Exits for Venture-Backed Companies

Is the Timing Right?

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You and your team have spent years working to develop your initial idea into a real company. You have put in the sweat equity. You have witnessed the various successes (and failures) of the start-up company you have formed. You may have executed multiple pivots. Now the passage of time and the company's growing value are combining to push you and the investors to consider options for liquidity.

The ultimate liquidity event for most venture-backed companies is likely to be an exit in the form of an acquisition. If a company has raised several rounds of venture capital financing, the founders may have incurred significant dilution (for a detailed discussion on dilution, see The Price of Growth – The Lifecycle of a Company from a Founder's Dilution Perspective). Timing a liquidity event correctly can be a challenging proposition, and the interests of the founders and the investors may not be identical.

What are the factors to consider from a business perspective when trying to determine whether to sell a venture-backed company? This article will explore the benefits/disadvantages of an acquisition and the potential advantages of remaining a stand-alone business.

Benefits of a Sale

There can be many advantages to a company of entering into an acquisition, including the following: (i) liquidity for investors and stockholders; (ii) minimizing the inherent risks in the market and reducing competition; (iii) accessing larger sales/marketing teams and more developed companies; (iv) avoiding potential burn-out for employees and founders; and (v) providing more security for employees.

When companies accept venture capital investment, the expectation of the investors will typically be an exit within a five to seven year time frame. Obtaining liquidity for the company's investors, as well as for founders and other stockholders of the company, can be critical for all of its stakeholders. However, determining the best time to sell a company can be difficult, particularly if the company is not able to receive the valuation and terms on an exit that the investors are anticipating. Many venture-backed companies do not yet have significant revenue and attempt to tie the valuation at the time of an acquisition to projections and future sales, which buyers may be unwilling to accept.

In addition, if the company has raised a significant amount of outside capital (for venture-backed companies who have raised several rounds, this amount could easily reach $30 or $40 million), depending upon the dilution and the terms of the preferred stock, although a $100 million sale may sound impressive, in reality it may not result in significant returns to the founders and employees. An important question to ask is whether the value of the company is likely to be increased by delaying an acquisition by a year or two. What if the valuation of the company today is only $50 million based on the past few years of trailing revenue, but the revenue

projections for the current year and the next year are significantly higher? Often potential acquirers will not consider these projections or will significantly discount them. Obtaining the right valuation and liquidity for all parties will be critical to timing a successful exit.

When analyzing the timing of a possible liquidity event, companies often review the inherent risks of a start-up, particularly in the specific market in which the company resides. Frequently, one of the major challenges for venture-backed companies is the competition which exists in the market place. Depending on the market, many start-ups face multiple competitors in the form of well-developed companies with significantly greater resources than a start-up. The ability for a start-up, even with venture financing, to compete with companies with significantly higher budgets, spending resources and employee resources, can be daunting. Often when companies are initially formed they do not face significant competition, but then it becomes a race to get the competitive product to market. Without access to an unlimited employee pool, timing can be a real issue for start-ups and these companies can simply be outmaneuvered because of the competition's greater resources. Deciding to team up with a larger company can be a logical exit strategy for many venture-backed companies and as companies review the landscape of possible acquirers, competitors are often on this list. Being acquired by a buyer not yet in the company's space but which will be enabled to compete with one of its main competitors can also be an extremely attractive alternative.

Many start-ups become frustrated with their inability to establish a large sales team. Even with venture financing, early stage companies are often faced with limited resources and are required to delay expanding their sales team. Often companies are faced with a chicken/egg situation in which the company does not want to put in place a structured sales team until the product is ready to hit the market. However, with a ramp up for sales personnel of often three to six months, the timing of hiring a sales team can then be too late. When start-ups are able to combine with much larger companies with more developed sales teams and distribution channels, they have immediate access to resources and contacts that may have taken them years to develop internally.

As anyone in the start-up world knows, the working hours for founders and employees can be literally around the clock for years. Most start-ups are run leanly with budgetary limitations on hiring. As the years progress, ongoing morale issues surface as the excitement of a new idea/ new start-up gradually wears off for the founders and early employees. After several years, it is not uncommon to see some founders/early employees transition out of the company, in many cases because of burn-out. The employees know and think about a potential exit. When this exit gets delayed and employees have been at a company for six, seven or eight years, in most instances their equity is vested, they continue to work extremely long hours, and they start to question whether a good liquidity event is in sight. Transitioning through an exit helps a company address this potential burn-out factor.

A similar benefit for employees is the potential to provide more security for employees at a larger, well-established company as compared to a start-up. While in most instances employees of both a start-up and a well-established company will be employees at-will, the stress and insecurity of a start-up (will we have cash for payroll in six months? Will we be able to obtain an increased valuation in the next round?) can be daunting. As these start-ups mature, much of this stress can be managed at the senior level, but it can inevitably make its way to the more junior employees. Although there can disadvantages to working at a larger company, these types of questions and concerns are less common at a more well-established company.

Disadvantages of a Sale

While there are many potential advantages to selling a venture-backed company, the timing is not always ideal. Some of the issues about which companies may be concerned include the following: (i) selling out before the company's value can be demonstrated by its financial performance; (ii) addressing cultural and integration issues in a transaction; (iii) losing control of the company and its strategic direction; and (iv) for the founders, letting go of the company.

As mentioned above, venture-backed companies often do not yet have significant revenue, but anticipate significant growth in their financial projections. Companies see the value and synergies of their business and in many instances have what they perceive to be conservative projections. Inevitably, however, the potential buyer will significantly discount projections and will usually value companies based on historical revenue. There is always the risk to a company that it sells out too early and would have been able to obtain a higher valuation had the company waited a year or two to enter into a transaction. The board of directors of the company of course has fiduciary obligations to act in good faith and in the best interests of the stockholders of the company to obtain the best possible valuation of the company (the details of which are beyond the scope of this article). As part of the transaction process, the company and its board should look closely at both historical financials and projections to consider the timing of the transaction (possibly with the assistance of an investment banker).

One of the most significant issues for founders and employees of a start-up in a transaction is addressing cultural and post-closing integration issues. Although this issue sometimes gets lost in the process and can be pushed off in the time line of the process, ideally it should be addressed as early as possible. If the buyer is well-established and experienced in transactions, it will likely have an internal HR team who will help address these challenges. However, if these issues are not addressed up-front by the buyer, a selling company should push to understand how the buyer intends to handle these matters at the beginning of the transaction process. Particularly if a company is in the position of having multiple buyers interested in entering into a transaction, the company should take the cultural fit into serious consideration when analyzing the terms of the transaction. Employees are often disappointed post-closing at how much the culture can change and addressing these issues up-front is critical for a successful transition.

Another issue for the founders relates to losing control of the company and its strategic direction. Founders begin their careers at the start-up typically having complete control of "their" company. As companies bring in an initial round of financing and then potentially additional rounds, this control gets diluted over time. At the point of an acquisition, although founders typically will no longer have actual control over a company (i.e., the right to appoint a majority of the directors or stockholder veto rights on material company action such as an acquisition), they often will still have a seat on the board, still hold a significant percentage of the outstanding common stock, and could still have significant control over the strategic direction of the company. Even if the founders remain with the company post-acquisition, this type of control will typically be further reduced and the management team of the company may find themselves post-closing reporting to several layers of senior management above them. This structure can be challenging to accept for entrepreneurs who have been more accustomed to being their own boss.

Hand-in-hand with losing control of the company is also the emotional issue for founders of letting go of their "baby". Although some venture-backed companies can get sold within a few years of incorporation, it is often the case that the exit takes significantly longer. Founders who have been there from the start struggle with letting go and are often concerned with selling out too soon, particularly if the exit opportunity is not at the expected valuation. Founders may feel a sense of loyalty to the company's employees and want to postpone a transaction with the hope that the company can be more successful remaining as a stand-alone entity.

Given the importance of timing of an exit, in addition to just focusing on the specific economic terms of a transaction, companies should continue to weigh the business issues described above when analyzing the benefits and disadvantages of an acquisition.

For more information on the timing of acquisitions of venture-backed companies, please contact **Mary Beth Kerrigan**.