"The book provides a thorough yet easy-to-follow playbook for entrepreneurs and VCs. It includes countless real-world examples that are both educational and entertaining. It's packed with tons of great lessons." —RICK MARINI, founder and CEO, BranchOut

THE ENTREPRENEURIAL BIBLE TO VENTURE CAPITAL

INSIDE SECRETS FROM THE LEADERS IN THE STARTUP GAME

CO-FOUNDER AND CO-CHAIRMAN OF GEORGETOWN ANGELS

ANDREW ROMANS

FOUNDER AND GENERAL PARTNER OF THE FOUNDERS CLUB

THE ENTREPRENEURIAL BIBLE TO VENTURE CAPITAL

INSIDE SECRETS FROM THE LEADERS OF THE STARTUP GAME

ANDREW ROMANS

Mc Graw Hill Education

New York Chicago San Francisco Athens London Madrid
Mexico City Milan New Delhi Singapore Sydney Toronto

8

Which Way to the Exit?

I made most of my money selling too early.

J. P. Morgan

M&A Is the Most Likely Positive Outcome for Most Entrepreneurs

Merger and acquisition (M&A) is the most likely positive outcome for most angel- or VC-backed technology startups and therefore worth understanding from the first moment you begin to conceive your new venture or as you move along the journey to exit. For acquirers M&A is about a lot of things. Is a dollar spent on acquisitive growth better than a dollar spent on organic growth? M&A is about revenue growth, innovation, augmenting the DNA of your employees and core leadership team, lowering attrition, and increasing the "coolness" of your company to appeal to new recruits. M&A is about confidence within a company, confidence in the macroeconomic environment, defense, economies of scale. M&A is about animal instincts.

Practical Ideas and Advice When Selling Your Company via M&A

It's rumored that Google had a chance to sell to Excite for $1 million and turned it down. I turned down an offer to sell my company for $6 million when I owned 50 percent of it with no investors. Instead of selling, I gambled, raising trainloads of VC funding. I went for it. More on that later.

When you go to networking events and conferences, lawyers and accountants will tell you tons of things you need to prepare and tidy up before selling your company.

The best advice I hear on selling your company is this: don't focus on *selling* your company, but rather focus on *building* a great company with strong revenue growth and very happy customers and partners. If you do that well, buyers will find you.

Keep talking to bankers and analysts about your business. These bankers have regular meetings with the big balance sheet buyers like Google. When they visit these acquisitive companies, they want to differentiate themselves from the other bankers. They want to be able to ask, "Have you heard of company XYZ?" That could be Goldman Sachs or Morgan Stanley pitching your deal to Google. It is worth your time to keep these bankers up on your company.

When you are approached by corporate development from some big balance sheet buyer like Google or Yahoo!, respond professionally but don't drop your focus on sales, on keeping your customers happy, and keeping your business on track. Everyone has seen a company sign a letter of intent (LOI) with a big balance sheet buyer, only to see the due diligence (DD) process became so grueling that sales slip, causing the price the buyer is willing to pay drop as well.

Everyone will tell you that you should never negotiate with only one buyer or investor. Good advice of course, but not possible for everyone. If you can, of course, try to get as many buyers to the table as you can, hire a banker, and have the banker approach the full constellation of would-be buyers while you keep driving sales and your core business. Try to involve your lawyers, your investors, your whole network. Try to persuade them to do as much of this work as possible for you. Your number one BATNA (best alternative to the negotiated agreement) is to keep going and not sell. Be polite and professional, but remember your priorities: If you can't attend a meeting with a potential buyer because you need to see a customer or hire a crucial new employee, don't overstress; that's where you should be—running the business.

You should conduct DD on your buyer just as you should on your investors and suppliers. Once they start asking for more time and information, you should qualify how serious they are given where you are in the process. Some entrepreneurs think they are in play when they are not. Corporate development folks are doing their job to meet you for lunch, but there may be no momentum or rhythm of a deal that's going to happen anytime soon. I've seen some of my own CEOs defer raising their next financing round because they think they are in play—big mistake.

Feel free to ask the person you are dealing with whether the CEO and CFO have signed off on the deal. Do they even know about the discussion? Is there a group head or business division sponsoring this acquisition, or are you just a bright and shiny object the corp dev group thinks would be nice to have?

Every M&A discussion is like a job interview. You should figure out whether you really want to "work" at that company. Some deals are talent deals, just buying people with a quick tuck-in. Most deals are buying intellectual property (IP), strategic growth, or expansion of some kind; but *every* deal is a talent acquisition to some extent. Cultures should match. In an ideal world, you will have "violent likability" where the buyer thinks the personalities of the target company's senior management team are a perfect fit with the culture of the buying company.

On a legal and deal structure front, you should always ask for a non-disclosure agreement (NDA) before sharing too much info. Urge the buyer to sign a non-solicit agreement (NSA) preventing them from trying to hire your CTO and other members of your team who have the IP and know-how in their heads. Some acquisitions are about expanding their corporate DNA. Google was an algorithm place trying to become a Facebook and Groupon place.

Always get as much cash up front as you can. Often with acquisitions, part of the consideration is paid to the management team of the acquired company in the form of individual compensation referred to as *earn-outs*. Earn-outs are often tied to specific performance milestones defined in the M&A

agreement. Earn-outs come and go. I am basically against them at a high level for a variety of reasons. They can lead to misalignment of interests. They may result in messy legal disputes. If you are the company being purchased and a big slice of the exit is tied up in an earn-out, you may have little control over making that new business division perform. Most acquisitions are like scrambled eggs, where your company will be integrated into a bigger machine. Good luck driving the metrics that release your earn-out cash. You may have been purchased as a hot topical accessory that may become less relevant to the strategic direction of the acquirer over time. After the purchase, you may no longer be as relevant or the buyer may drop your business line altogether. You have no control over this. Your key employees may not dig working for the man and miss the good old days when you and your cofounder set the vibe in the office. On the flip side, if you see 50 percent of your exit tied up in the earn-out, you may become obsessed with hitting your numbers to see your cash. This may not be in the best interest of the overall company and may prevent you from moving up in the new organization. Bottom line, make these earn-out arguments and transform all that promise into cash today.

If you are dealing with a big balance sheet buyer like a Google, you will be forced to sign a no shop/no talk agreement that says you will not shop your company to other prospective buyers during the period of time that Google is engaged to consider buying you. Make sure none of your opportunistic friends are shopping your deal hoping for a referral fee. Keep control of the flow of information. Stay focused on your current business.

Big balance sheet buyers acquire companies for different reasons. There is a hierarchy in how much they value your company: revenue multiples, profit, IP, or employees. Understand the buyer's hierarchy and position your company to move from one category to another to increase what the buyer is willing to pay for your company. Here are the most common buyer's hierarchies:

1. Team hire ("acqui-hire")
2. Team buy
3. Technology buy
4. Business asset
5. Strategic asset

Team hire or *acqui-hire* is the lowest value the buyer will place on your company. The buyer is literally picking up some technical talent for specific industry segments like apps or mobile, or for segments with a different DNA like gaming, social, or Groupon-esque daily deals. The team may be dispersed once the acquisition is made.

Team buys can have larger ticket size and range between $1 to 5 million paid per manager or engineer. In this case the team will stay together working on the same product or service, but the buyer does not see any acquisition of intellectual property or major market share.

In a *technology buy*, the technology is integrated into the acquiring company, hence worth more. Deal size goes up, and the terms get better for the purchased company. With a technology buy there are likely to be more companies competing to acquire the prized technology. The buyer might even buy the technology and not use it, to ensure that its competitor does not acquire it to fill a product gap or move ahead of the buyer.

Business asset is the same as a technology buy, but with more revenue and customers. Unlike the previous categories, discounted cash flow (DCF) models are used to value the purchase, both for the stand-alone company as well as for the integrated post-acquisition company. The deal size can be significant for business asset purchases. Classic M&A value is calculated considering how the buyer can increase sales of the target, reduce costs with roll-up economics, consolidate payroll and human resources (HR), and so on. Specific customers, actual contracts, and operating in new geographies begin to add to the price tag, making these acquisitions more and more valuable.

Strategic assets are the truly unique buys. There was only one YouTube, and Google had to own it. Facebook could not allow Twitter or Google to buy Instagram. This is essentially like bidding for the Mona Lisa—only one company with that one technology and that real category-killer business. Discounted cash flow is considered, but the auction drives up the value and the world reels at the price.

Once you determine in which category the buyer slots you, your job is to convince them that, with time, they will benefit from elements in the hierarchy above you. Help the buyer justify a higher price and more upfront payment to their target: your company. Identifying the buyer that gains the most from acquiring the mix of what you bring will also move you up the buyer's hierarchy.

If you are within 6 to 18 months of selling your company, now is the time to contact a reputable wealth management group that can help put your family estate plan in place to optimize your benefit over time. Trying to do this just before an exit is not a good idea.

Three Kinds of Business Buyers

Dave Berkus, author and business angel, describes three kinds of business buyers:

> This is one of my favorite insights, since I lived this one in a positive exit from my computer business. Most people will tell you that there are two kinds of eventual buyers for your business: financial and strategic. A *financial buyer* will analyze your numbers, past and forecast, to the nth degree and calculate the price based upon the result, after carefully comparing your numbers with those of others in the same and similar industries. The object of a financial purchase is to negotiate a bargain, capable of payoff through operating profits or growth over time, or even of immediate profit from arbitrage—knowing of a purchaser that is willing to pay more for your company if repackaged, or even with no changes at all.
>
> A *strategic purchaser* is one that understands what your company has to offer in its marketplace and how your company will add extra value to the purchaser's company. Strategic buyers look for managerial talent, intellectual property, geographic expansion, extension into adjacent markets, and more that will be achieved with the acquisition of your company. Such a purchaser usually is willing to pay more to secure this new leverage, understanding that the value of the acquisition is more than the mere financial value of your enterprise. Most investment bankers will coach you into

helping them find you a strategic buyer, knowing that such sales are quicker, often less focused upon the small warts of a business, and yield higher prices than financial sales.

There is a third class of buyer I discovered firsthand when selling my company—the *emotional buyer*. This rare buyer needs your company. He must have you or one of your competitors, and now. The buyer may be a public company attempting to defend decreasing market share and being overly punished by Wall Street. You may represent the only obvious way to protect against obsolescence from a buyer's declining marketplace or failure to compete against others with better, newer technologies. You may be a most successful direct competitor, one that the buyer's salespeople have observed jealously and nervously, sometimes even jumping over to your company as a result. No matter what the emotional focus, the buyer cannot continue to stand by and watch its business challenged so effectively. The price negotiated is not at all the critical factor in the emotional sale. It is the elimination of pain that drives the buyer to action.

I experienced just this phenomenon and profited by the added value in the transaction provided by an emotional public company buyer for my business. The potential buyer was a hardware company, well aware that margins were decreasing and that software companies, once considered mere vehicles to help sell hardware, were now becoming the central component in a sale, mostly because hardware was fast becoming a commodity as prices dropped. My buyer-candidate had previously licensed our firm as a distributor, a value-added reseller for its hardware. As we grew to capture 16 percent of the world market in our niche, we successfully migrated from the single platform of the buyer-candidate onto hardware from any of its competitors from IBM to NCR to HP and others. At the same time, the buyer-candidate realized that we had become its largest reseller. In one of many meetings with the buyer's CEO, I "accidentally" dropped the truthful fact that his hardware now accounted for only about a third of our hardware revenues, down from 100 percent several years earlier. It did not take but moments for him to realize that his largest reseller was giving his company only a third of its business, that his revenues were declining and ours increasing dramatically. Simple in-the-head math shocked him into the realization that if he could increase our use of his equipment in more sales, he could slow or stop the decline in his revenues and he could migrate into a more software-centric company, much more highly valued by Wall Street, which was punishing his company for its decline and coming obsolescence.

The resulting negotiation was rather quick and very lucrative for our side. It was the first time I had witnessed an emotional buyer, and I appreciated the difference between "strategic" and "emotional" immediately. Ever since, I have been urging my subsequent company CEOs and boards to perform an exercise at regular intervals to seek out and identify future strategic and emotional buyers.

How Instagram Secured a $1 Billion Valuation

Nic Brisbourne, partner at DFJ-Esprit, reviews the factors in Instagram's high valuation by Facebook:

> Facebook's $1 billion acquisition of Instagram has triggered discussions about how and why such a young startup with no revenues could achieve such a high valuation. If the gossip and rumors are to be believed, Instagram employed two pretty standard tactics to maximize their valuation on exit. First they used a venture capital round to induce Twitter to make an offer; next they took that offer to Facebook and doubled their valuation.
>
> There are elements of this that every startup can learn from. If you have M&A discussions that are not moving forward as fast as you would like, then raising a round of venture forces the poten-

tial acquirer into making a decision. They know that once a round is closed the valuation required to get a deal done will likely have to go up in order to satisfy the new investors; so if they want the company they will get off the pot and make an offer. According to Venturebeat, Instagram had been talking to Twitter for some time but didn't get an offer until their venture deal was about to close.

Fear and competition are important drivers in M&A. It is often the case that market leaders only become interested in buying startups when they learn that one of their competitors is close to making an acquisition; they start to fear for their market dominance. Photo sharing is at the heart of Facebook, and they are vulnerable on mobile. It is easy to see how the combination of Twitter's strength and Instagram's coolness might trouble them.

Obviously, these strategies only work if the startup is highly desirable. Instagram was hot enough to be wanted by Twitter, courted by venture capitalists, and scary to Facebook. Most startups aren't that lucky. It is important to be realistic about potential exit valuations and whether the company is special enough that acquirers will enter into a bidding war.

When I met Gary Johnson, director of corporate development at Facebook, I couldn't help but ask him about Instagram. He said, "Before talking price and terms when seeking to sell your company, you should first take the time to talk alignment, vision, product road map, cultural fit, etc. This is what happened with Instagram. We made sure that we agreed perfectly on the best way to share photos; the result is successful integration and retention of the team. Instagram went from 27 million to 100 million users in a matter of weeks. It was a $1 billion acquisition, now undoubtedly a huge success."

Advice on the $300 Million Sale of Adify

When Yahoo! called Russ Fradin, CEO and cofounder of Dynamic Signal and former CEO and cofounder of Adify, saying they wanted to buy his company, he was professional and took the position of, "Sure, I'm happy to tell you what we do . . . we'd be happy to sell our company to you, but we are in no rush, we are focused on our business and, oh, by the way, we are getting more valuable every day." Be professional and share information, but don't be or appear to be too eager.

How Liquidation Preferences and Carve Outs Play in Exit Scenarios

Antoine Papiernik, partner at Sofinnova Partners, gives this insight:

> The more VCs involved with a company, the harder it becomes to bring the company to an exit. With many VCs in the cap table, you get many differing point of views and motivations around each financing, staffing, and exit decision. Some of the VCs may be limited on cash to continue to invest in that company the reserves of their fund, the timing of their fund, loss of belief in the company, and many other factors. Management needs to lead a company to an exit with the support of a subset of the board. If management does not get paid, the exit will not happen. Liquidation preferences dictate how much of the exit price goes to pay back VCs before management gets any money from the exit proceeds. The result is that companies have a specific liquidation preference hurdle to clear before management sees any cash. Often in the capital-intensive deals the liquidation preference may be \$150 million to \$250 million.
>
> As a result, if an opportunity comes along to sell the company for \$250 million rather than \$1 billion, the VCs may not see that opportunity. Management simply would not inform the VCs of this. This is bad. So VCs need to provide management with an incentive. This is done with a management incentive plan known as a carve out. We at Sofinnova make sure our managers have carve outs so they know they will benefit from a sale. This is not the VC

> "being nice." VCs will regret it if you don't put these in place. We once had a deal where we invested in the series A alone and then carried the company through series B and C. We could have sold the company after series A and gotten our money back; but instead we replaced the CEO, recapped, and kept fighting on. We then ended up with a third CEO before getting to the exit with a 3-times liquidation pref. These nightmares and recaps could have been avoided had we exited after series A and rewarded the founding CEO. This is a mistake we would not make again. In the end, management needs to lead the company to an exit with the support of at least a subsection of the board.

Antoine Papiernik at Sofinnova is right. Always put a carve out in place. Do not wait until you think you need one to keep management around for a sale that returns 1 times your cash back or most of your cash back. Put a carve out in place for 100 percent of your deals so you get the information. You can always block the sale.

How to Smoke Out the Serious VCs in Your Syndicate

Antoine Papiernik had this to say about working with VCs:

> Sometimes a CEO or leading VC needs to smoke out the VCs that are not serious about supporting and building the company. One option at your disposal is to put in place a bridge financing with a 20-times liquidation preference plus a new option plan for management. This is a pay to play, and you find out pretty quickly who wants to play. If investors do not invest, they get washed out. You can't accept free riders who want to find reasons to look for the future. Only soldiers that can fight should be in the battle. If you lose belief, sell for one dollar. Toxic prefs protect against a dead syndicate.

Large Trade Sales of Private, Venture-Backed Medical Device Companies

Antoine Papiernik, partner at Sofinnova Partners, reviewed a few of the largest trade sales of a private, venture-backed medical device company in history:

> We put €49 million into Movetis and three years later sold the company for $428 million. This was a triple-digit exit for the founder, Dirk Reyn. We invested €4.5 into CoreValve, beating out two U.S. competing VCs, then followed 18 months later with a $33 million round, syndicating with Apex and Maverick; then sold to Medtronic for a $700 million up-front payment with 2 times $700 million in earn-outs, one of the largest trade sales of a private, venture-backed medical device company in history. This surgeon entrepreneur started with no money and personally reached a triple-digit exit in five years.

Acqui-hire Early Exits: VCs Versus Founders

Benjamin D. Kern, partner at McGuireWoods, discusses early exit scenarios where investors' and founders' interests conflict:

> During periods following spikes or rapid growth of seed stage or series A and B–round funding, it becomes more common to see companies acquired in their early stages, sometimes pre-revenue and before their products or approaches have matured. Established businesses who seek to grow their teams or technology platforms may make strategic purchases of startup companies because the valuations can be relatively low, and because the founding management team may have entrepreneurial energy to add to the acquirer's team. For investors, these "early" exits rarely represent a significant

ROI. This type of deal may be structured to provide a minimum positive return to investors, while the purchaser dangles contingent compensation packages potentially worth several million dollars over time in front of the young management team. Most standard investment documents do not anticipate these types of exits or provide investors with more than basic tools to leverage in the discussions with the founders or acquirer.

These early exits may invoke a discussion parallel to investors' "jockey versus horse" debate. While the quality of a company's management team is generally considered an important factor in making an investment decision, "horse" investors approach portfolio companies with the assumption that a management team may be reconfigured over several years. "Jockey" investors, however, cite the management team as the primary factor in choosing investments. When early-stage activity spikes, demand for enthusiastic technology talent can result in competition among investors, as well as a type of competition between early-stage investors and the strategic acquirers that investors seek to work with at later stages.

In describing the value of the target, a strategic acquirer may point to the young but aggressive team (especially when talking to the team) and praise their energy and accomplishments. Whether or not the acquirer is confident in the team, using a "jockey" approach to acquiring a company results in acquisition terms that can have very favorable characteristics to the acquirer: e.g., low purchase price for the technology and comparatively high, but contingent, compensation to the founding team, often in the form of restricted stock. Once the founding team has been sold on the deal, the discussion turns to the boardroom.

Selling a deal with a minimal return to investors would ordinarily be all but impossible. An investor who doesn't like the proposed return will almost always have a blocking right that can be used to stop it. However, a blocking right can be a blunt tool, and may not lead to a better result for the investor. Early in the company's life cycle, the investor may not have deployed significant funds into the company. The management team may be lean, and after the acquirer's pitch, is often highly motivated to do the deal. Unlike later-stage companies, where the investor may have deep relationships with other board members and relationships in the company's industry, an early-stage investor new to an investment may not have a large array of alternatives. Early in these deals, the investor may still be building relationships and may need to consider carefully the impact of blocking a deal on reputation, particularly when the proposed price cannot be disclosed. It is sometimes easier to take the low, but positive, return and move on.

I first saw this deal structure and dynamic several years ago in a healthcare technology company. That structure seems to have become the default for early-stage acquisitions since the public offering and acquisition markets have again become more active.

For illustration, let's say that a group of young entrepreneurs develop "CatBox.me," a social media business that revolutionizes the sharing, tagging, and curation of adorable cat videos, with robust cross-platform integration capabilities. The business thrives on the founders' viral and enthusiastic social media following; with sponsorship deals and an advertising gold mine just over the horizon, the company raises $1.5 million in series A funding on a $3 million pre-money valuation, contingent on the founders quitting college and on conversion of the business to a C-corp.

The company uses the growth capital to expand its outreach team by hiring bloggers, and engages Ruby developers to do product development, adding a clean mobile interface, real-time geo-tagged uploading, and fault-tolerant, high-volume cat video streaming.

The founders work hard for a year, but fund-raising and corporate management require significant time from the founders. On a visit to a prospective corporate partner, a large online pet food business, the pet food business presents an acquisition offer to the founders.

The offer details $10 million in total consideration. The term sheet refers to an asset sale for $5 million, with $2.5 million stock retention packages for each of the two founders. All consideration payable to the founders, in both the asset purchase and the retention packages, would take the form of restricted stock, vesting over four years based on continued employment. The pet food company explains to the founders that it is building its own cat video distribution network, which will soon result in a well-funded competitor to CatBox.me. Acquiring CatBox.me will give the pet food company an advantage of several months in its development efforts, but only if the offer can be accepted within a day and completed within a matter of weeks. The pet food company goes on to say that while the CatBox product is of only marginal value, it sees the founders as exactly the kind of go-getters it needs on the pet food company's new social media team.

The founders do some back-of-the envelope math and think the numbers look good. The total consideration seems like it's about 3 times their last pre-money. When the founders look at how the consideration is allocated among all the stakeholders, they estimate that the investors would get about $1.7 million—more than the original investment, and that the founders would split the remaining $8.3 million. By the time the founders leave the meeting, each has already mentally spent the acquisition proceeds.

But the frantically called board meeting does not go well. The investor directors call the offer a nonstarter, pointing out that the asset purchase structure in a C-corporation could result in high tax costs, most of which may not be offset by net operating losses (NOLs). The return to the investors would be negligible, and the founders may be saddled with huge tax bills for the present year, without any cash proceeds to pay the taxes. The investors suggest that the founders ask for a much higher purchase price, without the compensatory elements, and that the deal be structured in a way that reduces the tax cost.

When the founders go back to the pet food company, it acknowledges some of the deficiencies in the tax structure, but indicates that without some of the tax characteristics it wanted, it will not be willing to offer as much for the company. The founders are given a new term sheet that suggests that the documentation will reflect a tax-free reorg structure, keeps the price to be paid in the merger at $5 million, and reduces the founders' compensation package offer from $2.5 million each to $2 million.

The founders have a difficult conversation with the board, in which the founders express their fatigue, suggest that the pet food company is losing interest, begin to question their ability to continue CatBox.me as a separate business, and point to new competition in the market and increased capital needs if they are to continue. For the first time, the founders become extremely bearish on the prospects for their company and suggest that accepting this offer may be the only hope the investors will ever have to recoup their investment.

Now the investors are faced with few attractive prospects. The founders have suggested that there is no possibility to ask again for a higher valuation. They have further suggested that any restructuring of the consideration package will be unacceptable for the pet food company, as a critical driver of the deal structure is to reward and motivate the "jockeys," rather than to pay for a "horse" near the end of its racing career.

The investors can block the deal through exercise of their negative covenants, leaving them with an investment in a company with damaged founder relationships and with an unmotivated management team. Or the investors can accept an extremely small return from several years' worth of work for the company, while the founders take rich compensation packages. The investors grudgingly decide to approve the acquisition.

Only after the difficult interactions with the board, and after negotiations have progressed, do the founders begin to understand more about the deal they've accepted. The restrictions on the stock they will be receiving present some risk that the transaction will be taxable to the founders, despite the term sheet's recitation of an intent to structure a tax-free reorganization. The restrictions also provide little comfort that the founders will actually receive value for the sale of the company, or receive the full compensation packages they've been banking on. There is no guarantee that the $7.3 million portion of the consideration that will take the form of restricted stock will be received, or will be worth the value recited for the stock at closing.

It is not clear whether the acquirer really believes that the founders are prodigies, worth multimillion-dollar, multiyear compensation offers. The founders momentarily wonder whether the acquirer really plans to pay out these packages, or whether it has used a strategic approach to gain access to a network of cat lovers, and a platform built over several years and with investor money, for as little as $1.7 million plus transaction costs. If the founders turn out not to be prodigies, or can be replaced within the pet food organization, the company can easily transition them out and hold onto large portions of the consideration.

This story, despite its gritty feline realism, is an amalgam of four or five formation-to-exit deals we've recently done on the company side or investor side. None of the details are real, but examples of deals like this can be found in numerous securities filings, typically without disclosure of any numbers.

A quick search of publicly disclosed information about similar deals produces comments like the following from companies embarking on acquisition sprees: "The [acquired company's] team [members] have already become valuable contributors to [the acquirer's] social media capabilities. We're thrilled to have them aboard and excited to see what we can create in 2013 and beyond. . . . The company has a who's-who list of investors." And the following, regarding what may happen after an acquisition: "Within a year of [acquirer's] acquisition of [acquired company], a daily deals site, the founders of [acquired company] have left the company for other entrepreneurial ventures."

Investors shake their heads at these deals, and examine their portfolios for others where the outcome can be prevented. Founders approach them with optimism that they will secure a nice nest egg, but an understanding that, at worst, they will have achieved a résumé-builder and a good learning experience. Acquirers look at these deals with interest, seeing them as an attractive way to mitigate risk and take advantage of the proliferation of early-stage funding.

In a postmortem on these deals, the investors and their lawyers may look at ways that the outcome may have been influenced. Here are some of the candidates for approaches more nuanced than the exercise of a negative covenant.

Treat a Management-Focused Acquisition as an Employment Deal

When an acquisition offer is heavily focused on compensation, the deal starts to look more like an employment offer than an acquisition. A heavy focus on compensation can take the form of management compensation well in excess of market compensation or the acquirer's payment of a significant portion of the purchase price in restricted stock that is contingent on continued employment.

Few investors would be comfortable knowing that their investment money was going to be used more for the purpose of building the founders' résumés for future employment than for the purpose of building the company's technology or market position. Investment documents typically include tools for dealing with the departure of a founder who wishes to seek other employment.

There are a number of implications to treating a term sheet as primarily an employment offer rather than an offer for enterprise acquisition. Among other things: (1) a founder who accepts other employment may not be able to retain his or her stock in the company; (2) for a company where replacing the founding management is an alternative, the investor's investment in the company and its technology may be able to continue, despite the founder's departure; and (3) the company may be able to constrain the departing founder from competing.

The first of these, related to the founder's stock, may require additional thought in the drafting of standard investment-related documents, and the restricted stock agreement in particular. A standard restricted stock agreement may provide that a founder's stock may be forfeited or repurchased at cost if the founder leaves the company prematurely (before the stock has vested). However, founders often negotiate change of control vesting, which would accelerate vesting of the stock on an acquisition transaction. These change of control vesting provisions typically do not set requirements for the type of acquisition that will trigger the vesting, but they can be drafted this way. For example, change of control vesting could require that a certain return be achieved for investors or could require that the proceeds of the transaction, defined broadly, be allocated in accordance with the provisions of the company's charter.

Say No before the Founders Are Shown the Money

In the fictitious CatBox.me, the founders were seduced by the numbers presented by the acquirer in the initial meeting and probably effectively made the decision to sell the company before the investors were consulted. In some circumstances, better results could have been achieved if the investors had dealt directly with the possibility of this type of acquisition before the founders are confronted with the acquirer's sales pitch. This can be signaled by provisions in a company charter or stockholders' agreement that establish definitions for a category of compensation-based transactions and treat approvals, redemption rights, or control provisions differently in the context of these transactions. For example, the company's documents could make clear that a transaction with a disproportionate portion of the total consideration going to the company's founders will invoke the founder's fiduciary duty to avoid self-dealing and require involvement in negotiations and approvals by disinterested directors.

Less formally, an investor could simply start a dialogue with the founders early on, in which the investor describes a compensatory transaction and signals to the company that these types of transactions will not be approved. If a founder knows the investor's ultimate position before being presented with this kind of opportunity, it is more likely that negotiation for a less compensatory deal will begin earlier, before the founder has become enamored of the idea of the compensatory transaction.

Define Liquidation Consideration Broadly to Include Excess Comp Paid to Founders

A rigid approach, giving an investor a better starting point in negotiations, would be one that defines acquisition sale proceeds broadly enough to include some portion of founder compensation as proceeds that must be split according to the liquidation waterfall. For example, if an acquisition offer purports to provide the founders with compensation valued at more than a threshold percentage (50 percent, for example) above what they are currently receiving, the amount of that compensation must be included in the funds to be split among all investors. This is an approach that is not often proposed, and when proposed, does not often survive the initial round of negotiations.

None of these alternatives is foolproof for an investor, and an acquirer may be firm and uncompromising in the way that proceeds are allocated. However, in heady early-stage investment times, investors are becoming increasingly conscious of the pitfalls of these early acquisitions and are seeking to find tools beyond traditional veto rights as a means to improve their ability to negotiate with a seductive acquirer who seeks to win over a management team.

Several Perspectives on Acqui-Hires

I recently asked the head of corporate development and senior corp dev execs at Facebook, Yahoo!, and another large Internet company (let's call that exec "Anon") about their perspectives on acqui-hires where much of the economics flow to the team and not the investors. This is what they said:

"Anon" found the question to be of paramount interest. He advises entrepreneurial teams to discuss this openly with their VCs rather than try to push it past them without transparency.

Gary Johnson, director of corporate development at Facebook, responded, "When you are at the inflexion point of taking first investment from VCs after angels or taking more cash from your VCs, that is a good time to come and talk to us."

Jackie Reses, executive vice president of people and development at Yahoo! (interestingly in charge of both M&A and HR), said, "If you see your startup is not working, you should come to us and let us get you working on something with a higher purpose. If you are a VC you should view this as a good alternative to losing more money and refocus your finite time on your upward moving portfolio companies.

Rob McIntosh, head of corporate development at Autodesk, said, "I don't know if they teach this to budding investment bankers at Harvard Business School, but often in the Valley and around the world companies are acquired not for lowering costs, increasing revenues, product, or geographical reach, but to increase 'coolness.' This app we acquired may not make money for us, but it's 'cool' so it has marketing value and makes recruiting easier; therefore, we view it as a very successful acquisition."

I've heard people say that Silicon Valley outpaced Route 128, Boston's tech corridor, in the 1980s and 1990s because everyone in the Valley's ecosystem is open, whereas East Coast people are too protective of information and less likely to help each other before being helped. On the topic of M&A, Gordon Payne, SVP, general manager of desktop and cloud divisions at Citrix, said, "Openness and transparency benefits a startup. If we know the direction a startup is heading with their product, we are likely to stay out of that area to avoid overlap; so when we buy them it's a better fit. This kind of openness goes against the nature of many folks, but fits with my motto of 'no secrets in the fast lane.'"

Our friend "Anon" had some advice on how to get on the radar of the big balance sheet buyers: "If M&A supports an acquisition and our CEO wants the company and we buy it, but the product group does not like it, the body will reject the organ. The best way to get on our radar is to get a product group to champion the buy."

Parag Patel, VP of global strategic alliances at VMware, said, "VMware is always seeking out new technologies with which to differentiate ourselves and serve our customers better. To that end, one of the best ways to get on our radar for an acquisition is when we hear from our customers that they are using your product. Another very good way is to capture the interest of our senior technical people, who are always interested in technologies that can be disruptive or augment our products."

Back in the 1990s, I heard it said that the best way to get the attention of Chambers, CEO of Cisco, was to steal a customer.

Seek Truth in Facts: Statistics on Venture Exits

I crunched some numbers when thinking of starting The Founders Club equity exchange fund. I wanted to see what percentage of entrepreneurs were making nothing and what the distribution curve looked like for entrepreneurs making different-sized exits. This research helped drive my decision to create equity exchange pools and create a sensible solution for venture-backed entrepreneurs to smooth out the extreme variance in financial outcomes. I shared my research with Nic Brisbourne, partner at DFJ-Esprit, whose blog on the subject follows:

The Relationship Between Exit Value, Money Invested, and How Well the Founders Make Out

The following stats show exit values as a multiple of the amount of venture capital invested. I got the data from Andrew Romans of

> The Founders Club. Due to liquidation preferences you can expect that, if the exit is less than or equal to the amount of capital invested, the founders won't have made much money. It is common practice in these downside scenarios to do a deal that provides management incentives to execute on a low-value exit, so the founders will typically get something, but it will certainly be below early expectations. Clearly the VC hasn't done very well here either.
>
> If the exit is in the 1- to 4-times capital invested range, then the founders can expect to receive cash in the neighborhood of the paper value of their shares when the VC invested. This follows from the very rough rule of thumb that, in a typical VC round, the investor gets one third of the company for his or her money. In this scenario the VC has probably made a small profit, but not enough to get very excited.
>
> When the exits get to be more than 4 times the money invested, the founders start to do very nicely.
>
> If you take the standard venture capital model that looks for one third of the portfolio to be winners, and you factor in the fact that a good portion of companies never really exit, this figure feels about right. Much higher would suggest that VCs weren't taking enough risk; much lower would raise legitimate questions as to whether the venture capital industry was delivering any benefit to entrepreneurs, and we probably wouldn't be making acceptable returns for our investors.

Table 8.1 shows some of my research that Nic examined. The takeaway is that this is a game of extreme winners and losers, leading me to conclude that it makes business sense for entrepreneurs to invest 2 to 10 percent of their founder stock into an equity exchange fund managed by professional VCs like The Founders Club. The numbers in Table 8.1 are only for "disclosed" M&A transactions. Only a third to a half of M&A transactions disclose the numbers.

Table 8.1 Relationship Between Transaction Value and Investment

	2007		2008	
	M&A	Percentage of Total	M&A	Percentage of Total
Deals where transaction value is less than total venture investment	34	22.67%	24	27.59%
Deals where transaction value is 1 to 4 times total venture investment	55	36.67%	23	26.44%
Deals where transaction value is 4 to 10 times total venture investment	32	21.33%	26	29.89%
Deals where transaction value is greater than 10 times total venture investment	29	19.33%	14	16.09%
Total disclosed deals	**150**	**100.00%**	**87**	**100.00%**

Fund Physics: Expect Improved IRRs from Smaller Funds

The IPO market has reopened in the United States, but for most companies that fail to build sales above $100 million, M&A will remain the preferred form of exit. VCs are failing to react to this. A key driver for this is "fund physics." With the volume of companies and grouping of big balance sheet buyers, we will see many $30 million, $50 million, and $100 million size M&A exits. Driven by an increase in angels, accelerators, and crowdfunding, combined with the lower cost of starting companies, we will see an increase in smaller exits. In this new world, a smaller VC fund can achieve better returns than a mega-fund. Managers of a billion-dollar fund, or even a $200 million fund, cannot take the time to make a $100,000, $500,000, or $1 million investment. Selling a portfolio company for $50 million with a10-times cash on cash return has no meaningful impact on the mega-fund's IRR. The days of Cisco and Lucent paying $2 billion to $7 billion to acquire a venture-backed startup seem to be in the past. Most of the acquisitions made by the big acquisitive technology companies are under $50 million.

Despite these combined changes, VCs are accustomed to management fees on $200 million-plus sized funds. Fund physics now makes it hard for them to make angel investments or benefit from small exits, particularly exits where much of the value is in employment agreements for the founders. Some VCs have launched seed funds to address this market. The seed fund acts like a micro-VC, making many small bets on raw startups. The main $200 million-plus funds can still make $2.5 million to $10 million size investments into a small subset of the seed portfolio, those that progress to the venture stage of development.

The problem that emerges is negative signaling, when a startup raises seed funding from the branded seed fund of a known VC, but then pitches that VC's main fund to invest in a series A financing. If the answer is no, when that startup pitches another VC, the first question the new VC will ask is, "Is the main fund of your existing VC going to invest in this series A round?" Taking seed funding from a branded VC without the support of the main fund is poison for the operating company. Some of the large funds are now deploying seed funding via scouts, typically successful entrepreneurs they trust to go out and make small angel investments without bringing the negative signaling associated with investing from a seed micro-VC branded with the same name as the main VC. Net net, expect to see the launch of many smaller funds that are free of "big fund physics."

THE ENTREPRENEURIAL BIBLE TO VENTURE CAPITAL

INSIDE SECRETS FROM THE LEADERS OF THE STARTUP GAME

ANDREW ROMANS

McGraw Hill Education

New York Chicago San Francisco Athens London Madrid
Mexico City Milan New Delhi Singapore Sydney Toronto