless the investor has faith in the team and is comfortable with letting them loose to execute on the strategy, the investor should be very wary of entering into an investment agreement.

The Investment Proposal

It is highly unlikely that the investor should expect the entrepreneur to come with a business plan in hand which sets out a strategic sale opportunity. Almost without exception, it will be up to the investor to identify the possibility of a strategic sale and to bring this to the attention of the entrepreneur. Even if the entrepreneur sees the possibility of a strategic sale, they will not know how to execute it. You can expect that the investor and the entrepreneur will need to work together to build the investment case; identifying the strategic value, selecting potential strategic buyers, working out a possible exit value and then determining what needs to be done to prepare the business for the strategic sale.

The agreed business plan is simply about execution. The business is at point A (now) and it needs to get to point B (the exit), what needs to be done to get there? You need to see exactly how the strategy will be put in place over the preparation period.

Knowing that the management team is somewhat green and will need help to develop the business for the exit, the investor needs to work with the entrepreneur to determine the investment required and the program that needs to be undertaken to drive the strategic exit.

There is nothing wrong with the entrepreneur admitting they need help to develop such a detailed exit plan, but the investor should delay making any substantial commitment until a proper plan is in place, even if they help develop it. Only by getting down to this level of detail will you understand just how much

finance and effort you need to contribute, but also, just how likely the business is to succeed in getting to a strategic exit.

Before committing to the investment, you should be able to review every part of the plan and see exactly what each person will be doing to contribute to the overall plan. This should be set out in an organizational plan, including recruitment and training, office accommodation, manufacturing and warehousing space, infrastructure planning, a finance plan and a set of resulting financial statements and so on.

The more that you can define how to achieve the exit, the more convincing the plan is, the safer the investment will be.

Valuation

Before the Angel or VC investor contributes funds to the venture, they will need to agree with the entrepreneur some basis for an equity share – the valuation.

Entrepreneurs have always seen the initial valuation as the most important part of the investment process – as this can impact greatly on what they walk away with on the exit. At the same time, the investor sees entry valuation as the key to the investment return – if they get too little equity they may not see a reasonable return on the exit if the venture is not overly successful. Thus valuation discussions can be stressful on both parties and often emotional. Finding a path through this discussion is critical if both parties are to proceed with the investment and still retain a positive working relationship.

Historically, few Angels or VC investors have given the exit event much detailed consideration at the time of investment, leaving this to be undertaken further into the investment when they have a better idea of the market and the venture capabilities. Investors normally believe that a successful venture will provide adequate opportunities to exit and leave the exit planning to later. But in fact, this is the critical event and should play a much greater part in the investment decision. A venture with a highly probable exit path should be a preferred investment.

Valuation of an existing business before external funding and the subsequent valuation of a business with funding has to be the most controversial topic in the venture capital literature. It is the greatest source of conflict between entrepreneurs and external investors, is plagued by emotion, misunderstanding, entrenched position taking and ignorance. It has often been said that 40% of deals fail to secure VC funding due to a failure to agree a valuation. What is regrettable is that it is highly possible that many of these ventures could have made both the investor and the entrepreneur considerable wealth.

Valuation is the process of estimating the monetary amount the firm is worth based on its future expected returns. Historically, this has been based on the NPV of the future net earnings. But this is often a highly problematic calculation.

Consider the typical early stage entrepreneurial business. It often displays some or all of the following attributes:

- uncertain cash flows;
- few tangible assets;
- some specialised equipment which often becomes technically obsolete;
- few debtors;
- little inventory;
- new and sometimes unproven products or services;
- often an immature management team;
- an emerging market which is yet to be stabilized;
- no established market for shares, especially a minority holding; and/or
- uncertain timing of revenue and profitability.

So, unlike the secured investor such as a bank, the VC investor has an illiquid market in which to sell the shares, is dealing with high levels of uncertainty in the business, the market and the management team and has little security for the investment.

Which valuation method should you use?

Traditional valuation methods have been established to value existing business where historical data can be used to show revenue and profit trends and where established products have a market presence. However, most emerging ventures which seek Angel or VC funding are of limited life, have little history and a somewhat speculative future. Traditional methods of valuation don't really apply.

In order to start any sort of meaningful discussion, the conventional approach to an investor has been to write a forward projecting business plan and use this as the basis for a valuation. However, too many entrepreneurs produce five-year forecasts based on assumptions which are, at best, guesses as to the state of the economy, the reaction of competitors and the behaviour of prospects. Then they use complex formulae to work out a Net Profit After Tax (NPAT) over five years. From this profit forecast they calculate a valuation to four decimal places using an assumed discount rate. At the very best, it is one person's view of the future, but it fails to recognise that any other view may be equally valid.

In truth, no one can accurately predict the future. The entrepreneur is generally going to be optimistic and the investor somewhat pessimistic. Somehow, they have to come to an agreement on a valuation or the negotiation simply goes nowhere.

Entrepreneurs should be highly averse to high valuations. While they look good at the start of the venture, they place unrealistic expectations on the business to perform. Even the slightest slippage can lose the entrepreneur his business. Investors are not known to take shortfalls kindly. Far better for both parties to agree a lower/negotiated valuation where the investor can readily make the hurdle rate and the entrepreneur has a better chance of staying in control and making a reasonable return on their effort.

Now lets throw a strategic exit into the equation. The situation may change dramatically. No longer are we talking of 3 – 5 years and considerable execution risk. It is highly probable that the exit could be undertaken in less than two years. Former plans to expand the market, develop new products and grow the number of employees may all be discarded. A new plan is constructed which

focuses entirely on preparing for the strategic exit. No longer are net earnings the key factor, it is the exit valuation which determines the value of the venture, but this can be highly speculative. Depending on how successful the buyer approaches are and the timing of the exit, the potential valuation could vary from the worst to the best by a factor of 10.

In this situation, a flat percentage of the equity will be difficult to negotiate. A \$500,000 investment that could result in exit values of between \$10 and \$100 million needs a different approach.

Negotiated valuation

One method of arriving at a valuation which reflects a better balance between risk and reward for both parties and provides a fair method of compensation for their respective contributions, is to consider what the valuation of the business may be at a future exit event and discount this value back to today's dollars. The future exit valuation of the firm is a metric that is of real interest to both parties. If it was known with some certainty, the current valuation could be more readily determined by using a discounted cash flow methodology. The discount rate could be adjusted for higher levels of uncertainty but it would still be a place to start.

So, for example, a firm with an exit valuation of \$10 million in three years with a discount rate of 40% would be worth \$3.64 million now. A \$1 million investment would thus gain the Investor 27.5% shareholding.

Possible alternative valuation scenarios to the above are:

- The Investor wanted some higher comfort factor. A higher rate of discount could be used, say 50%, which would result in a lower Net Present Value (NPV) of \$3 million giving the Investor 33% equity.
- The Investor wanted some higher comfort factor. A lower exit valuation could be used, say \$8 million, which would provide a NPV of \$2.9 million, giving the Investor a share of 34.5%.
- The entrepreneur is more optimistic than the Investor and believes that an exit valuation of \$20 million is likely. This would give a NPV of \$7.3 million and the Investor share of this would be 13.7%.

The real problem lies in the balance of risk and reward. If in fact a low exit value was achieved, both parties lose but the Investor is likely to be the one with the highest cash investment loss. The entrepreneurial team will have put in time and sweat but probably much less cash.

At the same time, if a high value is achieved, both parties would seek the upside. The entrepreneur would most likely claim that he deserves the most credit because it is his vision, business model and leadership that are probably the key to success, not the cash from the Investor. The Investor would most likely argue that the business could not have achieved the high valuation without the cash injection from the Investor. The Investor, of course, wants the lower valuation in case things go wrong and so the upside is much higher. The entrepreneur wants a higher valuation to limit the equity of the Investor if the venture proves very successful.

The Investor would like to ensure that they don't lose any money on the deal. They are much more sensitive to a loss than to a significant gain. Thus there is considerable pressure on them to push down the valuation. However, a lower valuation means that the entrepreneur makes much less on exit and, therefore, is not as motivated to go through with the deal or work hard to make the exit happen. The Investor needs to find a valuation figure which strongly motivates the entrepreneur.

External investors can use a variety of techniques to achieve this balance. One simple technique is to set the return to the Investor at a specified rate of return. Any excess over this amount from the exit goes to the entrepreneurial team. Another technique is to set the external investment as preference shares with an accumulating dividend. Since preference shares are paid out before ordinary shares, the investor will recover some or all of their money before other shareholders share in the proceeds. An Investor might also have some ordinary shares to give the Investor a share of the higher exit valuations.

Some external Investors use options to provide additional incentives to the entrepreneur and senior management to allow them to accumulate additional equity in the business. The options may be set against certain milestones or performance targets which represent higher potential exit proceeds. The

entrepreneur gains a greater percentage of the proceeds as the options kick in at higher exit valuations.

An anti-dilution clause in favour of the investor in an investment funding agreement has the effect of protecting some or all of their investment in the event that the valuation falls with a subsequent funding round. This clause adjusts the shares of the Investor so that their original investment retains its monetary value under the new valuation. In this situation, it is the original founders who suffer the negative adjustment. This type of adjustment, however, typically will not be readjusted with subsequent higher valuations.

A solution for both parties lies in negotiating a valuation formula which both parties can live with. This could be a stated value at somewhere between the Investor valuation and the entrepreneur's valuation, or it could be a starting value but with equity adjusted up or down for different levels of success.

The parties could agree a strike point which would determine initial shareholdings. This could then be adjusted for higher or lower exit valuations. For example, the parties could take the two opposing valuations and use these as a basis for calculating the shareholding at exit.

Negotiated valuation example 1

- VC investment is \$3 million for an initial 33% equity share.
- Exit after three years.
- The Investor estimates a \$25 million exit.
- The entrepreneur estimates \$50 million.

In the example set out below the parties have agreed the following:

- VC fund's equity share will remain at 33% for all exit valuations below their expected valuation of \$25 million.
- The Investor's ROI on exit valuations between \$25 million and \$50 million are held at 40% thus giving the VC fund certainty of returns.
- Where the entrepreneur's estimate of \$50 million is achieved, he retains a greater proportion of the equity (i.e. the Investor's share is reduced to

16.4%), but the return that the VC fund earns is significantly greater than at lower valuations.

In this example, both the entrepreneur and the Investor share in the upside of higher exit proceeds.

Exit Valuation \$ million	Investor Portion \$ million	ROI to Investor % pa	Strike Valuation	Investor Equity %
5	5.0	-0		100.
10	8.2	19		82.0
15	8.2	40		55.0
25	8.2	40	VC Estimate	33.0
30	8.2	40		27.3
40	8.2	40		20.5
50	8.2	40	Entrepreneur Estimate	16.4
80	9.3	40		11.6
100	10.0	50		10.0

Negotiated valuation example 2

Alternatively, a much more aggressive model would see the valuations move in the Investor's favour with lower exit valuations and more security on the down side for the Investor. This acknowledges the need for the Investor to achieve their desired ROI. At higher exit valuations, the pendulum swings the other way, increasing the reward to the entrepreneur for outstanding performance.

An example might be:

- External investment \$3 million.
- Exit after three years.
- The Investor estimates a \$25 million exit.
- The entrepreneur estimates \$50 million.

In the example set out below, the parties have agreed the following:

- Investor's equity share increases at low valuations thus providing more security on the downside.
- The entrepreneur retains greater levels of equity at higher valuations while still allowing the Investor to earn significant returns.

Exit Valuation \$ million	Investor Portion \$ million	ROI to Investor % pa	Strike Valuation	Investor Equity %
5	5.0	-.0		100.
10	8.2	19		82.0
15	8.2	40		55.0
25	8.2	40	VC Estimate	33.0
30	8.2	40		27.3
40	8.2	40		20.5
50	8.2	40	Entrepreneur Estimate	16.4
80	9.3	40		11.6
100	10.0	50		10.0

Negotiated valuation example 3

For a smaller deal the model might look like this:

- External investment \$3 million.
- Exit after three years.

Exit Valuation \$ million	Investor Portion \$ million	ROI to Investor % pa	Strike Valuation	Investor Equity %
1	1.0	-0		100
3	3.0	-0		100
8	8.0	38.7		100
10	8.2	40.0	Strike Valuation	82
15	9.0	44.0		60
20	10.0	49.0		50
30	12.0	59.0		40
50	15.0	71.0		30
100	17.0	78.0		17

This type of formula can be used over successive rounds of external funding. Each round would put in place the formula for determining the share of the final exit valuation to the new investors.

The entrepreneur who is unwilling or unable to accept a lower/negotiated valuation, should consider seriously a ratchet where the entrepreneur earns additional equity for achieving certain pre-agreed milestones/targets. These targets could be qualitative or quantitative in nature.

These types of valuation formulae are especially useful with strategic exits where the investment may be relatively small, since they are only being used to execute the exit and not grow the business. The timescales are often short. The risks are relatively contained since the investment is not undertaken unless a clear path to a strategic exit is obvious. The Investor, even at relatively low equity portions, still makes a very good return on the investment.

Staged exits

One of the possibilities in many strategic value deals is that the venture will have a range of IP which can be exploited in different markets. One of the difficulties in assessing the best method of selling the business is that a buyer for one part of the IP may have no need for other IP held by the firm. If, however, the IP can be split, it may be packaged in such a way that different buyers can be secured for different IP.

To provide the necessary separation of the IP, it is useful if the IP can be bundled in such a way that one set gives no advantage or entry point in a different market held by a different sector buyer. Sometimes this can be difficult where a platform IP contributes to all the market applications. If, additional but different IP can be used to create unique applications in each sector, the platform IP can be licensed to each of the buyers. Each buyer would then acquire exclusive rights to that IP specific for their sector. In this way multiple sales can be achieved.

This does complicate the investment and exit strategies somewhat as these different exits may be staged over time. The venture may focus on one sector, package that up and sell it before moving onto the next. It is possible that this could be done multiple times before the IP is fully exhausted.

Another possibility is that the venture has a development capability which can produce new IP over time. In this case a different form of exit might be used. As each set of IP becomes available for commercialization, it could be spun out into a separate firm. This could then attract additional investment specifically to progress the exit of the spin out.

12 Executing the Exit Strategy

Once the strategic value has been determined and a number of potential buyers identified, the next task is to build an execution plan which will achieve the strategic sale. In a very simple deal, say just involving the sale of established IP, the process may be achieved in only a few months, however, more complex situations will take much longer. If the business has to be prepared for due diligence, restructured to improve its value and buyers have to be contacted and relationships established, it is likely that process will take at least two years. It is likely that the process of preparing the business for sale will involve hundreds of activities spread across a number of individuals. All these activities have to be planned, monitored and reviewed on a regular basis. In addition, the normal activities of the business need to be planned, executed and monitored. Implementing a reporting structure to ensure that the business is run efficiently and major objectives are achieved is an essential part of the exit strategy.

The diagram below sets out a structured process for preparing for a strategic sale.

Strategic Trade Sale Strategy

Alignment of interests

- Directors, managers and key employees
- Build after-sales scenarios
- Agree trade sale objectives

Due Diligence

- Audit Contracts
- Review OH&S
- Business plan
- Due diligence file
- Professional tax advice
- Develop incentives
- Standardize agreements
- Audit infrastructure
- Protect IP

Strategy

- Review assets and capabilities
- Select potential buyers
- Review valuation
- Build relationships
- Understand acquisition processes
- Build scale capability

Sale Negotiations

- Competitive tension
- Define value for buyer
- Negotiate Contract

As you can see the process involves reducing risk in the business, developing the strategic assets or capabilities of the business, assembling the deal team, building relationships with buyers and then undertaking the competitive bid process. Without a proper project plan in place and widespread agreement among all the stakeholders to the plan, it is unlikely to be well executed.

Managing the Business

The process of securing the strategic sale starts by putting in place systems and processes to manage the daily operation of the business.

Angels and VC investors typically invest in start-up or early stage businesses and normally before they become very sophisticated in their management and governance processes. While many early stage ventures are started by ex-corporate executives, their personal experiences of working with enterprise wide performance setting and monitoring systems is likely to be non-existent. Even entrepreneurs who have managed ventures before may not have experienced a well designed reporting system.

Of course, many Angels and VC investors themselves do not have this experience. Just because they have high net worth, or because they have sold their own venture or have held a senior corporate job, does not ensure that they have personal experience with a quality performance setting and monitoring system across an enterprise or in working with a Board of Directors. Yet this is what the Angel and VC investor needs to have implemented within the investee firm if they are to properly prepare it for sale to a large corporation.

Very few investee firms can be expected to have sophisticated systems or good governance processes. You can anticipate this when you look at the typical firm in which an Angel or VC investor invests:

- Start-up or early stage venture;
- Immature products or products still at design or prototype stage;
- Often emerging markets;
- A management team that may not have senior management experience;
- Gaps in the management team experience;
- Almost certainly a lack of formal management reporting systems;
- Lack of key performance indicators, lead indicators, individual targets and budgets;
- Probably a business plan but a lack of operational detail.

If the Angel or VC investor is to guide through the process of preparing for a strategic sale, they have their own issues to cope with. The Angel and VC investor must deal with:

- Limited time to spend with each investee firm;
- They are normally only a minority investor;
- They are not running the business on a day to day basis;
- They may not be experts in the underlying technology or marketplace;
- They don't have the time or the knowledge to make operational decisions.

While Angels may be regarded as 'hands on' investors, this is not the same as day to day management. Without adequate performance setting and monitoring systems, they are effectively working in the dark. No doubt they have chosen a specific investment because they do feel comfortable with the marketplace and with the potential of the business and no doubt have also taken into account where they can add real value to the product/market or other aspect of the development of the business. But they are still not there day to day making the decisions.

They also have a major role in preparing the business for a number of possible outcomes, additional rounds of investment from other Angels or a VC, a trade sale or an IPO or for independent growth. In order for the business to be successful, each one of these outcomes really needs the business to be running effectively and efficiently. It is in preparing the business for these possible outcomes that the investor has his most important mission in the business. This is the critical value that he brings to the table – steering the development of the business at a strategic level and guiding the management in establishing and working with proper controls.

As the business develops and the number of employees grow, the task of monitoring at an operational level will become increasing more complex. This is where a range of guiding mechanisms and controls help. While the business is small and everyone is working closely together, the amount of information needed to be formalized is slight, but as the business develops and grows, no one person is able to assimilate all the different activities of the business and ever more information about what is happening inside and outside the business needs to be collected, understood and acted upon.

The task of the investor in most investee firms is to anticipate these needs, educate management on the need, what type of systems etc are needed and assist them in planning the necessary changes. Nothing can be more damaging to a growing business than to find itself without adequate planning and operational control systems.

In planning for a strategic exit, those planning systems need to be in place to ensure that day to day operational activities are undertaken effectively and that those tasks required to get the exit deal done are acted on and monitored. At the same time, it reassures the buyer to know that good reporting systems and governance systems are being used to manage the business.

At an operational level, the following reports and actions might be considered:

Stage One: Up to 10 employees

- Quarterly financial statements
- Monthly cash flow reports
- Monthly creditor and debtor reports
- Quarterly budget performance
- Annually revise the business plan
- Monthly list of priorities for each manager
- Monthly action plan for each manager
- Monthly review against action plan
- Monthly review of critical KPIs
- Board meetings quarterly

Stage two: Up to 30 employees

- Monthly Financial statements
- Monthly budget performance
- Quarterly revised business plan
- Quarterly report on lead indicators
- Major topics reviewed at each Board Meeting
- Board meetings every two months

- Job descriptions for all manager and supervisor jobs
- External advisor on employment terms and conditions and compliance issues
- Part time CFO

Stage three: Up to 100 employees

- Full time CFO
- Weekly Creditor and Debtor reporting
- Weekly sales performance reports
- Weekly project completion progress reports
- Training of senior management in employment compliance issues
- Job descriptions for all employees
- Formal annual performance reviews for all employees

At an operation level, early stage ventures are especially sensitive to cash flow more than anything else and yet they often lack the knowledge and discipline to manage it carefully. Traditional financial reports are not designed for this purpose and, in any case, making profits is not the same as having enough cash to be solvent. Thus part of the discipline that an Investor should insist upon is rigorous and detailed cash flow analysis. Every member of management should be involved in the analysis of cash flow since every activity within the firm has an impact on cash availability. Management should be sensitive to how cash is being generated and used as well as how they can impact it through their own actions and decisions. Only by working with the detail will they assimilate this information. It is the area of greatest risk to the emerging venture.

One way to bring this lesson home to an inexperienced management team is to have them prepare a worst case cash flow. This report sets out the cash projection of the business using different layers of cash inflow and outflow. The beginning layer has only committed cash flow. That is, only cash inflows that the firm can reliably count on and only cash outflows that the firm is committed to in the foreseeable future. The report is usually prepared over individual weeks for three months and then monthly for a further 6 – 9 months depending on the horizon for projects under management.

Worst case cash inflows would normally include:

- Cash at bank
- Aged accounts receivable (expected date of payment)
- Work in progress completions (date of invoice plus collection period)
- Recurring payments on customer agreements (support fees, royalties etc)

Worst case cash outflows would normally include:

- Aged accounts payable (expected date of payment)
- Purchase order commitments (date of invoice plus expected payment period)
- Recurring administration, office, payroll, tax expenses. (excluding aged payables)

This should produce a cash flow balance (surplus or deficit) for the planning period. A shortfall may be met with an existing line of credit or bank overdraft, use of credit cards and personal loans from shareholders. A difficult situation should result in an examination of customer accounts to see if any payments can be pulled forward through follow up activity, early payment discounts etc. WIP payments might be pulled forward by early completions and bring forward invoicing. Payments to suppliers might be delayed where this can be arranged with the supplier.

Added in the next layer are the most likely additional sales to customers. This might be actual named prospects or additional work to existing customers. Alternatively, in a high volume business, it could be the minimum level of repeat business the firm experiences at that time of the year. On the expenses side, the report would start to layer in discretionary expenses, cash permitting. This might include new employees, new equipment, office expansion, additional product and market development costs and so on.

Additional layers of less probable revenue and less urgent discretionary expenses are added to gain a complete picture of the business under worst, most likely and best case scenarios.

Every business has a critical time horizon for new business. If the cash inflow looks weak and it cannot be improved in the short term, then management and the Board are warned well in advance and they can start to take corrective action. These may include switching resources to income generation, cutting back on expenses, deferring some projects and making staff redundant.

Other reports should be developed within the business to focus on critical areas. These might be for sales lead tracking, quality control, project completion and so on. Every business has aspects of its activity that provides an early warning of problems to come, either too much activity or too little. These lead indicators are the monitoring points within the business. The investor needs to help management identify these and help them design monitoring systems to track them. Policies can then be developed for when management and/or the Board need to be informed and action taken.

Part of the contribution that an investor makes to an investee firm is to help them work with external investors where they have not experienced this before. Entrepreneurs that have been used to making their own decisions, deciding on their own priorities and setting the direction of the firm without having to gain approval from a 3rd party, will find this very challenging and confronting. But if they wish to grow the business and bring in additional external funding, take the business public or secure a strategic buyer, then this is an environment and a discipline that they need to learn. The Investor can help by leading the way, showing them how a Board works and how they can make positive use of the Board.

Many firms implement standard financial reporting for the Board but fail to adequately deal with strategic or risk issues. The investor should develop a schedule of major issues that should be dealt with at Board level. I have set out below a possible list of topics. Some may be more appropriate at later stages in the growth of the business.

The investor may play many roles including mentor, coach, consultant and sounding board for the management team. But he/she also represents minority investors, external investors and, hopefully, future investors or a buyer. Establishing the right systems, setting the right direction, building the right

culture and developing the right disciplines is an important contribution that the investor makes to executing the business strategy.

Proposed major topics for Board Meetings

1. Strategy

- Review of overall direction of the business.
- Where do we want to be in 12, 24 and 48 months.
- What are the major changes in the organization that we should be planning for.
- Summary of a SWOT analysis for each product/market. What major changes should we be making at that level.

Input: Strategy paper from the CEO

Output: Approved strategic initiatives

2. Acquisitions and Integration

- Review of landscape.
- Check on current criteria for targets.
- Review of targeted acquisitions and whether the firm is at the stage of building relationship and/or discussions.
- Review of likely acquisitions and or gaps that would be useful or are needed to be filled.
- Review of integration issues with current acquisitions.
- Discussion of integration capacity and policies.

Input:

- Review of marketplace in each of the firm's major sectors. What companies are operating in each one. Where are the possible targets that conform to the acquisition criteria.

- Update on relationships with approved targeted businesses.
- Update on negotiations of those businesses approved to proceed.
- Review of integration issues and problems associated with acquired businesses.
- Criteria for acquisitions.

Output:

- Changes to integration resources and policies.
- Identification of target markets and possible target businesses for analysis.
- Approval to proceed with relationship building.
- Approval to proceed to acquisition discussions.
- Update on acquisition criteria.

3. Budgets

- Discussion of major assumptions underlying budget preparation.
- Review of performance statistics across the business.
- Review of capital expenditure, product, market and staff development plans.

Input:

- Proposed budget with current year end forecasts. Including pro-forma year end Balance Sheet and Income Statement compared to current year forecast. Projected cash flow on monthly basis.
- Proposed major changes to budget from prior year with justification.
- Capital expenditure proposals with justification.
- Product development proposals with justification.
- Market development plans with justification.
- Staff development plans with justification.

Output:

- Approved budget

4. Risk Assessment

- Review of all insurance coverage.
- Superannuation/pension review.
- Review of internal controls including a report from Auditors with recommendations for changes.
- Market risk assessment.
- Business risk and disruption assessment.

Input:

- Review of insurance coverage across the business with recommendations for changes.
- Auditors report on internal controls plus recommendations.
- Internal review by CFO and recommendations.
- Market risk assessment by CEO.

Output:

- Approved changes to insurance coverage.
- Approved changes in internal controls.

5. Organizational Review

- Review of Board of Directors performance including individual contributions, gaps in skills and changes in Board composition.
- Review of roles and responsibilities of Board members.
- Review of Directors compensation, allowances and support.
- Review of Senior Management compensation.
- Succession planning across the business.

- Review of the use of options, profit share, bonuses, allowances and other incentives for the business.
- Methods of performance measurement and rewards.
- Review of turnover, sick leave, absenteeism, health statistics.
- Review employee survey.
- Review customer survey.

Input:

- Survey of Board members on personal experience of the Board meetings and suggestions for improvement.
- Independent review of Directors compensation and recommendations.
- Proposals from the Chairman on Board on composition, roles and responsibilities
- Independent review of Senior Management compensation with recommendations.
- Assessment of the performance of CEO, CFO, Company Secretary, and Senior management by the CEO in consultation with board members.
- Review of current staff incentives with recommendations.
- Review of current performance measurement methods with comparative statistics of performance with industry standards and across units with recommendations for changes.
- Review of statistics across the group on turnover, sickness, absenteeism and health issues by business unit with recommendations.
- Employee survey results
- Customer survey results.
- Succession plans to supervisor level across the business.

- Succession plans for critical employees (R&D, Sales, etc.)

Outputs:

- Approved changes to compensation for Directors and Senior Managers.
- Approved changes in options and other incentives to staff.
- Actions to be taken with respect to succession issues
- Actions to improve staff morale, retention, health and performance.
- Actions to improve customer satisfaction.

6. Compliance and Regulatory Requirements

- Review of Health and Safety regulations that impact the business.
- Review of tax reporting, statutory filings and financial reporting.
- Review of policies with regard to bullying and harassment, sexual and racial discrimination, equal opportunity and maternity leave
- Assessment from Corporate Lawyers and Auditors on compliance performance and recommended actions.
- Annual General Meeting (AGM) preparation including approval of dividend, changes to constitution, Board membership, etc.

Inputs:

- List of regulatory requirements and regulations that impact on the firm with current compliance experience and recommendations.
- Incident reports on any staff compliance problems.
- Report from Corporate Lawyers and Auditors certifying that the firm has complied with all reporting and filing requirements over the last year.
- Recommendations for AGM.

Outputs:

- Approved changes in internal procedures and policies.
- Actions required to bring the business up to date with statutory requirements.

Division/Business Unit Reports.

In addition to a special topic that will be dealt with at each Board meeting it would be useful for each of the major business units to have an opportunity to present their current business plans. This should include:

- Description of the business
- Organizational data (locations, size in revenue and staff)
- Organization structure
- Principal activities
- Competitive landscape and how they compete for business
- Wins on the board, things they have achieved, successes etc.
- Problems, challenges, issues
- Recommendations.

It should be presented by a Senior Manager that is not a Director to give them the opportunity to meet the Board and get some feedback from the Board.

Do it for yourself and for the buyer

A comprehensive planning system backed up by good performance setting, review and accountability systems provides a strong base for managing a business, especially in difficult times. As an investor you should be insisting that such systems are installed to allow you to better monitor and influence the direction of the business.

Always keep in mind the end objective. What will help convince a buyer that the business is being run efficiently and effectively? Clearly a comprehensive planning and reporting system. Your investment in current systems may well help get the ultimate deal over the line.

13 Structuring the Trade Sale Deal

Good deals occur where parties are reasonably flexible, understand that no one wins if no deal is made and that everyone needs to walk away feeling they have won. Good deals usually can be done quickly where both parties see a good result being achieved for both parties. A buyer that feels that they have acquired a firm that can provide many times the return on the purchase price, is a deal that can later absorb some problems. A seller who knows they achieved a strategic sale that was worth many times the conventional financial value of the firm can also feel rightly proud of the deal. The key is to make everyone happy with the result.

Whether you are approached with an offer or you stimulate an offer by establishing the relationships as described in this process, you will end up negotiating a deal with many dimensions. Generally in this type of process it is important to meet somewhere on the same page and in the same book. If you are on another planet with respect to price and conditions, the time will be entirely wasted and both parties will end up frustrated.

In most cases, most elements of a deal are negotiable. Whatever constraints you have and whatever constraints they have in negotiating a deal should be uncovered as soon as possible. For example, you might decide that you wish to retire and staying on for

any period other than a short handover is not what you want. There may be pressing family or personal reasons for your decision but it may be sufficiently important for you not to wish to compromise that part of the deal. It may be important for you to have some guarantees of further employment for some of the staff. The buyer may wish to have a guarantee that certain key staff stay on for some minimum period. Whatever these issues are, they should be set out before the serious process of negotiation begins because they help to determine whether they can be met.

I like to think of a deal as representing a certain target value to the buyer. That value represents their view of the balance between the risks in the deal and what they are prepared to pay for the opportunities it represents to them. They will have perceptions of risks based on industry and personal experience.

Part of the entrepreneur's negotiating objective is to show how the risks have been minimized or removed and how they can fully exploit the opportunity. Imagine the target value as a point on a continuum that moves down with higher risk and up with greater opportunity actualization. Their initial task is to move the point up as high as possible by reducing risk and showing greater opportunity realization.

Once the best price that can reasonably be expected is offered, you can start to break that value, the 'deal value', up into deal elements. The deal value can then be carved up in any number of ways but, at this point, the pie does not get any bigger. With that approach both parties can start to set out where they want the value to be spent.

The deal value may be achieved by the seller at some period in the future based on certain conditions being met. To the extent that those conditions can be met, the buyer is normally willing to make available the whole deal value. However, to the extent that it cannot be met or is not met, the deal value is reduced by some amount representing the cost of correcting the shortfall or the opportunity cost of not having that advantage.

Some minimum level of performance may not be negotiable. So, for example, if the deal depends on certain key employees staying on after the acquisition, additional incentives may be offered to them to gain such assurance. You

should consider this additional incentive as a deduction from the deal value, but perhaps essential to satisfy the buyer. Some period of non-compete may also be required to prevent the key managers and shareholders from joining the competition or setting up a new company in competition. If three years was the desirable period but the sellers want only two, the deal value should be reduced by some amount representing the additional risk faced by the buyer.

This framework can provide a workable method of negotiating elements of the deal. Any reduction in risk moves the final deal value up, although this may appear as an increase in the purchase price to the seller. Any increase in risk or reduction in the ability to exploit the opportunity simply reduces the deal value.

In order to fully achieve the value from the deal, the buyer may wish the seller to complete R&D projects, sign up key customer contracts, cancel or negotiate specific obligations, negotiate redundancies or relocate staff. These could be framed as staged payments, earnout or fixed payments on achievements. In other words, the final acquisition price can be made up of many elements, each of which has a fixed or calculated value, which can be paid out in stages or accumulated to an end point and then paid out in some mixture of shares and cash. The period can be relatively short if it is expected that key objectives can be determined quickly, or it could be over a number of years if it requires a considerable period for the objectives to be achieved.

Elements which may be included in the final deal may include the following:

Base Price:

This should represent the minimum that will be paid for the firm. It may be subject to adjustments through a balance sheet audit which will verify valuations and liabilities. It also may be subject to adjustment through warranties and representations for some specified period of time. The base price might be offered in the form of shares in the acquiring corporation, or cash or some combination of both.

Escrow:

An escrow sets aside some portion of the purchase price against adjustments and warranty claims. Generally this will be held by an escrow agent and may be claimed against by providing specific evidence of claims. Usually it

is limited in time, such as one year. At the end of the escrow period, the remaining shares are returned to the selling shareholders.

Options:

Options of selling employees may be converted to ordinary shares prior to the sale being consummated or may be carried over into options of the acquiring corporation. Options carried forward provide incentives for employees to stay with the buyer. Additional options may be offered to key employees to retain them.

Stage Payments:

Stage payments are normally aligned to the achievement of objectives. So, for example, they could be aligned to the delivery of certain key R&D milestones, or completion of certain contracts, or the signing of certain key contracts.

Earn Out:

An earnout aligns the purchase price with the achievement of specified revenue targets or other milestones. This may be set at specified increases in the purchase price or a percentage of the purchase price based on specified targets. The additional earnout would normally be for a set period and may or may not be capped. The earnout may be for all shareholders or limited to key shareholders who stay with the buyer.

Continued Employment:

Continued employment of former owner/managers and/or key employees may be sought by either or both of the parties depending on how important those staff are to achieving future objectives. Specific jobs could be negotiated. Specific management agreements and remuneration and incentives may be included in the deal. Some staff may prefer a short term consulting agreement.

Director Position:

Either or both parties may want former key executives to continue on a Board of Directors for some period.

Warranties and Representations:

The acquirer will not be able to verify everything in the deal. To overcome this limitation, they would normally require the Directors and/or shareholders, or some subset of them, to provide warranties and representations about key elements of the firm. This might be asset valuations, contingent liabilities, incomplete litigation, prior balance sheet and revenue statement assurances and so on. Any claims in this area might be taken against an escrow account if that is set up, adjust the final purchase price if some balance is still to be paid, or might be subject to a recall of value through arbitration or litigation.

Non-Compete:

Generally the buyer wants to protect themselves from competition from former key shareholders and executives of the selling firm. This is usually set for a limited period like 2 to 3 years. It would normally exclude the individual from working with a competitor or from undertaking a start up which would compete.

Holding Period:

Where publicly listed shares are being taken as part of the purchase price, these may be subject to registration. That process may take some months. During this period the selling shareholders will not be able to sell their shares. There also may be further restrictions on the sale of shares which the buyer requires in order to not flood the market or not to show a lack of faith in the future of the corporation. Shareholders continuing on as key executives may also be subject to non-trading or blackout periods or sale restrictions due to insider trading restrictions.

Specific Liabilities:

The selling shareholder may be asked to take over specific liabilities or contingent liabilities. This may happen where key shareholders have personal loans to the firm. The buyer may regard their repayment as an obligation of the sellers and not theirs. They may also decide that the risks inherent in specific contingent liabilities are too difficult to assess and ask that the sellers absorb whatever is the eventual outcome. Since contingent liabilities

are often deal killers, this is something which sellers need to give special consideration to. If the alternatives are no deal or a deal with some possible downside, the latter may still be worth doing. At other times the contingent liabilities may be capped on either side or may be handled through the escrow.

Costs:

Legal and Accounting professional fees incurred by each party are normally borne by the respective parties. However, these costs may be assigned in some proportion to one or both of the parties depending on the deal structure.

Use of Intellectual Property:

Normally full rights to any IP passes to the new owner, but this need not necessarily exclude use by the seller. It may be possible to negotiate the use of IP for personal or non-competing purposes post sale.

In negotiating the deal, both sides have issues which need to be addressed and both sides usually have some flexibility to trade. A higher risk taken by one side should result in a change in the purchase price. If the sellers absorb some contingent liability risk, this should result in some other advantage to them, such as a higher price or more options etc.

Earnout

Owners of the selling firm often agree an earn-out as a way of securing additional compensation for the business they are selling. This frequently occurs where the price the buyer is willing to offer is seen by the selling shareholders as inadequate compensation for the potential of the business. Circumstances where this might occur are;

- Significant expenses have been incurred in recent research and development which has been written off but has not yet translated into revenue;
- The owners have taken either very low salaries or excessive salaries or benefits which are not able to be easily calculated;

- Large contracts have been secured, or are about to be secured, where the benefits have not flowed back into the accounts;
- The sector is experiencing significant growth and the firm is well poised to take advantage of that; and
- The potential acquirer is able to remove an impediment to growth which will return premium profits to the acquirer.

The selling shareholders argue for a higher valuation on the basis of potential. The acquirer may be reluctant to agree the higher value arguing that the benefits may not be realized. The compromise is often negotiated as an earnout based on the future performance of the acquired firm or the combined entity.

Another reason for an earnout arrangement is a performance based purchase price where other activities or achievements other than revenue or profits may be the basis for such payments. This might include;

- Completion of development milestones
- Acceptance of products by named customers
- Completion of key contracts
- Signing of key agreements by customers, suppliers, partners or distributors
- Approval of products by licensing authorities
- Granting of rights under patents, trade marks, or licenses
- Achievement of various quality targets

Earnouts should be used where there is a reasonable level of uncertainty of some future event or future performance which can have a material impact on the value of the acquisition. There should also exist the possibility that none of the earnout will be earned if the anticipated events or targets are not met in a material manner.

Where events are more certain, such as the outcome of a litigation settlement, lease payout, warranty claim and so on, these are better handled through escrow arrangements and under warranties and representations. In

these situations, the valuation is set on a positive note where all outstanding items are worth zero. A portion of the purchase price is then set aside, generally in escrow and claims are made against that portion as each item is finalized or settled. These items are generally discrete in nature, often able to be calculated in advance and not overly subject to effort by either party and will normally be limited in time.

The earnout approach is best used when the parties are not able to agree on a purchase price because future events, which could materially affect the value acquired, cannot be determined with any certainty. Alternatively, the buyer is willing to pay more but only if the seller can achieve certain predetermined performance or event objectives.

As a general rule, a good earnout formula is one where the buyer is very willing to pay the earnout if objectives are achieved and the seller has a reasonable degree of influence over the events that contribute to that level of achievement. A good earnout formula is also easily defined, measured and objective and not capable of manipulation by either party at the expense of the other.

Earnouts are however not as common as may be expected.

Example:

In an article in CFO magazine titled 'Caution: Earnouts Ahead', the author Roy Harris notes that contingency terms were found in 4 percent of all announced U.S. M&A deals, with over 10 percent of all deals valued at or below \$250 million, encompassing such terms. More than two hundred acquisitions in the U.S. have contained earnout agreements in each of the five years to 2000, with a total value of such transactions peaking at \$27.9 billion in the year 2000.

Source:<http://www.indiainfoline.com/nevi/earn.html> Accessed 9th
May 2004

Term of the earnout

There is considerable disagreement among practitioners about the most workable term of an earnout. On the one hand, shorter terms have higher degrees of likely achievement while longer terms allow for too many influencing events to occur. Also longer earnouts reflect lower present day values due to the discounted cash flow impact of distant payments. Thus the further out the potential payout, the less value it has for the sellers and the more likely it is to be disputed or not achieved.

Example:

Baltimore-based Sylvan Learning Systems Inc. certainly found it so. The company, a prolific acquirer of educational companies in recent years, started out by setting up one-year earnouts. For the managers Sylvan retained, “the natural response was to go gangbusters in terms of revenues and not spend for future growth,” says senior vice president and CFO Sean Creamer. Sylvan now designs earnouts for three years or more and monitors the deals carefully, sometimes using special audits to make sure the managers aren’t “gaming the system.”

Source: <http://www.cfo.com/article/1,5309,7261|0|C|2|,00.html>
Accessed 9th May 2004

To a certain extent, it depends on which party has the greatest influence over the target achievements. The longer the buyer is in effective control, the more influence, positively or negatively, they can impact on performance.

How large should the earnout be?

Conventional wisdom suggests that earnouts should be limited to 10-25% of the ultimate purchase price. One of the issues that both parties should be aware of is that earnouts are really only appropriate where there is some degree of uncertainty in achieving defined potential targets. If the events or targets were guaranteed, these can be factored into the base price. Where

probable outcomes may in fact not be achieved, both parties need to think through the consequences if the earnout is not achieved or substantially not achieved.

An earnout element based on specific large events may be quite reasonable if the final determination cannot be readily influenced by either party. This could be, for example, FDA approval which is awaiting final determination. This might significantly change the valuation and both parties may agree a significant earnout on the conclusion. However, if the earnout requires active co-operation of all parties and is based on many contingencies, it simply opens the gates to a claim of lack of effort on the part of the buyer.

How should the earnout be calculated?

There is no magic formula for earnout calculations especially those that are performance based. Should they be based on a cumulative achievement or on stage targets? The problem is one of uncertainty for both parties. The seller will want to ensure that payments, once achieved, are not subject to clawback while protecting against events outside their influence, while the buyer wants to reach certain long term objectives.

The biggest problem in all earnout calculations is finding an objective formula that is not subject to manipulation or re-interpretation by either party.

Revenue

May be boosted by promotions, discounts, poor contracts, early shipments, false invoicing, manipulated stage payments, etc. Revenue may also be negatively impacted by cutbacks in allowable marketing expenses, promotion of competing products, interference or delays in completing contracts through approval cycles or newly imposed conditions.

Expenses

Can be reduced by reducing staff, delaying staff replacements, delaying purchases, cutting back on R&D, delaying performance bonuses, buying lower quality stock or components, fighting warranty claims and so on. Additional costs may be imposed for redundancies, implementation of

new systems, additional reporting and budgeting requirements and so on.

Net Profit

Calculations can be influenced by changing depreciation methods, how goodwill is expensed, reclassifying expenses as capital items, excluding some payments as extraordinary items and so on.

Even where the manner of calculation has been specified, there can be alternative calculations. The words 'According to GAAP' (Generally Accepted Accounting Principles) need not ensure that a particular method is used if the auditors recommend a change due to legislation or a new accounting standard. Even 'as applied at the time of the agreement' will not necessarily cater for an event not foreseen. The terms 'consistently applied' are often used to overcome changes. Setting out the method of calculation during the earnout discussions may help bring out any differences in treatment. The measurement issues become increasingly complex as operations are merged with those of the buyer or central services are undertaken by the parent which results in disputes over transfer prices between entities.

Where competing products are being offered, the earnout may be calculated on both product lines in order to avoid any issue of deliberate bias.

Targets should be kept simple, easily and unambiguously calculated and subject to objective measurement by an independent auditor if necessary. Revenue, for example, is easier to calculate than profits. Specific milestones are easier to determine than profits. Earnouts can be based across a range of events or targets, some financial and others based on specific events.

Example:

SAL's former shareholders and creditors have an *earnout* that is contingent upon three events in 2002: 1) an *earnout* note, due in twenty-four months, for \$500,000 will be issued if the SAL Model 5 stepper's performance satisfies stated stepper throughput and mechanical performance criteria by no later than March 31, 2002; 2) a second *earnout* note, due in twenty-

four months, for \$500,000 will be issued if the combined Model 5 stepper and JMAR X-ray source demonstrates X-ray lithography exposures which satisfy stated performance criteria by September 30, 2002; and 3) a total of 354,736 JMAR shares and an *earnout* note, due in twenty-four months, for \$1.2 million will be issued if an order from a commercial semiconductor manufacturer is received by December 31, 2002 (with pro rated reduction of the payment to zero if the order is received between December 31, 2002 and March 31, 2003).

Source: http://www.bristoldirect.com/adobe/JMAR_Research_1-22-02.pdf. Accessed 9th May 2004

How should the earnout be paid ?

The parties need to agree how the additional valuation created through the earnout will be paid out. Sometimes this is done in cash, other times in cash and shares, or just in additional shares. When shares are used for the earnout, both parties need to agree a formula for how the number of shares is to be determined. This might be at the same market price as for the base compensation, or it might be the price on the day of the payout. Sometimes it is hard to judge where the sellers might be better off. What would happen, for example, if there was a major change in the share price?

Example:

The last round of Nasdaq listings was triggered by the success of Chinadotcom's listing, which having both 'China' and 'dotcom' in its name ensured it had a very hot reception. Who could have guessed at the time that it would trade down from a peak value of \$73.43 to a 39th of that (\$1.86) at its low?

Source: <http://www.financeasia.com/Articles/18395183-969A-41CD-A63F80D95A44D208.cfm> Accessed 9th May 2004

How much freedom to operate should the seller have?

This is an area of much dispute between buyer and seller. If the earnout is based on operating the business as a continuing concern to achieve the performance targets, this may not sit comfortably with the buyer. The buyer is exposed to expense blowouts, capital project commitments and agreement obligations. Also the buyer will want the business run so that it reduces risk exposure while putting the business on a good footing for the time it takes over effective control.

This potential conflict in interests often results in the acquired business being subject to numerous reporting requirements, expenditure approvals and restrictions on borrowings, capital commitments and so on. Working out the operating conditions and then recalculating the earnout on the new basis can help. It may be appropriate to work out various critical factors such as headcount, expense budgets, capital expenditure allowance, marketing spend and so on.

Example:

Autonomy Corporation plc, a leading provider of infrastructure software for the enterprise, today announced it has entered into a definitive agreement to acquire etalk Corporation, a leading provider of enterprise-class contact centre products, for a purchase price of US\$70 million payable in a combination of cash and Autonomy ordinary shares, with an opportunity to earn additional consideration payable in Autonomy ordinary shares upon meeting and exceeding certain future performance-related targets.

Source: http://www.cambridgenetwork.co.uk/pooled/articles/DF_NEWSART/view.asp?Q=BF_NEWSART_156736 Accessed 18th February 2006

A more serious issue is conflict of interest over where the efforts of the newly acquired business should be directed. With an earnout in place, acquired management will have a focus on maximizing their earnout. At the same

time, the reason for the acquisition may be to integrate the businesses or to leverage the assets or capabilities across a wider corporate entity. It is difficult to do both at the same time. The most capable people and those with the most knowledge in the acquired business will want to focus on the earnout. However, it is these same people who need to be involved in assisting the roll-out of the newly acquired assets or capabilities.

The new owners have to decide one way or the other. Either they leave the business alone during the earnout or they compensate the prior owners for the time required to work with the new larger entity. This may ultimately result in the new owners paying out all, or most, of the anticipated earnout in advance.

Earnout or employment compensation?

Where the selling shareholders argue that the business being acquired has unrealized potential and they wish to be compensated for that – the earnout is correctly paid out to all shareholders. However, where the new owners wish to motivate the newly employed managers to achieve certain objectives or targets, the additional value should be included within employment agreements as additional bonuses or compensation.

The difficulty here is to separate that which rightly belongs to the shareholders as a group and that which is reasonably held to be personal effort. Shareholders may well object to one of their number being offered an overly generous package where they think the compensation should go to them all for creating the foundation on which the near term benefits are being achieved. Where business deals or significant milestones are clearly in progress, the shareholders could argue that the benefits should accrue to all shareholders even if some additional compensation was paid to an individual to see it through to completion.

As a general rule, the more certain the target is to being achieved, the more the compensation should be directed to the selling shareholders as a group. Alternatively, where significant effort is still required, compensation should be directed to the individuals who can best deliver the results.

Whatever is agreed, it is best if all the selling shareholders, or at least the larger non continuing owner/managers, sign off on the deal as this should avoid future litigation.

Example:

Billabong International Ltd., Australia's largest publicly traded surfwear manufacturer, has acquired the Honolua Surf Co. apparel brand and its 19-store retail network. Depending on the eventual payout, the acquisition will cost Billabong between \$10 million and \$15 million.

The acquisition will be funded by debt and paid in two installments, according to Billabong. The initial payment to Honolua is 75 percent of the agreed purchase price. After three years, Honolua will receive 25 percent of the initial purchase price plus an incentive-based payment calculated on the increase in retail profits over the period. In addition, Honolua's co-founders, Tom Knapp and Randy Blumer, receive an annual earnout over three years based upon continued employment.

Source: <http://www.insider.com.au/inside/html/modules.php?name=News&file=article&sid=1724> Accessed 9th May 2004

Renegotiation or payout

Not all events can be forecast and there will be occasions when the earnout is frustrated by events outside one or both parties' influence. Some of these may be anticipated, such as the resale of the acquired firm and an agreement entered into about the resulting impact on the earnout.

What happens, for example, if the prior management is unable to continue due to ill health or if actions of the buyer cause the acquired business to be severely disrupted?

Earnouts are frequently renegotiated as events unfold. This however requires goodwill on both sides.

Example:

“In July we indicated that 100% of the Group’s total potential earnout liabilities had been realized, renegotiated or capped. Further progress has been made in renegotiating Parsec’s earnout due to some major changes in that business.

Agreement has therefore been reached with the vendors of Parsec to settle their outstanding earnout (maximum total of £6.8m payable in Anite’s financial year 2005/6) for £873,000, to be paid in guaranteed loan notes, repayable after one year.

This, together with other minor adjustments, has reduced the total future cash earnout liability from £25.4m to £19.5m, whilst bringing forward all remaining 2005/6 financial year liabilities, thus ensuring that all outstanding earnouts will have been paid out by the year ended 30 April 2005, subject to performance.”

Source:<http://www.pressi.com/int/release/74044.html> Accessed 8th
May 2004

Example:

Brooktrout Inc., a provider of telecommunications hardware and software, tried earnouts in an acquisition in the early 1990s and discovered that a demotivated workforce can destroy all the supposed benefits of the approach. In its case, says CEO Eric Giler, Brooktrout agreed to assume the liabilities of a Texas company and to make contingency payments to the selling executives if they hit certain sales goals they set for themselves.

“Entrepreneurs are their own worst enemies,” often setting targets that are too ambitious, says Giler. And they did that here, falling far short of the earnout goals. While conventional wisdom may say that this would be good because Brooktrout wouldn’t have to pay the earnout amounts, Giler soon learned otherwise. “As you start to miss your targets, the incentive goes way down and you have to fix that” so the employees will stay committed, he says. In Brooktrout’s case, that meant “resweetening the deal” with a whole new set of stock options and cash bonuses for the very employees who had failed to achieve their original goals.

Source:<http://www.cfo.com/article/1,5309,7261%7C10%7C%7C2%7C,00.html> Accessed 9th may 2004

“Best efforts”

Where the owner/managers are not employed by the new owner, they are very dependent on the buyer following through with agreed programs of promoting the product or services to achieve potential revenue and profit targets. However, many times the buyer has other priorities and the potential may not be realized. This is a recipe for litigation.

Example:

Even if the seller is successful in getting the buyer to accept sales revenue as the appropriate target, problems can persist. For example, in *J. Bloor v. Falstaff Brewing Company*, 601 F.2d 609 (2d Cir. 1979), Falstaff acquired Ballantine’s brewing business and agreed to pay the Ballantine sellers a royalty of \$0.50 per barrel for 6 years after closing. Post-closing, Falstaff slashed the annual advertising budget from \$1,000,000 to \$115,000 and reduced distribution centers. Profits rose dramatically, but sales dropped 29% in one year and 45% in the next year. Nevertheless, the seller was successful in its

breach suit against the buyer since the contract required the buyer to “use its best efforts to promote and maintain a high volume of sales.”

Source: http://www.imakenews.com/techyvent/e_article000100532.cfm Accessed 8th May 2004

Example:

Melbourne, Australia, 5 May 2004

Biota Holdings Limited (ASX:BTA) announced today that it had issued a writ in the Victorian Supreme Court, claiming breaches of contract and fiduciary duties by the worldwide GlaxoSmithKline (GSK) group for failing to promote and support Relenza™. The writ seeks unspecified damages for lost royalty revenues to date, as well as future losses through the life of the product’s patents.

“Relenza was a breakthrough influenza drug that had great potential, but it was effectively abandoned at birth,” said Biota’s CEO, Peter Molloy. Biota claims that the product failed not because of any inherent disadvantages or deficiencies, but principally because support for the product was withdrawn immediately after the launch year.”

Source: <http://www.biota.com.au/announcements/2004/press120.html> Accessed 6th May 2004

Taxation implications

The payment of cash or shares after the closing date of the acquisition may be treated as income or capital gains depending on the way in which the compensation is worded, calculated and timed. Different rulings may apply in different states and countries. Before any earnout is agreed, both parties should take professional advice on the matter. With some change in structure, the same end result may be achieved with different tax consequences.

14

Selecting Professional Advisors

While every entrepreneur knows how to properly package a product or service to achieve a profitable sale, few would claim that they have the same competence when it comes to selling a business. The fact of the matter is that selling a business is a specialist activity with its own set of legal and accounting issues and this is one area where experience does count. That being said, the entrepreneur knows his business and should understand better than anyone where it has growth potential, the basis for a higher sale price.

The same may be said of the inexperienced Investor. VC firms and experienced Investors who have participated in a number of investments should have some experience working with professional advisors and probably have some existing relationships which they can use. However, selling a business to a large global corporation based on strategic value is not something many investors have experience with and, to be frank, few advisors have either.

In my experience, there are few professional advisors who understand how to position a sale on strategic value. Most often they tend to push the deal back into a conventional framework based in an EBIT multiple and in doing so miss the whole point of the exercise.

They are not only a waste of time but tend to get in the way of the deal being done properly. The choice of advisors is critical.

Apart from the support you will need from professional legal and accounting firms, should you use a business broker or investment banker to help sell your business? The answer really depends on how well you understand the process of selling a business, whether you already have willing buyers in your sights and whether you have prepared the business for sale. If you are unsure about how you should prepare your business in order to achieve the best offer, or if you are uncertain how to attract the right buyers, then getting help from professionals who undertake those tasks on a regular basis makes sense. Even an experienced entrepreneur who has sold several businesses may like to have an advisor in the team to assist in the negotiations. There is considerable benefit in having an objective, knowledgeable person on your team to provide feedback, suggestions and to keep the negotiation process moving forward.

The key to the use of such professionals is, however, to use them to assist the Investor and internal management team in the process, not to take control. Too often business owners have allowed professionals to control the process and the negotiations not recognizing that their primary motivation is the commission on a quick sale. The entrepreneur who understands his or her business well and spends time identifying and connecting to the best potential buyers, will generally achieve a much better price for the business. The best buyers will be those corporations who can best exploit the potential in the business. Positioning the business with these potential buyers and preparing the business so that it can support such potential is best undertaken by the entrepreneur. It also takes time and cannot be undertaken properly if the business is rushed into a sale.

At the same time that the entrepreneur is preparing the business for sale and positioning it with potential buyers, professional legal and accounting firms need to be appointed to assist with both preparation and sale transaction support. Better sale prices are achieved where business risk for the buyer is minimized. This process often requires the business to undergo a vendor due diligence as part of the preparation process. By proactively undertaking their own due diligence review, the entrepreneur can discover risks in their business which can be addressed long before a potential buyer emerges. Not only does

such an activity improve the current business but it significantly reduces buyer due diligence costs and time during contract negotiations. A business which is well prepared for buyer handover will attract better buyers and a better sale price.

The smart entrepreneur needs good advice and smart people to support the sale process. The result usually is a much better price.

The Professional Accounting and Advisory Firm

The type of advice and help that a professional advisor can provide includes assistance in the following areas:

Valuation

If the firm has already prepared a valuation of the current business and projected valuation of the business opportunities to potential acquirers, this will contribute considerably to the discussion with the potential buyer. The advisor can review the financial projections, provide conventional valuations and brief the entrepreneur on how best to present their case. Understanding how an acquirer undertakes a valuation will ensure that the firm has prepared the proper information, presents it properly and is able to validate the underlying assumptions and values.

Preparing an Information Memorandum

The Information Memorandum (IM) is the document that most firms use to solicit interest in their business. It describes the business, sets out the historical and projected financials and provides background information on the industry, the competitors and the acquisition opportunity to allow a potential buyer to decide if they wish to proceed to a more detailed examination of the business. It is the foundation document that will be used by the potential buyer to evaluate the acquisition. It is important that the IM be prepared thoroughly, be properly explained and contain the information needed by the potential buyer to undertake their initial due diligence on the opportunity. The advisor can prepare the IM to ensure it is readable and persuasive and provides an appropriate level and type of information.

Reviewing financial information

Current financial information needs to be prepared according to generally accepted accounting principles and presented in a conventional format that allows easy analysis. Your advisor can ensure that the statements are prepared correctly and that the accompanying data fully supports a detailed investigation. This information is normally reviewed by your advisor to ensure that financial information is presented on a consistent basis from year to year and that any extraordinary or abnormal items are fully explored.

Helping with introductions and referrals

Well established accounting firms and investment banks participate regularly in transactions involving buyers. They are, therefore, in a good position to know most local large corporations on a personal basis and certainly by reputation. If they consider that you have a good business proposition they can help short list potential buyers you should approach and then can help with introductions or referrals. They may also be able to assist with the search for prior acquisitions and with uncovering news items that related to them. They may have connections to assist you to contact prior sellers so that you can gain an independent view of the potential buyer.

Since many professional firms have national and international offices and affiliate networks, this can be used to uncover other possible buyers and generate introductions. Having the right potential buyers in the final bid process can make a huge difference to the ultimate sale price.

Reviewing purchase terms and conditions

While purchase agreements are often set out in a conventional format, the vendor is not normally in a position to know what terms would be reasonable for their business. The advisor should be able to recommend where terms should be renegotiated, however, always obtain proper legal advice on contract terms.

Assisting in negotiations

The firm that is represented by a well established and respected advisor is likely to be better prepared for the negotiation. At the same time, the buyer

knows that the terms are going to be reviewed by a knowledgeable party. This should result in more productive discussions and the result is likely to be better for the firm. The buyer may prefer to deal with a business represented by a professional advisor as they know that the entrepreneur will not need to be educated about conventional terms and conditions or the warranties and representations required under a normal deal.

Advice on preparation

Preparation for an acquisition is much more than preparing a business plan. The advisor reviews the likely buyer's investment criteria and investment process in advance with the management team to ensure that the vendor has prepared itself for both the negotiation and the due diligence processes.

Due diligence

Due diligence will be carried out by the buyer as part of their initial evaluation of the acquisition opportunity. This is mostly a product/market evaluation to see if the merged business can support the opportunity claims of the firm. After the business terms of the acquisition are agreed, the buyer will then carry out an extensive review to further ensure that it has a thorough understanding of the business and the management and has uncovered any data discrepancies and investment risks. Your advisor can undertake a trial due diligence process to ensure the firm is fully prepared and help to correct any deficiencies.

Advice on pensions, option schemes and remuneration

Once the buyer is involved, the firm will have little opportunity to change the remuneration and benefits of its staff. A professional accounting firm can review these before an approach is made to a buyer to ensure that the current remuneration and benefits are fair and reasonable and provide the most positive basis for the planned sale.

Tax advice

Few firms are structured from the outset to be optimal for a sale. Overtime the tax regime will most likely have changed, especially with regard to retirement strategies, trusts, capital gains and options. The corporate structure of the business may not be suitable for an outright sale or be optimal if there is an

earnout portion. A professional accounting firm can also review the current business processes for compliance, tax collection and reporting. At the same time, personal tax planning for the major shareholders should be undertaken to establish the right basis for the planned sale. This will include the best format for the sale (ie- sale of shares or sale of assets).

Exit strategy assistance

From their knowledge of prior acquisitions, your advisor can help define strategic value, identify integration issues and/or show how the firm can best position itself for a sale.

The Professional Legal Firm

The type of advice and assistance that a professional legal firm can provide includes help in the following areas:

Review purchase agreement

The purchase agreement would often be prepared by the vendor's lawyers, however, this protocol varies in different countries. In addition, some buyers insist on having their lawyers prepare the contract. This is a complex legal document that few entrepreneurs will have ever seen and certainly few would understand in any depth. The professional legal firm can either draft the documents for you or construct the terms and conditions and identify any harsh or unusual conditions that the buyer has requested and assist in the renegotiation of those where the buyer prepares the document.

Review warranties and indemnities

The vendor would normally be expected to provide warranties and representations and indemnities to the buyer. These can often be renegotiated to be less harsh. The professional legal firm will know what is reasonable and what is not. This is one area where proper preparation, good reporting and compliance systems and good governance can significantly reduce the exposure of the vendor.

Review employment or non-compete agreements

The buyer will expect the key executives and major shareholders to enter into employment agreements and/or non-compete or restraint of trade agreements. The professional legal firm can ensure that the terms and conditions associated with these agreements are reasonable.

Preparation of disclosure letter

The vendor should be prepared to disclose any issues which may effect the decision of the buyer to purchase. They should also identify any potential liabilities of the business. The professional legal firm can advise on the types of disclosures and how the letter should be worded to best protect the sellers and to ensure there is no avenue for redress on the part of the buyer if events do not go to plan.

Review corporate documents

As part of the preparation for the sale, the professional legal firm will review the corporate documents which authorize the firm to undertake business to ensure it meets the requirements of the buyer. This review would normally extend to board minutes, shareholder agreements, option schemes and any material contracts the firm has entered into.

Depending upon the size of the transaction, the vendor should plan for approximately 5 - 10% of the sale price to be spent on their professional services fees noting that smaller transactions are likely to have a higher percentage associated with advisors fees.

Not all professional services firms have the necessary experience to undertake this type of work effectively. The Investor should not assume that their current professional services provider has the expertise to properly advise them in this area. They should seek independent advice as to which professional services firms are best equipped to handle the transaction they wish to enter into. Before they start to incur costs for this service, they should undertake some due diligence and investigate the extent to which the referred firm has a track record of success in working with clients on sales and acquisitions of similar sized businesses or to similar sized acquirers.

Asking for references would not be unreasonable and they also should ask for a list of transactions that the professional services firms has participated in and some details of the work performed for the clients involved. People move between professional firms and so the firm should ensure that the expertise is still with the professional services firms. They should ask to be allocated an advisor with personal experience in these types of transactions.

Some advisors, whether they be accounting, legal or corporate finance executives, are so locked into a traditional model of firm value that they simply 'don't get it'. They will want you to undertake a conventional valuation based on historical earnings, a conventional information memorandum and won't grasp the impact of the opportunity that the buyer can extract from the strategic value in your business. Certainly you and they will have difficulty trying to put a value on the business if it is based on the buyer's potential rather than your net worth or profitability and your advisors may be uncomfortable going forward on that basis. However, if you have clearly identified potential buyers that have expressed interest in an acquisition this should provide a good base from which they can assist you to prepare the business for sale.

If your initial discussions with a professional advisor show you that they want to take you down the conventional path, you should move on and find one that you feel can best represent the potential in your business. Ask them to provide you with references to similar strategic sale transactions that they have advised on.

Entrepreneurs and Investors who have not participated in large transactions are often concerned about entering into relationships with Investment banks, larger accounting and legal firms and often hesitate because they feel that the larger firms carry considerable overhead and that gets passed back down to the client in higher fees. It is certainly true that the larger firms typically have higher charge out rates but they also need to compete for services of the smaller clients and so it is not unreasonable to ask for a smaller charge out fee given the size of the firm.

The larger firms do have an advantage of being national and international organizations and having specialists in most areas and this can be to the benefit of the smaller firm involved in complex trading transactions. When it comes to

contracts and agreements which can materially effect value dilution, a little more up front may better protect the value of the firm on ultimate sale. This would certainly apply to IP agreements, option schemes, shareholder agreements and any acquisitions that the firm entered into.

The larger professional advisors have a decided advantage in M&A transactions. They see them often, they regularly advise on both acquisitions and on sales. Larger accounting and legal firms are often asked to undertake due diligence work on behalf of larger corporations and thus are very familiar with the entire process. Larger firms are taken seriously when it comes to negotiations and thus can better protect the entrepreneur who has never experienced these types of deals.

In the end it may come down to spending a little more over a longer period to be better prepared rather than spending a lot near the end closer to the transaction.

The business is likely to be better managed and be less risky as a result of that preparation. At the same time, the impact of a large professional firm in the deal process can enhance the reputation of the seller and may result in a better price being negotiated. Certainly it should speed up the due diligence process which in itself can have a significant positive effect on deal price. It should also speed up negotiations as the buyer knows it does not have to educate the seller about normal terms and conditions of a sale.

I have often been asked why I used a big four auditing firm with my last venture given that the business when it started only had a dozen staff and, when sold, had only grown to 30 employees. My answer has always been to show the impact on the final due diligence and deal discussions and to ask whether the person asking the question thought I got value for money.

My last business went into free fall after several large software corporations decided to enter my market with similar products. All my prospects were their customers as our supply chain optimization software sat alongside a large ERP system such as those sold by SAP, Oracle or Peoplesoft. When these corporations announced that they were going to develop their own supply chain optimization solutions, their

customers decided to wait for the integrated solution from their main software vendor. Thus I found myself in a situation where I had 30 staff and no prospects. Naturally we decided to sell the business before we were forced to close the doors.

This was my fourth software business and I had the experience of working through the sales process for the earlier ones. I also had been through the due diligence process for raising venture capital twice and taking on a large corporate loan. I knew from those experiences that being prepared for due diligence was a critical part of getting a quick decision. I also knew that the quickest way to get through the due diligence process was to ensure that the professional advisors I used had high credibility. Basically, I wanted to have all my source documents accepted without question. The only effective way to achieve this is to have the biggest and the best.

When you are selling out to a large, perhaps, global corporation they are going to undertake a very extensive and sophisticated due diligence. They will almost certainly use a large auditing firm and a highly respected legal firm. In order to uncover the risks and problems in your business, these advisors are going to review everything. The only way you can speed up this process is to demonstrate to them that they don't need to audit most of the historical information because they will be able to rely on the documents produced by your own advisors. My approach here was to push back hard and state that any additional audit was wasting my time and the buyer's money but that I was willing to provide warranties for the quality of the information presented. In any case, if there was a subsequent problem, they could always go back and litigate against my advisors who would normally have much deeper pockets than me.

This last business of mine was sold for six times revenue to Peoplesoft in a period of just over two weeks. Given that it was losing over \$1 million at the time, whatever additional fees I paid to my advisors was well and truly worth it. When you are dealing with large corporate buyers, it is best to have good quality advisors in order to be very well prepared for the due diligence and the negotiations.

15 Conclusion - Impatient Capital

Every time I see the words ‘we are here to help you’ or ‘we help grow businesses’ in promotional material for private equity investments, I bite my tongue because it is fundamentally misleading. The ultimate goal of the investor is not to grow the business, it is simply to earn a high return on the money invested. It is not to help grow the company, their strategy is almost always directed towards selling the business.

So if we are to be honest with ourselves as investors, then we should come out into the open and state that we are there to achieve great exit values for ourselves and the founders. There is nothing wrong with that as an objective and many entrepreneurs will be encouraged by working with investors who understand how to do it.

Selling out successfully is a great outcome for all parties. The investors achieve a good return on their money and are thus encouraged to do more investments. The entrepreneurial team is cashed up and is likely to go and do another one. If they make enough money, they are likely to become angel investors and help others do the same. The proceeds feed the tax man and thus help with nation building. Cashed up entrepreneurs spend money and donate to charities thus help their communities. Their employees often end up

working for larger, more resilient companies and have better career prospects as a result.

I see no benefit in pushing a company to grow just for the sake of increased revenue and profits when, at the same time, it dramatically increases the risk of failure. I also see no reason to embark on any activities which does not directly contribute towards the ultimate investment objective – the exit.

For any angel or venture capital investment, the exit must inform the development strategy. We should work back from the ultimate objective to determine what we need to do to create a successful exit. Whatever investment we need should be directed towards creating the conditions for the exit and not for more product development, more market penetration or proving any part of the business concept which is not relevant to the buyer's decision.

If it is simply about the exit, then the decision to invest should only be positive if a successful exit can be achieved. It matters little how great the invention is or how competent the management team if an exit cannot be readily achieved. Instead of an 'A Team' what you should be seeking is an 'A Exit' and a management team which is committed to it and capable of executing the strategy to achieve it. Instead of looking for the well rounded team that can build out a business concept and grow revenue and profit, we should seek out only those sets of skills needed to create the exit vehicle. It may be that this will have very little sales, marketing, distribution and service components. The key here is to work out what you need to do for a successful exit, not what it will take to grow the business.

Always remember that your investee does not have to successfully commercialize the innovation, the buyer will. Your job is simply to give the buyer the opportunity of taking it off your hands so that they can exploit it. The right business development strategy is to achieve the exit in such a way that you are well rewarded for creating the opportunity for the lucky buyer.

Too often Angels and VC investors leave the decision on how to exit too late. By then they have often created businesses which are difficult to sell. The buyer ends up having to unwind a lot of activities to get back to what they can properly exploit. This lack of focus results in excessive due diligence periods,

bits of the business which the buyer does not really want and a longer period after the sale for the buyer to exploit the underlying assets and capabilities. All this leads to lower exit prices.

At the same time, undue attention to revenue and profit growth create the seeds of destruction in the investee firm. Too often investee firms get into trouble and have to be sold quickly to recover some of the investment money. Because little attention has been given to preparing the business for sale, it is usually too late to find the best buyers and so the sale proceeds are almost always suboptimal.

When the focus from the outset is the exit, the investment is only entered into if a probable exit can be anticipated. Since potential buyers are identified from the beginning, the business can be quickly offered for sale during most of its life. Even a business which has failed can still be an attractive acquisition for the right buyer. Remember, it is not the investee which will execute on exploiting the underlying strategic asset or capability, it is the buyer. It may matter little to the buyer what state the investee firm is in at the time of sale providing the buyer gets the assets or capabilities they want.

If the business is approached with an offer to purchase, the same logic applies. A business with an exit focus can be quickly put into a competitive bid because the work has already been done to setup that situation.

By taking a pragmatic focus on the exit from the outset, the angel and VC investors have a much higher chance of having a successful outcome. The investment periods can be expected to be shorter, the exit values much higher and the execution risk significantly lower.

What if you have to sell

Few businesses can guarantee that they will never get into trouble. Early stage companies frequently fail in the first few years but even large corporations have been known to disappear. Look at the household names which failed – Enron, Ansett, Worldcom, HIH and so on. Of course, if you do get into serious trouble then just getting enough cash in the door to cover payroll can be a challenge. At the same time, staff will be deserting, suppliers will be hounding you for

payment and you will be chasing customers. Not a great time to start thinking about selling.

The truth is that many companies end up on the auction block at the worst possible time, sometimes due to their own failures but often just because external events went against them. Whether it was a change in industry regulations requiring a major investment, a new aggressive competitor or a natural disaster, there are many events and circumstances which can derail a business. Planning for such an eventuality should consider the possibility that the business should be sold to recover as much of its value as possible.

However, it is very difficult to sell a business when the business itself is under pressure. The executives will be busy fighting fires and there will not be time to identify and court prospective buyers or time to engage the best advisors. Clearly, if you haven't put the time in to develop a robust exit strategy for this set of circumstances, you will have left it too late to be anything but a fire sale.

Value in a business is related to its potential in the hands of the buyer, thus even a business heading for insolvency can be a great acquisition for a buyer who is not constrained by the situation facing the vendor. The key to a quick sale, which still gains a premium on sale even when the business is in trouble, is to have identified in advance those buyers who can develop the underlying potential in the business. The entrepreneur and the Investor should set out to identify a small group of such buyers, engineer a situation where those prospective buyers are informed of the potential in the business and then kept up-to-date with the progress of the business over time. The aim of the exit strategy should be to have each prospective buyer understand what they could gain from an acquisition.

Of course, in the unfortunate situation where the business has to be sold, it would be much better if the seller could quickly bring into a competitive bid a number of prospective buyers who were already apprised of the potential of an acquisition. The competitive bid process would then protect as much of the value in the business as possible. As part of the preparation for such an event, even if unlikely, the business needs to be put on a basis where the buyer can quickly undertake due diligence. This means that the business has to be fully prepared for such an investigation. If the seller has also ensured that the

business is run effectively and efficiently and has few risks for the buyer, the due diligence process will conclude quickly and the buyer will be more willing to negotiate a deal.

What if you receive an offer?

Many entrepreneurs are quite surprised when a prospective buyer turns up at the door with an offer to buy. Even when they anticipate it might happen one day, the actual event is still surprising. Then of course, the entrepreneur and Investor must consider whether to entertain the offer or reject it without consideration. Few of us can resist at least finding out what is on the table and so it is more than likely that some discussion will be entered into. Sometimes this is 'just in case', that is, just in case it is a crazy high offer and you might want to seriously consider it.

If you are a high growth potential business at an early stage of proving your business model and you are hoping for a strategic buyer, you might have some difficulty working out what a reasonable offer might be. Even so, there will clearly be a price where you will move forward with the negotiation. But how do you know you have the highest price you could achieve at that moment in time?

Most acquirers are not in the business of being generous and they will pitch their price at a point which will just get your interest and secure the deal. If they don't need to offer more to secure the deal, why should they? Even if you thought your business had greater potential, you still might be willing to settle for a bird in the hand. Once you have decided that the offer price is at a point where you will sell the business, the only way you can be sure of getting the best price is to put your business into a competitive bid.

When you have an offer, it is unlikely that the prospective buyer will hang around while you start the process of working out who else might be interested and go through the exercise of making contact and educating other prospective buyers. Most offers have relatively short offer periods – basically take it or leave it. However, if you like the price, the only way you can move it to a competitive bid is to have the other prospective buyers waiting in the wings. That is, you will have set out sometime in the past to proactively identify and make contact

with a group of prospective buyers with the intention of setting up a future competitive bid. Whether you trigger off such a bid or it is activated by an offer, you need to be prepared for such an event.

An offer often comes with a condition of exclusive dealing, however, this is normally done so that the prospective buyer doesn't waste their due diligence time and costs. If the business is already prepared for due diligence and the prospective buyers already understand the potential in the business, the vendor can hold off on due diligence until more prospective buyers are in the frame. Then only the highest bidders will be invited to undertake a limited due diligence to arrive at a preferred buyer.

What is very clear is that, if you want the best returns under a wide set of circumstances, preparation for sale is the key. If you are dealing with strategic value, then by following the process outlined in this book, you will have the best chance of making a good return, even in poor circumstances. What you don't want to do is depend on luck to get a good return on your investment. Only with preparation can you insure that you can get a reasonable return and, then of course, because you are prepared, you can always make the lucky breaks work for you.

The Beginning is about the End

The greatest influence on the exit returns to the Investor is the initial decision to invest. If you get into the wrong deals, it is highly unlikely that it will end well. However, if you choose the right investments, the probability that you will come out with a good return will increase significantly.

For too long the strategic exit has been seen as the exception – all luck and timing. But this is certainly not the case. There are numerous examples of strategic deals which occurred because the entrepreneur and the investors set out to be acquired by a strategic partner. Biotech deals are always strategic since it is certainly the case that the R&D teams never have the intention of selling and marketing their own inventions.

What has been missing is a well documented process to show how a strategic deal is executed. If you accept that the process in this book works, the investor

then only needs to invest in ventures which have a probable strategic exit as the harvesting method. This book sets out both a model for identifying strategic investments as well as a process for achieving a strategic exit.

Basically, you should not enter into any investment where the outcome is not a strategic exit. While there will be exceptional situations where an IPO is probable, few ventures have the attributes to drive such an exit. Much better to set out with the objective of sourcing strategic value ventures where the probability of a strategic exit is high, the amount of investment is reasonable as it only funds exit activities and not business growth and, the tasks needed to set up the strategic exit are well within the capability of the Investor and the venture management team.

The overall investment results will be considerably improved over traditional Angel and VC investment returns.