CHAPTER 13

Valuing and Exiting Your Venture

NESS COMPUTING ACQUIRED BY OPEN TABLE

Ness Computing, makers of a popular restaurant recommendations app was acquired in February 2014 by the restaurant reservation platform OpenTable. The acquisition was an all cash deal worth $17.3 million. Terms of the acquisition include the provision that the Ness Computing team will work at OpenTable's San Francisco headquarters. The Ness app and site will be discontinued as the technology will be integrated into OpenTable.

Although the deal seems to be positive for Ness and its investors, the reality is somewhat different. Ness, launched in 2011, has raised more than $20 million in investor capital. Ness started out as a personalized search engine technology for mobile. Ness pivoted from that model to specific restaurant recommendations—but always had its sights set on eventually developing beyond just restaurants. That growth model was behind its $15 million Series B investment that it concluded in 2012.

With this transaction, Ness's technology, and talent, will be tasked with enhancing OpenTable's restaurant recommendations. The Ness technology should help OpenTable add more features to attract more restaurants to its platform and potentially take home more returns on the commission it charges them.

Source: *Lunden, I. 2014. "OpenTable Buys Ness for $17.3M to Beef Up Mobile and Restaurant Recommendations."* TechCrunch, *February 6.*

13.1 INTRODUCTION

Perhaps the most ironic part of entrepreneurship is the need to build your venture every day with some idea of how you will exit. The reason this is important is that there are different options for exiting your venture and each option requires that you build your venture in different ways. For example, if you intend to pass your venture on to your heirs, there are things that you should do to prepare them for a smooth succession. On the other hand, if you are planning on exiting your venture via a sale of stock on a public stock exchange you will be focusing on different types of things than if you were handing the keys to your heirs.

A good bit of advice that entrepreneurs learn to follow is to "manage your business every day as if you are going to sell it tomorrow." The reason this is good advice is because you never really know when the right offer may come along that enables you to sell the business that you've diligently been building. If you've been practicing good business techniques along the way, the path to completing the sale will be far smoother. For example, no one wants to purchase a business at top dollar if it has been doing a terrible job with its accounts or if it is dealing with multiple ongoing lawsuits. Expert entrepreneurs know that it is important to pay attention to the details of the business. And this needs to be done whether it is the entrepreneur or someone else who actually keeps track of the details. Ultimately, of course, the entrepreneur is responsible for creating the business culture that leads to a well-run business venture.

In the case that you intend to sell your venture to another party, whether it is another entrepreneur, another venture, or a venture capital firm, the other party is going to perform what is called **due diligence** on your venture. The due diligence process usually includes a thorough on-site visit to your venture's headquarters, review of the accounts, and many other things. In this chapter, we'll introduce you to the due diligence process and discuss how you can be prepared for that in the event that you will one day desire to sell a venture you've created.

The due diligence process is generally undertaken for two purposes. One is to evaluate the long-term viability of the venture, as we've mentioned. The other reason to conduct due diligence is to help establish a value for the venture. **Valuation** is the term used to refer to the process and calculations used to establish a dollar value for your venture. You will need to establish a value for your venture when you exit. You'll also need to establish a value for your venture anytime you sell equity to others. We discussed valuation very briefly in Chapter 8 when we explored the venture fund-raising process. The same techniques that you use to value your venture for an exit are used to value your venture for a fund-raising transaction. We will provide you with some simple techniques that can be used to establish a reasonable value for your venture.

The primary purpose of a venture's **exit strategy** is to develop a roadmap by which early-stage investors can realize a tangible return on the capital they invested. The entrepreneur spells out a reasonable scenario—the exit strategy—by which a later round of funds will be raised. This later round should provide the original investors with an opportunity to sell their shares and realize a capital gain.[1] Second, the intent of an exit strategy is to suggest a proposed time window that investors can tentatively target as their **investment horizon,** placing a limit on their involvement in the early-stage funding deal. The founding team wants to assure investors that the venture will grow to a point whereby the initial investors will receive all of their original investment back, plus a sizable return for the risks they took by investing in a start-up venture. To investors and other shareholders of a private venture the exit is a **liquidity event.** It is the event which enables them to convert their shares into cash.

The problem in projecting an exit strategy is that it's based on several major assumptions. The speed of market penetration, the ability to sell at expected price levels, the costs of doing business, the margins on sales, the management team's ability to arrange consistent deals, and the impact of competition and other economic factors collectively affect the new venture's projected market share and bottom line. Certainly, when these factors are all aligned in the most favorable way the firm will experience significant market share, consistent high-growth sales rates, strong profit margins, and positive earnings. And such a scenario in the first two to three years is typically the story told by firms that eventually go public.

In this chapter, we provide an overview of the various ways that you may elect to exit your venture. The options that we will review include passing on the venture to heirs (succession), selling the venture to another party (acquisition), merging the venture with another firm, or taking the venture public through an initial public offering (IPO). Each of these exit strategies provides you with different challenges and opportunities as the entrepreneur and owner. We will examine each exit strategy, look at how the venture should be positioned during its growth stages to best pursue each of the various exit strategies, and review the advantages and disadvantages of each.

Let's begin by examining the due diligence process that precedes most exit strategies.

13.2 DUE DILIGENCE

If the exit process includes bringing in new buyers or investors it will also include in-depth analysis of the venture, its operating history, its future prospects, and many other things. This analysis is referred to as *due diligence* and is normally conducted by the parties that are interested in acquiring or investing in the venture.[2] Due diligence involves examining a number of key elements of the target venture, including financial health, status of the venture's product line, the potential for synergy with the acquiring firm, market position and future potential of the venture, research and development history and roadmap for the venture, legal considerations, and plans for managing the acquired entity.[3] Let's examine each of these factors in turn with an eye toward common analyses used in the due diligence process and how the entrepreneur can prepare for a due diligence review.

13.2.1 Finances

The due diligence process usually begins with a financial analysis—analyzing the profit and loss figures, operating statements, and balance sheets for the years of the company's operation, concentrating on the more recent years. Past operating results, particularly those occurring in the preceding three years, indicate the potential for future performance of the company. Key ratios and operating figures indicate whether the company is financially healthy and has been well managed. Areas of weakness, such as too much debt, too little financial control, dated and slow turning inventory, poor credit ratings, and bad debts are also carefully evaluated. The entrepreneur can prepare the venture for this portion of the due diligence process by ensuring that accurate, timely, and regular accounting reports have been prepared and filed. Here's where the entrepreneur can take advantage of having invested in hiring an accountant to ensure all the books have been well managed and stand up to auditing review.

13.2.2 Product/Service Line

The past, present, and future of a firm's product lines will also be examined. The strengths and weaknesses of the firm's products are evaluated in terms of design features, quality, reliability, unique differential advantage, and proprietary position. The life cycle and present market share of each of the firm's products are verified. One method for evaluating the product line is to plot sales and margins for each product over time.[4] Known as S or life-cycle curves, these indicate the life expectancy of the product and any developing gaps. The S-curve analysis could reveal that all products of this firm are at or near their period of peak profitability. We discussed the product life cycle in Chapter 10. Exhibit 13.1 is a representation of the product life cycle. It's important to know the life cycle status of the venture's product lines to understand whether there is a fit with the acquiring party's product portfolio and operating expertise. For example, a venture that is good at introducing new products would not be a good fit with a company whose primary product line is mature and stable.

13.2.3 Synergy

The phrase, "the whole is greater than the sum of its parts" is a good definition of the concept of **synergy.** Entrepreneurs who seek to exit their companies via acquisition should consider whether the company provides any synergies to potential acquirers.[5] The synergy should occur in both the business concept—the acquisition functioning to move the acquiring company toward its overall goals—and the financial performance. Acquisitions should positively impact the bottom line of the acquiring firm, affecting long-term gains and future

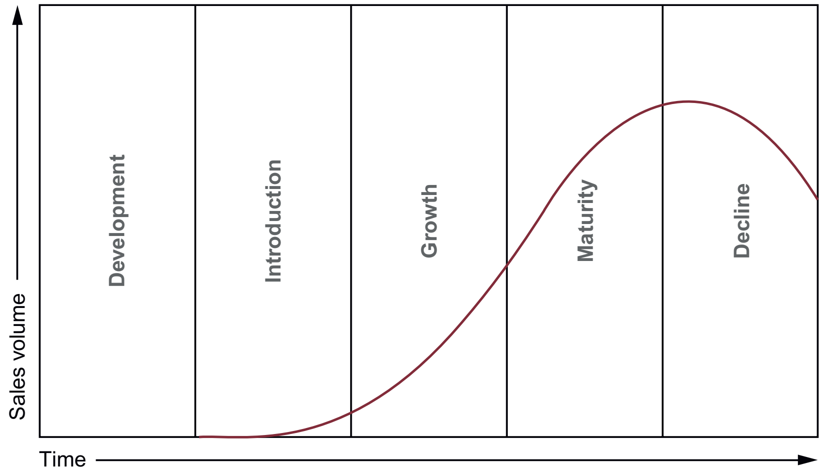

EXHIBIT 13.1
The product lifecycle.

growth. Lack of synergy with the existing business is one of the most frequent causes of an acquisition failing to meet its objectives.

13.2.4 Markets and Customers

The due diligence process includes evaluation of the entire marketing program and capabilities of the venture. Although all areas of marketing are assessed, particular care is normally taken in evaluating the quality and capability of the established distribution system, sales force, and manufacturers' representatives. For example, one company may acquire a venture primarily because of the quality of its sales force. Another may acquire a venture to obtain its established distribution system, which allows access to new markets. Entrepreneurs should be aware of which of these elements of enterprise value will be of interest to potential acquirers.

Acquiring companies can gain insight into the market orientation and sensitivity of target ventures by looking at their marketing research efforts. Does the venture have facts about customer satisfaction, trends in the market, and state-of-the-art technology of the industry? Ventures that are setting up for an exit by acquisition should be collecting, storing, and actively mining their customer data.

13.2.5 Research and Development and Intellectual Property

The future of the venture's products and market position is affected by its research and development (R & D) and the extent to which the venture has established intellectual property rights in the results of the R & D. The due diligence process normally probes the nature and depth of the venture's research and development and its ability to adjust to changing market conditions. The due diligence process will assess the strengths and weaknesses of the venture's innovation capabilities and its IP portfolio. Although the total amount of dollars spent on research and development is usually examined, it is more important to determine if these expenditures and programs are directed by the venture's long-range plans and whether or not the venture has been successful in introducing new offerings to customers. The due diligence process will scrutinize the intellectual property protection held by the venture, and assess its efficacy to sustain competitive advantage, generate royalty income from third parties, and/or secure freedom to operate for the venture through cross-licensing with competitors.

13.2.6 Operations

The nature of the venture's business processes, for example, the facilities and skills available, its efficiency and work flow, and its productivity, are also examined as part of the due diligence process. Are the facilities obsolete? Are they flexible, and can they produce output at a quality and a price that will compete over the coming years? Are there procedures in place to systematically review products and operations for potential intellectual property assets, and to establish and maximize protection of those assets? Acquiring firms do not want to build this infrastructure themselves. Typically, an acquiring company focuses on the growth prospects of the target venture and looks carefully at its overall operation to determine if it is poised to deliver on its growth potential.[6]

13.2.7 Management and Key Personnel

Finally, the due diligence process evaluates the management and key personnel of the venture. The individuals who have contributed positively to past success in sales and profits of the firm should be identified. If a company is conducting due diligence as part of a potential acquisition, they want to know if the key personnel will stay once acquisition occurs? Have they established sound objectives and then implemented plans to successfully reach those objectives?

Additionally, acquiring companies examine whether any of the venture's personnel are indispensable. Generally, it is not good for the acquiring company to have such individuals. There is too much risk associated with those key people leaving, becoming disabled, or worse. As such, technology ventures strive to ensure that knowledge and other key assets are not dependent on any single individual or groups of individuals.

13.3 VALUATION

Investors expect entrepreneurs in whom they invest to use their money wisely and carefully to build **enterprise value**. Enterprise value refers to the value of the enterprise as a whole. Enterprise value is easy to determine for companies that trade on the many public stock markets worldwide. The value of an enterprise whose shares trade on public markets is simply the price per share times the number of outstanding shares. This is also referred to as the firm's **market capitalization** or **market cap**. In the case of private ventures, the efficiency and effectiveness of operations and demonstrative intellectual property assets (such as patents) are the essence of its enterprise value. Efficiency refers to the cost-effectiveness of the venture's systems. Effectiveness refers to how well the systems produce value that customers demand.

13.3.1 Valuation Techniques

There are a number of techniques that can be used to determine the value of a venture.[7] Some of these techniques employ sophisticated mathematical formulas and statistics; others use primarily qualitative judgments and educated hunches. We'll look at a subset of these techniques, including the multiples technique and the discounted cash flow method.

13.3.2 Multiples Technique

The multiples technique is the least mathematical of the methods for determining venture valuation and perhaps the one most often used. It is a straightforward technique that relies on identifying recent comparable transactions, i.e., recent acquisitions of, or sale of equity in, comparable entities, where definitive valuations were established by the transaction. The valuations of those "comps" are then used to establish the valuation of the venture. This is analogous to the process used by appraisers to establish the value of real estate. Where technology ventures are involved, however, is not always easy to identify comparable entities; what metrics should be considered to in identifying "comps" for a venture? In some cases, key metrics for valuation have been established within an industry. For example, in the Internet industry a common key metric is "registered users." Instagram was acquired by Facebook in 2012 for $1 billion. At the time of the acquisition, Instagram had only a dozen or so employees, no revenue, and no real business model. However, it did have something that Facebook valued highly: registered users. At the time of the acquisition, Instagram boasted 33 million registered users, and it had only launched 18 months prior. In essence Facebook calculated that the value of each registered user was approximately $33. To arrive at the $1 billion valuation, then, is simple arithmetic:

$$30{,}000{,}000 \text{ users} \times \$33/\text{user} = \$1{,}000{,}000{,}000$$

Companies in similar industries can now use the same multiple (i.e., $33 per registered user) to develop a reasonable valuation based on the registered user metric. Note that the valuations vary depending on which variable a venture chooses to use in generating a reasonable valuation. In general, the owners of a venture will want to choose the variable that gives them the greatest value, even though potential investors will argue for the variable that gives the venture the least current value. There is no such thing as an "absolute" or "true" venture value. It all depends on the argument that can be made for one or another metric and a comparable company to serve as the baseline for calculating valuation.

13.3.3 Discounted Cash Flow Technique

For most start-up ventures the old mantra clearly applies: "Cash is king." What that simple phrase means is that start-up ventures must organize their growth and operations to ensure an ample supply of cash on hand to meet current obligations, including operating expenses and debt liabilities. One of the primary ways that entrepreneurs track and manage cash in the venture is via the cash flow statement. Unlike the income statement, the cash flow statement does not track operating performance according to rules of accounting. The cash flow statement tracks the actual movement of cash into and out of the firm. The technical term "discounted cash flow" is a refined measure of cash that subtracts one-time capital expenses and dividend obligations from the projected cash position at some future date.

To determine valuation using the discounted cash flow method requires understanding the concept of **present value.** Present value is defined as the value in the present of some future cash flow. A simple technique has been developed to determine the present value of a future cash flow. Let's say that you are promised some cash right now or $100 dollars one year from now. How much cash would you need to receive right now to decide to forgo the $100 future cash flow? Important to this consideration is how much a person could have earned by investing cash in hand over the one-year period. If the investment would return more than the $100, then you should take the cash in the present and invest it. If it would return less than the $100, then you should take the money in the future. The interest rate used to determine the return on current cash is called the **discount rate.** Here's how the calculation works:

$$\mathrm{PV} = \mathrm{FV}/(1+r)$$

In this equation, PV is the present value of the future value (FV) divided by the discount rate, r. If the discount rate was 8% (.08) with a FV of $100, someone would need to give you at least $92.59 in the present to make it worth your while to forgo the future cash. Applying this logic to a venture requires identifying a future cash flow that will be put into the calculation above. As we've noted previously, your business plan should include a financial forecast that provides interested investors with cash projections for at least three years into the future. A simple way to generate the FV variable in this equation is by using the projected cash position of the venture at the end of the three-year period. This would be the last line of the cash flow statement in month 36 (if you need a refresher on the cash flow statement, see Chapter 6).

Investor expectations of future returns are based on their estimate of risk. One element of that risk is the alternative investments they could have made. One alternative investment would be to purchase fixed-income securities, such as U.S. treasury bills. Such notes are backed by the U.S. government and are assumed to be risk-free. Thus, the prevailing interest rate paid on U.S. treasuries is known as the risk-free rate of return. At minimum, investors in start-up ventures would expect to meet and exceed this risk-free rate. If the entrepreneur cannot demonstrate how that is possible, then investors would purchase the bonds instead.

In addition to the alternative investments that comprise one element of the risk associated with investing in any particular venture is the risk of the venture itself. The risk-free rate of return is relatively straightforward, and can be known with a high degree of accuracy. However, the risks that are associated with any particular venture are more difficult to quantify. One technique that is used to arrive at a discount rate that includes both the alternative investment risk and the venture risk is known as the **risk-adjusted discount rate** method, or RADR. This approach is summarized in the equation below.

$$r_{\mathrm{vt}} = r_{\mathrm{ft}} + \mathrm{RP}_{\mathrm{vt}}$$

This equation states that, for a particular venture, v, that yields an uncertain cash flow at some future time, t, the discount rate is expressed as rvt. In the equation above, rft is the so-called risk-free rate of return, and RPvt is the risk premium that is associated with the venture. The discount rate that is used to determine the present value of future cash flows, then, is a combination of the risk-free rate and the risk premium. This is the minimum rate of return that investors would expect to receive on their exit from the venture.[8]

The important point to remember is that, using this method, valuation is based on the likely future cash flows that will be generated by the venture. The various assets of the organization, such as intellectual property, products and services, customer lists, and brand value are not considered. Many entrepreneurs don’t have a lot of experience in predicting future cash flows, and they are at a disadvantage when the time comes to place a value on the venture. This lack of experience can be offset by consulting with independent firms that specialize in placing a value on ventures. Paying for such a service prior to seeking capital, especially from experienced venture capital firms who are usually very good at determining the value of a venture, can be a worthwhile expense. Arming oneself with rational and defensible arguments about the future value of a venture can help when the time comes to negotiate with others about the value of a venture.

13.4 EXIT VIA SUCCESSION

Succession is a common exit strategy used in family-owned businesses. Such ventures often are handed down from generation to generation. Some of the largest private companies in America, such as Koch Industries, and Milliken & Company are family owned and continue to be run primarily by members of the Koch and Milliken families, respectively. These companies have developed detailed succession planning guides that help them groom and prepare the next generation to take over the company. Exhibit 13.2 indicates the primary industry categories for family businesses in the United States.

Many family-owned businesses aspire to keep the business in the family via succession, but they don't plan very well for it. As a result, many family-owned businesses suffer setbacks and occasionally bankruptcy because of poorly designed succession. For example, many fail to help the next generation come to terms with the difficulties of running a company, assuming instead that a college degree or MBA will prepare them for leadership. By way of contrast, family-owned ventures that manage the succession process effectively realize that there's no better way for the next generation to learn the business

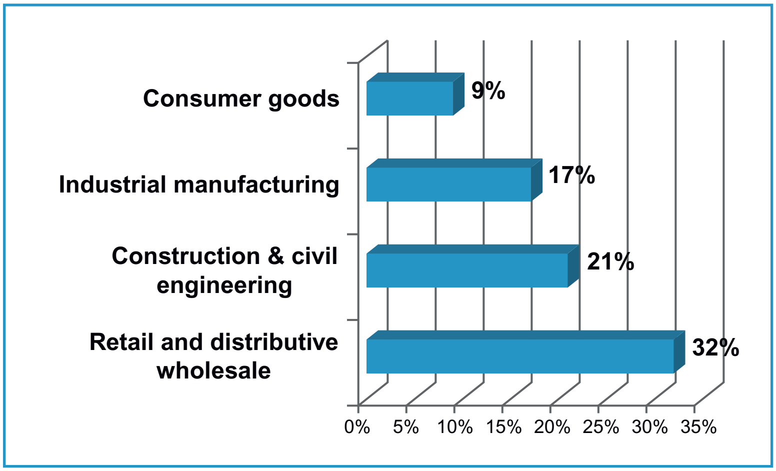

EXHIBIT 13.2

Industry types for family businesses in the United States. Source: "Choosing Your Next Big Bet." PriceWaterhouseCoopers family business survey 2010-2011; p. 6.

than the way the first generation did. Effective succession planning generally exposes the upcoming generation to all facets of the business. Family members who aspire to lead the venture someday will spend time "in the trenches" with other employees learning about the business from the ground up. Such lessons can be invaluable as the older generation steps aside and the next generation takes over.

There has been extensive research into the processes that can be used to better manage the succession process. One of the first things that should be considered in succession planning is to ensure that the transfer process doesn't incur burdensome taxation. A good accountant will be essential to help ease the tax burden associated with transferring ownership of a major asset (the business) to heirs.[9] Many family businesses have had to be liquidated on succession because the heirs could not afford the taxes associated with ownership transference. An estate planning accountant and attorney can be valuable in avoiding that problem.[10]

Of course, in order to use a succession strategy there must be someone in the family willing and able to take over the business. If no one has a passion for taking over, it would be wiser to exit the venture via acquisition—selling to someone outside the family. If there is someone in the family who passionately wants to run the business and is prepared to take the reins, you have no problem. But, what if multiple family members are interested in the business? If that circumstance arises, there are several things that can be done to avoid hard feelings. The most common strategy in such a situation is to bring everyone together and determine who is best suited for which role in the venture. This is best handled after the family members have each had an opportunity to work in various roles within the venture to determine the best fit for their own talents and experience. Allocating roles within the venture is part of the challenge when multiple family members are interested in running the venture; the other challenge is ownership percentages. A good way to manage that is to transfer ownership based in part on performance goals. In that way, no one can claim a large ownership stake without having demonstrated the ability to manage and lead the venture effectively.

Ultimately, the decision must be made concerning who will be in charge of running the company on succession of the current CEO. A firm decision must be made on this important part of the succession plan. Some family businesses opt for leadership by committee, where a committee of family members makes most of the major decisions for the venture. This can work but it can also be unwieldy and political as the venture grows or experiences challenging times. Not many large companies are run by committee, and it is not recommended that family businesses operate under that style. Most management and leadership scholars will point to the value of having a single individual who ultimately is responsible for the strategic and operational effectiveness of the venture.

Finally, the most effective succession planning eases the new generation into their respective leadership roles rather than all-at-once immersion. We mentioned before that it is useful for family members aspiring to leadership to work in various roles within the venture prior to assuming day-to-day leadership. It is also very useful to have the previous generation stay on during the early days of succession to help the new generation of leaders understand the context of their decisions. Although it is not advisable for the senior generation to intervene too soon, as some of the greatest lessons for the new generation will come via mistakes, it is advisable for the senior generation to help the new generation understand the lessons being learned.[11] This is not to say that the outgoing leaders should sit idly by if disastrous decisions are being made. The point of the nonintervention strategy is to allow the new generation to make mistakes that don't threaten the health of the business. Gradually stepping aside and allowing the incoming generation to assume larger and larger responsibilities is the preferred succession management technique. In fact, succession planning can often be a 10-year process.[12]

13.4.1 Advantages of Exit Via Succession

There are a few advantages to exit via succession. Perhaps a primary advantage is that the current business owner can decide when, where, and how he or she will exit. Family successions can be managed over a long period of time, as the incoming generation is brought up to speed on managing the venture. In addition, for business owners who have a difficult time "letting go" of the venture the exit via succession option can allow them to ease out over a longer time. Family members are generally going to be more tolerant of a former owner having some responsibility than is a total stranger.

Another advantage of exit via succession is the opportunity to pass on a healthy and viable business to one's family members. Many entrepreneurs work long and hard hours in large part for the benefit of their family. This motivation is strong for many entrepreneurs and small business owners and is rewarded when the next generation is groomed effectively to take over the business.

13.4.2 Disadvantages of Exit Via Succession

There are some disadvantages to the exit via succession strategy. Obviously, one of the disadvantages is the potential for family squabbles to arise. For example, if one family member is passed over to lead a business in favor of another family member, hard feelings could arise. In that sense, it is important for a succession plan to be put in place early so that people are allowed to "grow into" their future roles in the business.

Another disadvantage of exit via succession is that the current owner may not receive full compensation for the hard work he or she has put into the venture. An outright sale of the venture to a nonfamily member would be negotiated more strenuously than would the transition to next-generation ownership. As such, the current owner must take as part of his or her reward for years of hard work the satisfaction of passing on the venture to family members.

Where there are investors in the entity that are not family members, exit of the founders by a succession can be problematical; it does not necessarily provide a liquidity event for those investors. Accordingly, the organizational documents (e.g., operating agreement, or shareholders agreement) may include provisions that would effectively preclude and exit via succession strategy or make it very difficult and costly.

As we mentioned, the first thing that is required for the succession strategy to be used to exit the venture is to have a willing and able family member who is ready to take over. If one is not present, the business owner may be better positioned to exit the venture via selling to another party. This is known as "acquisition." Let's explore exit via acquisition next.

13.5 EXIT VIA ACQUISITION

Before the entrepreneur can build value attractive to a potential acquirer, he or she must understand the buyer's perspective.[13] Most **acquisitions** are undertaken because the acquiring company sees one or more strategic advantages that can be obtained by buying another business. These advantages, or **value drivers,** vary from industry to industry. They also change over time in specific industries because of evolving product life cycles and external developments that affect the industry. Generic categories of strategic value drivers include:

- **Broadening product lines:** The buyer adds complementary products to increase revenues. This is a common strategy for both product and service companies.
- **Expanding the technology base:** The buyer adds technology skills or intellectual property that enhances or complements the company's current base.[14]
- **Adding markets and distribution channels:** The acquirer obtains channels it doesn't currently serve. Companies that start out with a **vertical strategy** can add new industry expertise by widening its distribution capabilities. A vertical strategy is one where a venture develops expertise in a given industry that can be expanded to other industries with only slight modifications.
- **Increasing the customer base:** The buyer adds a company that is similar in product offerings or in its business model, yet focuses on a different customer segment. This strategy is enhanced if the target company has a good reputation or strong brand. It also can expand the acquirer's geographic coverage.

- **Creating economies of scale:** The combined company can offer a more efficient use of physical assets or overhead—a critical need in consolidating industries.
- **Extending internal skills:** The buyer can add new capabilities such as consulting or service offerings, international management skills, or various types of management and business skills. These skills can be offered as independent revenue producers or enhance a company's competitive edge.[15]

Many acquirers hope to leverage several value drivers in a single deal. Google, for example, has regularly used acquisitions as a strategic tool to bring in new skills, new technology, and, sometimes, new customers. Google has developed expertise for integrating these newly acquired technologies into their complete product offerings.

When the perspective of potential buyers is factored into the development of a new venture's strategy, the strategic planning process becomes very important. Internal characteristics of the company will influence the acquirer's final valuation.[16] These factors are related to fundamental business management, strong cash flow, and accurate books and records. Although they are obviously necessary for closing a deal, they must be augmented by significant value

KEY POINT

Preparing Your Venture for Acquisition

As you begin to study your industry, you will need to look at both industry trends and the strategies of competing companies in handling those trends. Some of the questions that need answers include:

- Why are your customers presently buying from you?
- What are the customers' sourcing alternatives, including direct competitors, internal competition within the customer company, inaction or not buying at all, and innovative alternate solutions?
- How will customers' needs change?
- What alternatives will customers have tomorrow?
- What is happening in related markets to influence buying patterns?
- What will the market look like tomorrow?
- What will other players be looking for in executing acquisitions?

The critical conclusion to this process is in the last two questions about the future. Doing your homework through the earlier points should help you develop a vision of future trends and value drivers in the industry.

Source: *Adams, M. 2004. "Exit Pay-Offs for the Entrepreneur."* Mergers & Acquisitions: The Dealmaker's Journal, *39(3): 24-28.*

drivers to motivate the buyer to pay a premium price.[17] The Key Point box below highlights some actions entrepreneurs can take to prepare their venture for an eventual acquisition.

13.5.1 The Acquisition Deal

Once the venture has been identified as a good candidate for acquisition, an appropriate deal must be structured. Many techniques are available for acquiring a firm, each having a distinct set of advantages to both the buyer and seller. The deal structure involves the parties, the assets, the payment form, and the timing of the payment. For example, all or part of the assets of one firm can be acquired by another for some combination of cash, notes, stock, and employment contracts. This payment can be made at the time of acquisition, throughout the first year, or over several years.

The two most common means of acquisition are the **direct purchase** of the target venture's entire stock or assets, and the **bootstrap purchase** of these assets. In the direct purchase of the firm, the acquiring company often obtains funds from an outside lender or the seller of the company being purchased. The money is repaid over time from the cash flow generated from the operations. Although this is a relatively simple and clear transaction, it usually results in a long-term capital gain to the seller and double taxation on the funds used to repay the money borrowed to acquire the company.

In order to avoid these problems, the acquiring company can make a bootstrap purchase, acquiring a small amount of the firm, such as 20% to 30%, for cash. The acquiring company then purchases the remainder of the target venture by a long-term note that is paid off over time out of the acquired company's earnings. This type of deal often results in more favorable tax advantages to both the buyer and seller.

13.5.2 Advantages of Exit Via Acquisition

There are numerous potential advantages of the acquisition strategy. The most obvious is that the entrepreneur and any other owners of the venture's equity have the opportunity to convert their interest into cash. This is the ultimate goal for a lot of entrepreneurs, and it is certainly the goal of every one of the investors. The amount of cash that will be involved in the acquisition transaction depends upon the valuation of the venture. The more enterprise value the entrepreneur has created, the greater will be the cash required to purchase the venture. The cash that is used to purchase the venture is then distributed to each of the investors according to each investor's percentage of ownership interest.

Another advantage of acquisition is that the entrepreneur now has the cash needed to launch a new venture. Many so-called **serial entrepreneurs** continue to build new ventures with the cash they have obtained through past deals.

You may have heard of the boom-and-bust nature of entrepreneurship. Many entrepreneurs obtain a lot of cash early in their careers and erroneously conclude that entrepreneurship is easy or that they are uniquely talented. Some end up bankrupt because they used all of their cash to try to achieve the thrill of success once again. Expert entrepreneurs follow the affordable loss principle throughout their entrepreneurial careers. That is, even though they may have had a big payday from a successful exit via acquisition, they don't risk all of their gains on their next ventures. Instead, they put away enough money to live on, if they can, and continue to leverage other investors to help them reduce their personal financial risk.

Other advantages of the acquisition strategy include the opportunity to exit a venture that has grown too large for the entrepreneur. By getting out of a growing venture that exceeds the entrepreneur's leadership and management skills, the entrepreneur can avoid the problems associated with decline and, potentially, failure. Handing over the reins of the venture to better qualified leaders is common for expert entrepreneurs who prefer starting ventures over managing large and growing ones. Finally, the entrepreneur gains more respect and credibility among investors and others potential stakeholders if he or she can demonstrate a track record of building and selling companies. It will be far easier in future ventures for the entrepreneur to raise capital and acquire needed resources with such a track record of success.

13.5.3 Disadvantages of Exit Via Acquisition

One of the major disadvantages of exit via acquisition is that the entrepreneur loses control of the venture that he or she has been nurturing. In the succession exit, as we've seen, it is very useful for the previous generation to stick around and help the incoming generation manage the venture for awhile. This not only provides the incoming generation with valuable mentoring as it comes up to speed on leading the venture, but it also lets the outgoing generation ease slowly into retirement. Many entrepreneurs who sell their companies are not prepared for the idleness that comes with the sales transaction. Most acquiring ventures are not interested in keeping the founder around, and will simply take over the operation as soon as the sales transaction is closed. For some entrepreneurs, the lack of a place to go, challenges to meet, and people to interact with can be upsetting. In fact, many entrepreneurs quickly leap into a new venture because they simply are not ready to be idle.

Another disadvantage of exit by acquisition is that the parties to the deal must come to agreement on the valuation of the venture. This can be a lengthy and potentially expensive process that may take the entrepreneur's attention away from running the business. The due diligence that needs to be conducted can also be disruptive to an operating venture. Employees who are aware of the potential for the acquisition may be concerned about their jobs and perform less well while the veil of uncertainty exists.

The final disadvantage of the acquisition exit strategy that we'll mention here is the challenge of finding a qualified buyer. This can be a major challenge, depending upon the type of venture. Ventures that are primarily based on local customers and local sales will most likely need to find a local buyer, or someone willing to relocate. If the economy is good there may be many potential buyers around. If the economy is not so good, there may be fewer potential buyers. The entrepreneur who wishes to exit via acquisition does not always have control over exactly when that may occur. It can take years to find a qualified buyer, in which case the value of the business may also change between the initiation of a search for a buyer and finally closing a deal. There are **business brokers** who can help entrepreneurs sell their companies, but they are fee based agents who may also require an up-front retainer. In addition to business brokers, there are a number of websites that entrepreneurs can use to list their business for sale. Some websites that offer such as service include:

- www.bizbuysell.com
- www.businessesforsale.com
- www.businessmart.com
- www.businessbroker.net

In the event that a qualified buyer cannot be found in a reasonable time, the entrepreneur can consider exit via merger. A merger will result in a change of ownership, but does not always include cash as part of the transaction. An entrepreneur who can no longer wait for a buyer can exit the venture by merging with another entity and then holding onto the stock of the merged enterprise. Of course, that is not the only time a merger strategy makes sense. Often two or more companies may be able to pursue more, significant new opportunities under a single venture than they could alone. Let's turn next to the exit via merger strategy.

13.6 EXIT VIA MERGER

Another method for exiting a venture is via a **merger**—a transaction involving two (or more) companies in which only one company survives. Acquisitions are similar to mergers and, sometimes, the two terms are used interchangeably. In reality, they are quite different, with the primary differences between mergers and acquisitions centering on the relative size of the entities involved and on who is in control of the combined entity. Mergers generally occur when the relative size of the ventures involved is equal—or at least they are perceived to bring equal value to the merged entity.

When an entrepreneur decides to merge with another company it's usually the case that the two entities are similar in size and offer similar value to the merged entity. For example, it would be quite unexpected for Google to merge with a five-person technology start-up. More likely, Google, with its tremendous assets and global reach, would be in control and simply acquire the smaller venture.

When two entrepreneurial ventures merge, the question of who will control the merged companies is part of the merger negotiations. An entrepreneur who wants to exit a venture may elect to merge with another company, but it may take some time for the entrepreneur to wriggle free of the new company. Often, when a merger occurs the merged company requires that the top executives from each venture stay with the merged entity to ensure its success. Depending on the size of the new company, the entrepreneur may be able to negotiate a deal whereby he or she earns out of the company over a period of time.

An **earn-out strategy** is used for ventures that have begun to generate consistently strong positive cash flow.[18] The management team initiates a monthly or quarterly buyback of common stock from the owners of one of the merged entities. Typically, an earn-out can be accomplished over an agreed-upon period of time and can provide the entrepreneur seeking to exit with a strong return as company sales expand and costs decline because of increased operating efficiencies. The purchase price can be scaled upward incrementally over time because the entrepreneur seeking to exist provides the luxury of time for the management team to complete the deal.

Why should an entrepreneur merge his or her venture with another firm? There are both defensive and offensive strategies for a merger. Merger motivations range from survival to protection to diversification to growth. When some technical obsolescence (loss of market or raw material) or deterioration of the capital structure has occurred in the entrepreneur's venture, a merger may be the only means for survival and exit. The merger can also protect against market encroachment, product innovation, or an unwarranted takeover. It can also provide a great deal of diversification as well as growth in market, technology, and financial and managerial strength.

A successful merger requires sound planning by the entrepreneur. The merger objectives, particularly those dealing with earnings, must be spelled out with the resulting gains for the owners of both companies delineated. Also, the entrepreneur must carefully evaluate the other company's management to ensure that it would be competent in developing the growth of the combined entity. The value and appropriateness of the existing resources should also be determined. In essence, this involves a careful analysis of both companies to ensure that the weaknesses of one do not compound those of the other. Finally, the technology entrepreneur should work toward establishing a climate of mutual trust to help minimize any possible management threat or turbulence.

13.6.1 Advantages of Exit Via Merger

One major advantage for many entrepreneurs to the exit via merger option is that they can exit their venture more slowly and methodically than exit via acquisition. Usually, in exit via acquisition the entrepreneur is out on the close of the deal. In a merger, the entrepreneur (from either of the merging parties) may elect to stay with the new company after the merger deal. Of course, the entrepreneur may need to take on a lesser role in the merged entity. It is simply untenable for both of the former CEOs to retain that title, for example. The entrepreneur may elect to exit the merged entity over time via what is termed an *earn-out strategy*. That is, the entrepreneur will be retained by the new company through a period of time in which the entrepreneur's stock in the merged entity fully vests. At that point the entrepreneur may leave and start another venture.

Another major advantage to exit via merger is that the entrepreneur may realize greater value in his or her stock holdings in the new company than would have been realized in their former venture. The entrepreneur may have been at the limits of his or her capabilities to lead and manage, and an exit via acquisition would have valued the venture at its current value. In contrast, by accepting ownership of the new, merged company, the entrepreneur may realize significantly greater value due to the greater capabilities of the combined leadership team.

13.6.2 Disadvantages of Exit Via Merger

The primary disadvantage of exit via merger is the need for the merging companies to integrate their businesses into a single business. This can be very difficult for a variety of reasons. For example, if the two companies have vastly different information systems, it can be expensive converting the merged entity to a single system. Another factor that is often cited as an impediment to a successful merger is if the merging businesses have different cultures. A venture's "culture" consists primarily of the unspoken understandings that people share about, for example, how work is done and how customers are handled. If these are not aligned, the merged entity may have a difficult time bringing the two workforces into a cohesive unit.

Another disadvantage of exit via merger is that it can be more time consuming and expensive than other exit options. For example, a merger will require that both of the merging parties undergo due diligence and valuation. The reason this is necessary is that shareholders in the separate entities need to be compensated proportionately based on the combined value of the newly merged entity. In order to determine one's share of the merged entity, it is necessary to have agreement on how much of the merged entity's value was contributed by each of the merging companies. That proportion will then be used to allocate new company shares to the combined ownership pool. This process of valuation, new stock creation and distribution, and other things associated with merging can be expensive and time consuming. Both parties need to be highly motivated to complete the deal.

13.7 EXIT VIA INITIAL PUBLIC OFFERING

Going public via what is called an IPO occurs when the entrepreneur and other owners of the venture offer and sell some part of the company to the public through a registration statement filed with the Securities and Exchange Commission (SEC) pursuant to the Securities Act of 1933. The resulting capital infusion to the company from the increased number of stockholders and outstanding shares of stock provide the company with financial resources and a relatively liquid investment vehicle. Consequently, the company will have greater access to capital markets in the future and a more objective picture of the public's perception of the value of the business. However, given the reporting requirements, the increased number of stockholders, and the costs involved, the technology entrepreneur must carefully evaluate the advantages and disadvantages of going public before initiating the process. Here we'll review some of the major factors and documents associated with IPO transactions. We'll begin by examining the timing of the transaction.

13.7.1 Timing

Is this a good time for the venture to initiate an IPO? This is the critical question that technology entrepreneurs must ask themselves before launching this effort.[19] Some critical questions in making this decision follow.

First, is the company large enough? Although it is not possible to establish rigid minimum-size standards that must be met before a venture can go public, New York investment banking firms prefer at least a 500,000 share offering at a minimum of $10 per share. Assuming that the company is willing to sell shares representing not more than 40% of the total number of shares outstanding after the offering is completed, this means that, in order to support this $5 million offering, the company would have to have a post-offering value of at least $12.5 million. This size offering will only occur with past significant sales and earnings performance or a solid prospect for future growth and earnings.

Second, what is the amount of the company's earnings, and how strong is its financial performance? Not only is this performance the basis of the company valuation, but also it determines if a company can successfully go public and the type of firm willing to underwrite the offering.

Third, are the market conditions favorable for an IPO? Underlying the sales and earnings, as well as the size of the offering, is the prevailing general market condition.[20] Market conditions affect both the initial price that the entrepreneur will receive for the stock and the aftermarket—the price performance of the stock after its initial sale. Some market conditions are more favorable for IPOs than others.

Fourth, how urgently is the money needed? The entrepreneur must carefully appraise both the urgency of the need for new money and the availability of outside capital from other sources. Given that the sale of common stock decreases the ownership position of the technology entrepreneur and other equity owners, the longer the time before going public, given that profits and sales growth occur, the less percentage of equity the technology entrepreneur will have to give up per dollar invested.

Finally, what are the needs and desires of the present owners? Sometimes the present owners lack confidence in the future viability and growth prospects of the business or they have a need for liquidity. Going public is frequently the only method for present stockholders to obtain the cash needed. The Mini-Case below discusses the 2012 Facebook IPO and what it meant to shareholders.

MINI-CASE

Facebook IPO Raises $18B

Oh, to be 28 and a multi-billionaire. That's the outcome of Facebook's IPO for founder and 50% shareholder Mark Zuckerberg. Facebook went public on the NASDAQ exchange on May 18, 2012 amidst much fanfare and hype. The stock was priced at $38/share but opened at over $42/share. More than 82 million shares of the Internet giant were traded in the first 30 seconds after it began trading. On opening day, the stock reached a high of $45/share before settling down and closing just above the IPO price of $38/share. Final trading volume for the day was more than 573 million shares. Zuckerberg's stake in Facebook is estimated to be more than $19 billion. The IPO raised $16 billion for the company to use to grow and hunt for ways to monetize its more than 800 million active users. That is roughly one-eighth of the entire world's population.

Source: *Adapted from Koba, M. 2012. "Facebook's IPO: What We Know."* CNBC.com, *http://www.cnbc.com/id/47043815/Facebook_s_IPO_What_We_Know_Now, accessed on May 20, 2012; Deluca, M. 2012. "Facebook IPO by the Numbers: Zuckerberg's Loot and More."* The Daily Beast, *http://www.thedailybeast.com/articles/2012/05/18/facebook-ipo-by-the-numbers-zuckerberg-s-loot-more.html, accessed on May 20, 2012.*

13.7.2 Selecting an Investment Bank

While a public offering of equity can be through direct sales (e.g., over the Internet) to the public (assuming compliance with all securities laws and regulations), public offerings are normally done through an **underwriter** that acts as an intermediary between the venture issuing the stock and the public. The venture enters into an agreement with the underwriter pursuant to which the underwriter distributes the securities to dealers (brokers) for resale to the public.

Once the entrepreneur has determined that the timing for going public is favorable, he or she must carefully select a managing **underwriter**, an investment bank that will take the lead in forming an **underwriting syndicate**.[21] For example, Goldman Sachs is an investment bank with broad and deep experience as an IPO underwriter. The firm selected to perform as the lead investment bank is of critical importance in establishing the initial price for the stock of the company, in supporting the stock in the aftermarket, and in creating a strong following among security analysts. A syndicate is a group of investment banks and other, usually institutional investors who subscribe to the IPO. That means, they designate in advance how many shares they will purchase at the IPO. This is important because it could be disastrous for a venture to have an IPO where no one purchased the stock.

Selecting the investment banker is a major factor in the success of the public offering. So, the entrepreneur should approach one through a mutual contact. Commercial banks, attorneys specializing in securities work, major accounting firms, providers of the initial financing, or prominent members of the company's board of directors can usually provide the needed suggestions and introductions. As the relationship will be ongoing, not ending with the completion of the offering, the technology entrepreneur should employ several criteria in the selection process, such as reputation, distribution capability, advisory services, experience, and cost.

The success of the offering also depends on the underwriter's distribution capability. An entrepreneur wants the stock of his or her company distributed to as wide and varied a base as possible. As each investment banking firm has a different client base, the entrepreneur should compare client bases of possible managing underwriters. Is the client base made up predominately of institutional investors, individual investors, or balanced between the two? Is the base more internationally or domestically oriented? Are the investors long-term or speculators? What is the geographic distribution—local, regional, or nationwide? A strong managing underwriter and syndicate with a quality client base will help the stock sell well and perform well in the **aftermarket**. The aftermarket is the term used to refer to the performance of a stock in the public markets after the excitement of the IPO has subsided. How a stock performs in the long run is often dependent on the ability of the underwriters to gain interest from *their* investors.[22]

The final factor to be considered in the choice of a managing underwriter is cost. Going public is a very costly proposition and costs *do* vary greatly among underwriters. The average gross spread as a percentage of the offering between underwriters can be as high as 10%. Costs associated with various possible managing underwriters must be carefully weighed against the other four factors. The key is to obtain the best possible underwriter and not try to cut corners given the stakes involved in a successful IPO.

13.8 REGISTRATION STATEMENT AND TIMETABLE

Once the managing underwriter has been selected, a planning meeting should be held of company officials responsible for preparing the **registration statement**, the company's independent accountants and lawyers, and the underwriters and their counsel. At this important meeting, frequently called the "all hands" meeting, a timetable is prepared, indicating dates for each step in the registration process. This timetable establishes the effective date of the registration, which determines the date of the final financial statements to be included. The company's end of the year, when regular audited financial statements are routinely prepared, is taken into account to avoid any possible extra accounting and legal work. The timetable should indicate the individual responsible for preparing the various parts of the registration and offering statement. Problems often arise in an IPO due to the timetable not being carefully developed and agreed to by all parties involved.

After the completion of the preliminary preparation, the first public offering normally requires six to eight weeks to prepare, and file the registration statement with the SEC. Once the registration statement has been filed, the SEC generally takes four to eight weeks to declare the registration effective. Delays frequently occur in this process, such as: (1) during heavy periods of market activity, (2) during peak seasons, such as March, when the SEC is reviewing a large number of proxy statements, (3) when the company's attorney is not familiar with federal or state regulations, (4) when a complete and full disclosure is resisted by the company, or (5) when the managing underwriter is inexperienced.

In reviewing the registration statement, the SEC attempts to ensure that the document makes a full and fair disclosure of the material reported. The SEC has no authority to withhold approval of or require any changes in the terms of an offering that it deems unfair or inequitable as long as all material information concerning the company and the offering are fully disclosed. The National Association of Securities Dealers (NASD) will review each offering, principally to determine the fairness of the underwriting compensation and its compliance with NASD bylaw requirements.

13.8.1 The Prospectus

The prospectus portion of the registration statement is almost always written in a highly stylized narrative form because it is the selling document of the company. Although the exact format is decided by the company, the information must be presented in an organized, logical sequence and in an easy-to-read, understandable manner in order to obtain SEC approval. Some of the most common sections of a prospectus include: the cover page, prospectus summary, the company, risk factors, use of proceeds, dividend policy, capitalization, dilution, selected financial data, the business, management and owners, type of stock, underwriter information, and the actual financial statements.

The cover page includes such information as company name, type and number of shares to be sold, a distribution table, date of prospectus, managing underwriter(s), and syndicate of underwriters involved. There is a preliminary prospectus and then a final prospectus once approved by the SEC.

The preliminary prospectus is used by the underwriters to solicit investor interest in the offering while the registration is pending. The final prospectus contains all of the changes and additions required by the SEC and blue sky examiners and the information concerning the price at which the securities will be sold. The final prospectus must be delivered with or prior to the written confirmation of purchase orders from investors participating in the offering.

13.8.2 The Red Herring

Once the preliminary prospectus is filed, it can be distributed to the underwriting group. This preliminary prospectus is called a **red herring** because a statement printed in red ink appears on the front cover which states that the issuing company is not attempting to sell its shares. The red herring for Mahindra Holidays and Resorts, an India company, is shown in Exhibit 6.3. The registration statements are then reviewed by the SEC to determine if adequate disclosures have been made. Some deficiencies are almost always found and are communicated to the company either by telephone or a *deficiency letter*. This preliminary prospectus contains all the information contained in the final prospectus except that which is not known until shortly before the effective date: offering price, underwriters' commission, and amount of proceeds.

13.8.3 Reporting Requirements

Going public requires a complex set of reporting requirements. The first requirement is the filing of a Form SR sales report, which the company must do within 10 days after the end of the first three-month period following the effective date of the registration. This report includes information on the amount of securities sold and still to be sold, and the proceeds obtained by the company and their use. A final Form SR sales report must be filed within 10 days of the completion or termination of the offering.

The company must file annual reports with the SEC on Form 10-K, quarterly reports on Form 10-Q, and specific transaction reports on Form 8-K. The information in Form 10-K on the business, management, and company assets is similar to that in Form S-1 of the registration statement. Of course, audited financial statements are required.

The quarterly report on Form 10-Q contains primarily the unaudited financial information for the most recently completed fiscal quarter. No 10-Q is required for the fourth fiscal quarter.

A Form 8-K report must be filed within 15 days of such events as the acquisition or disposition of significant assets by the company outside the ordinary course of the business, the resignation or dismissal of the company's independent public accountants, or a change in control of the company.

The company must follow the proxy solicitation requirements regarding holding a meeting or obtain the written consent of security holders. The timing and type of materials involved are detailed in the Securities and Exchange Act of 1933.

These are but a few of the reporting requirements of public companies. All the requirements must be carefully observed, because even inadvertent mistakes can have negative consequences on the company. The reports required must be filed on time.

13.8.4 Advantages of Exit Via IPO

There are three primary advantages of going public: obtaining new equity capital, obtaining value and transferability of the organization's assets, and enhancing the company's ability to obtain future funds. Whether it is first-stage, second-stage, or third-stage financing, a venture is in constant need of capital. The new capital provides the needed working capital, plant and equipment, or inventories and supplies necessary for the venture's growth and survival. Going public is often the best way to obtain this needed capital on the best possible terms.

Going public also provides a mechanism for valuing the company and allowing this value to be easily transferred among parties. Many family-owned or other privately held companies may need to go public so that the value of the company can be disseminated among the second and third generations. Venture capitalists view going public as the most beneficial way to attain the liquidity necessary to exit a company with the best possible return on their earlier-stage funding. Other investors, as well, can more easily liquidate their investment when the company's stock takes on value and transferability. Because of this liquidity, the value of a publicly traded security sometimes is higher than shares of one that is not publicly traded. In addition, publicly traded companies often find it easier to acquire other companies by using their securities in the transactions.

The third primary advantage is that publicly traded companies usually find it easier to raise additional capital, particularly debt. Money can be borrowed more easily and on more favorable terms when there is value attached to a company and that value is more easily transferred. Not only debt financing but future equity capital is more easily obtained when a company establishes a track record of increasing stock value.

13.8.5 Disadvantages of Exit Via IPO

Although going public presents significant advantages for a new venture, the numerous disadvantages must be also carefully weighed. Some technology entrepreneurs want to keep their companies private, even in times of a hot stock market. Why do technology entrepreneurs avoid the supposed gold rush of an IPO?

One of the major reasons is the public exposure and potential loss of control that can occur in a publicly traded company. To stay on the cutting edge of technology, companies frequently need to sacrifice short-term profits for long-term innovation. This can require reinvesting in technology, which in itself may not produce any bottom-line results, particularly in the short run.

Some of the most troublesome aspects of being public are the resulting loss of flexibility and increased administrative burdens. The company must make decisions in light of the fiduciary duties owed to the public shareholder, and it is obliged to disclose to the public all material information regarding the company, its operations, and its management. One publicly traded company had to retain a more expensive investment banker than would have been required by a privately held company in order to obtain an "appropriate" fairness opinion in a desired acquisition. The investment banker increased the expenses of the merger by $150,000, in addition to causing a three-month delay in the acquisition proceedings. Management of a publicly traded company also spends a significant amount of additional time addressing queries from shareholders, press, and financial analysts.

If all these disadvantages have not caused the technology entrepreneur to look for alternative financing other than an IPO, the expenses involved may. The major expenses of going public include accounting fees, legal fees, underwriter's fees, registration and blue sky filing fees, and printing costs. The accounting fees involved in going public vary greatly, depending in part on the size of the company, the availability of previously audited financial statements, and the complexity of the company's operations. Generally, the costs of going public are around $300,000 to $600,000, although they can be much greater when significant complexities are involved. Additional reporting, accounting, legal, and printing expenses can run anywhere from $50,000 to $250,000 per year, depending on the company's past practices in the areas of accounting and shareholder communications.

The underwriters' fees include a cash discount (on commission), which usually ranges from 7% to 10 % of the public offering price of the new issue.

In some IPOs, the underwriters can also require some compensation, such as warrants to purchase stock, reimbursement for some expenses—most typically legal fees—and the right of first refusal on any future offerings. The NASD regulates the maximum amount of the underwriter's compensation and reviews the actual amount for fairness before the offering can take place. Similarly, any underwriter's compensation is also reviewed in blue sky filings.

There are also other expenses in the form of SEC, NASD, and state blue sky registration fees. The final major expense—printing costs—typically ranges from $50,000 to $200,000. The registration statement and prospectus discussed later in this chapter account for the largest portion of these expenses. The exact amount of expenses varies depending on the length of the prospectus, the use of color or black and white photographs, the number of proofs and corrections, and the number printed. It is important for the company to use a good printer because accuracy and speed are required in the printing of the prospectus and other offering documents.

Regardless of how much preparation occurs, almost every entrepreneur is unprepared and wants to halt it at some time during the makeover process. Yet for a successful IPO, each entrepreneur must listen to the advice being given to make the recommended changes swiftly.

13.9 CHAPTER SUMMARY

This chapter examined the topic of valuing and exiting your technology venture. We began by reviewing the due diligence process that usually precedes an exit event. Due diligence is the process used by those who will be acquiring or investing in the venture to ensure that it meets their guidelines and standards. Entrepreneurial ventures can prepare for the due diligence process by running the business efficiently and effectively from the beginning. That means establishing management systems that are aligned with industry best practices and abiding by the accounting rules governing the industry in which the venture competes.

Next we discussed the concept of enterprise value and explored some of the ways in which venture valuation is determined. For example, using a recent valuation within the industry as a comparison, one can then get a rough estimate of the value of another venture. In some industries, a rough valuation can be determined based on a key metric. For example, if a social media company with one million registered users was recently acquired for $5 million, then the value of each registered user was $5. Using simple math, one then can calculate the value of another social media company by multiplying the number of registered users by $5.

More sophisticated valuation techniques are based on future cash flow projections of a company to derive a net present value. Various techniques use different discount rates to account for the risks associated with particular industries.

Next we examined the various strategies that technology entrepreneurs can use to exit their ventures, including succession, acquisition, merger, and IPO. Each of these exit strategies represents a liquidity event for the entrepreneur, and each has its advantages and disadvantages. In particular, the strategies of acquisition, merger, and IPO will be preceded by in-depth due diligence which can be costly and time consuming. Succession, on the other hand, is fraught with its own challenges because it involves handing down ownership of a venture to one's heirs. Entrepreneurs should build their companies from the beginning with some idea in mind of how they would like to exit. The manner in which a company is built and positioned can affect the ease and likelihood of fulfilling a particular exit strategy.

KEYTERMS

Due diligence Involves examining a number of key elements of a target venture, including its financial health, the potential for synergy, the market position and future potential of the venture, the research and development history and roadmap for the venture, legal considerations, and plans for managing the acquired entity.

Valuation The term used to refer to the process and calculations used to establish a dollar value for a venture.

Exit strategy The technology entrepreneur's strategic withdrawal from ownership or operation of his or her venture.

Investment horizon The time an investor's money will be tied up in a technology venture until the time of exit.

Liquidity event The exit from a private venture for shareholders that represents their opportunity to covert shares to cash.

Synergy A concept where the phrase, "the whole is greater than the sum of its parts" is a good definition.

Enterprise value The value of the enterprise as a whole.

Market capitalization The value of public companies calculated as a function of the number of outstanding shares times the price per share.

Present value The value in today's dollars of some future cash flow; because money today can earn interest, future cash flows must be discounted by at least as much as that interest amount to convert to its present value.

Discount rate A discount rate where in conducting a present value analysis, a future cash flow must be discounted by the rate of interest that otherwise could be earned by present dollars.

Risk-adjusted discount rate A discount rate used in the discounted cash flow valuation technique that includes both the alternative investment risk and the venture risk.

Acquisition A transaction involving two companies in which one company purchases the other; the company that is purchased no longer exists, but is incorporated into the other company.

Value drivers Strategic advantages that lead to value creation in an industry and that are attractive elements of an acquisition candidate in an industry.

Vertical strategy A marketing strategy that targets clients by industry type.

Direct purchase A purchase of the firm in which the acquiring company often obtains funds from an outside lender or the seller of the company being purchased.

Bootstrap purchase A purchase where the acquiring company can acquire a small amount of a firm, such as 20% to 30%, for cash; the acquiring company then purchases the remainder of the target venture by a long-term note that is paid off over time out of the acquired company's earnings.

Serial entrepreneur A type of entrepreneur that starts multiple ventures over a career.

Business broker Third-party agents who assist entrepreneurs in the exit process.

Merger A transaction involving two or more companies in which the companies join to form a new bigger company.

Earn-out An strategy used for ventures that have begun to generate consistently strong positive cash flow; the management team initiates a monthly or quarterly buyback of common stock from the owners of one of the merged entities.

Initial public offering A process whereby a private company qualifies to sell its shares on a public stock exchange.

Underwriter A company that administers the public issuance and distribution of securities; a company will utilize one when filing an IPO.

Underwriting syndicate A group of investment banks and other, usually institutional investors who subscribe to an IPO.

Aftermarket The term used to refer to the performance of a stock after the excitement of the IPO has subsided; how a stock performs in the long run is often dependent on the ability of the underwriters to gain interest from their investors.

Registration statement Document filed with the SEC before a company can go public; it consists of two parts: the prospectus and the registration statement.

Red Herring The name given to the preliminary prospectus document due to the red ink used in the printing of the front cover.

ADDITIONAL READING

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WEB RESOURCES

http://www.nvca.org/ This is the website for the National Venture Capital Association. It has many resources and helpful guides to conducting rational venture valuations.

http://www.inc.com/tools/due-diligence-checklist.html: This website provides a due diligence checklist for ventures, which helps them prepare for a thorough due diligence prior to an exit event.

http://venturebeat.com/: This is a good site for tracking recent acquisitions, mergers, IPOs, and other news associated with technology ventures.

ENDNOTES

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