Dr. Tom McKaskill

MASTERCLASS FOR ENTREPRENEURS

on

Angel Investing

INSIGHTS ON HOW TO DEVELOP SUCCESSFUL ANGEL INVESTING OUTCOMES

BREAKTHROUGH PUBLICATIONS

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Insights

Angels are active investors. They mentor, coach and fund early stage ventures through to an exit.

Most early stage firms lack business acument, have emerging products and are often in emerging markets and in markets where technologies are evolving.

Most early stage firms lack systems and processes and this is one area where the experience of the Angel is of most benefit.

Angels need to develop a systematic process of selecting, managing and exiting their investments.

Angel Groups now account for a significant portion of Angel investments. This provides strength in numbers for sourcing deals, undertaking due diligence, funding and managing investments.

A focus on strategic exits will ensure Angels invest in ventures which have a lower execution risk, higher ROI and a shorter timescale for the investment period.

Dr. Tom McKaskill

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

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

After a year as visiting Professor of International Business at Georgia State University, Dr. McKaskill was appointed Professor of Entrepreneurship at the Australian Graduate School of Entrepreneurship (AGSE) in June 2001. Professor McKaskill was the Academic Director of the Master of Entrepreneurship and Innovation program at AGSE for the following 5 years. In 2006 Dr. McKaskill was appointed the Richard Pratt Chair in Entrepreneurship at AGSE. Dr. McKaskill retired from Swinburne University in February 2008.

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

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

Dr. McKaskill completed six e-books for worldwide distribution. He has also produced over 150 YouTube videos to assist entrepreneurs develop and exit their ventures.

Tom McKaskill is a member of the Brisbane and Melbourne Angel Groups and of the Australian Association of Angel Investors.

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Preface

Angels have a special place in my life. When I started my first business in the late 70's a group of wealthy individuals put up a small amount of money to enable the firm to buy the computing equipment we needed to launch our business. One of them subsequently became our Chairman of Directors. Thirteen years later we sold out to a listed USA corporation and the Angels all cashed up very well.

Many years later when I was the Professor of Entrepreneurship at the Australian Graduate School of Entrepreneurship, there were many Angels who sat on my student business plan panels and freely gave their time to mentor my students. At that time I was actively involved in publishing a series of books for entreprenerus and added one on Angel Investing. That led to some workshops for Angels on how to invest and exit their investments.

In the last several years since retiring from the University I have been active in several Angel groups. My major role has been Angel education and undertaking sceening and constructing exit strategies for the investee firms.

PART ONE: INTRODUCTION

Angel investing has evolved greatly over the last 20 years. They are much more sophisticated in their approach, have a better education in Angel investing and often invest through Angel Groups. However, many lack a wide business experience and tend to invest only within the industry from which they derived their wealth. Historically Angels have invested in early stage ventures, assisted them with mentoring, coaching and funding to grow their businesses and prove their business concept and then sold them onto larger businesses. Today, the emphasis on the exit has moved to strategic trade sales requiring a new approach.

INVESTOR INTEREST

The compelling investment concept

Entrepreneurs generally believe that, if they want to raise Angel finance, they have to first prove your business concept! This means they will have an established business with real product and real customers and be able to show how the business will generate significant revenue and profit in the future. One might argue that if they could do all that, they wouldn't need the investment.

There can be no doubt that understanding the business concept and being able to articulate how the business makes money is an essential precondition to raising external investment. One also must accept that for the last few decades the criteria used by VC and Angel investors centered on the business concept. Investments were made in higher growth ventures which could produce a harvest through an Initial Public Offering (IPO). Since an IPO business is a stand alone business which must achieve relatively high growth in revenue and profit, this was not an unreasonable request. The problem is that this entire approach was flawed.

It is not a proven business concept which the Angel investor should be seeking, it is an attractive investment opportunity. While there is a close alignment between the two, they are not the same. A business which has good growth prospects does not necessarily make a good Angel investment. Given that less than 5% of Angel investments are harvested through an IPO, the normal exit path is via a trade sale. If you look at the historical data and exclude the IPO exits in boom market conditions, what you see is only a very rare IPO, perhaps less than 1 in 100 investments. This leaves the trade sale as the normal investment exit objective. Angels are not in the business of collecting dividends on their investment. They want to see their investment back and achieve a profit on the funds employed and that means the investee firm will be sold. So an attractive investment opportunity is actually one which has a very good potential high value exit. Clearly, that is not the same investment criteria as the proven business concept.

The reason why the business concept is important is because that is the place where the Angel investment analysis starts. The Angels wants to know how the business makes money and what its growth potential is to see if it would make a good exit candidate. The best exits are based on strategic value where the investee firm is sold at a premium to a large corporation who can better exploit the underlying potential. The business concept will show the market potential of the venture's product or service. If the business has products or services which a large corporation could rapidly scale or replicate to generate large short term revenue – you have the basis of a strategic sale.

What is often overlooked by business advisors who assist firms to raise external equity finance is that it is not the firm's business concept which is critical in a strategic sale, it is the business concept of the strategic buyer. If the acquiring corporation already has the distribution channels, the supply chain logistics capability and the funding to exploit the acquisition, the capability and capacity of the selling business may be entirely irrelevant. A strategic buyer wants something which they can exploit, like a great product or service which can be sold back into their existing customer base. Whether the acquired firm has customers, distributors, revenue growth or even a profit may make no difference to the value which they put on the firm. Their estimate of value is based on what they can do with the underlying products and services not what the selling business has done.

Historically, Angel finance has been seen as external funding to help an entrepreneur develop and grow their business. Because the conventional wisdom of Angel and VC finance had developed in the boom markets and especially for an IPO harvest, investments went into firms with high growth potential. However, experience has now proved that the IPO was an unrealistic exit strategy and that investment need to be focused on trade sale exits. This fundamentally changes the investment criteria. When you then review the trade sale exits, what you see is that growth firms sold on the basis of their own revenue and profit generating capabilities generate far lower investment returns than strategic trade sales. A venture which can produce a good strategic exit is often a very different investment proposition to a conventional high growth business. It is this realization which has moved Angel investors away from the proven business concept investment criteria to those based on strategic value.

The critical question to ask is - What does a strategic buyer need in my business to make it an ideal acquisition? The strategic buyer is looking for something which will generate significant revenue by taking advantage of the resources which already exist within the buyer. They want a proven product which targets their existing customers, solves a compelling need and has good sustainable competitive advantages. If the entrepreneur can satisfy those needs, you have the basis of an attractive investment opportunity. Of course, it would greatly help the prospective investee's case with potential investors if they could set out the case for a strategic sale, including identifying the potential buyers.

ANGEL GROUPS

The new public face of Angel Investment

Angel Groups in the USA now account for 50% of all Angel investments and invest in about 15 times the number of ventures invested in by formal venture capital funds. Furthermore, they achieve a good return on their investments. Angel Capital Education Foundation reported that, for the 539 Angels surveyed across 86 Angel Groups they reviewed in 2007, the average return on the 1,130 exits of that year was 27%. However, 20 years ago you would have had difficulty finding any Angel Groups in the USA. Angel investment in the USA has dramatically changed over the last decade and is likely to become increasingly important in early stage private equity financing.

There are several reasons why this change has occurred, not least of these being the growth in the number of entrepreneur millionaires generated by the computer, internet and biotech booms of the past three decades who make up the bulk of the participants. Venture capital funds have moved up market and away from funding early stage ventures leaving a gap to be filled by Angel investors. However, probably the most significant factor has been the rise of the public face of angel investing – the Angel Group.

Historically Angel investing has been the province of a few wealthy entrepreneurs and the private family investment fund. Angels have shied away from publicity and worked within their own communities and with their own private networks. Entrepreneurs seeking Angel finance had to work through a myriad of contacts to find an Angel. Even then, the Angel may not have the right experience or interest in their specific sector or venture. While there were informal Angel syndicates, they still operated under the radar and were difficult to contact.

What we have seen in the USA over the last decade is an explosion in the number of active Angels Groups. What was once a small portion of all Angel activity is now about half of all Angel investments. Angel Groups are well organized, often have a full time or part time administrator, usually have a website and host a formal program of meetings, entrepreneur presentations and Angel education workshops. Over 350 Angel Groups belong to the Angel Capital

Association which fosters best practice, provides a library of materials to help Angel activity and host an annual conference for Group members.

Australia is running about 8 to 10 years behind the USA in the development of a formal Angel Group network but is fast catching up, partly due to the assistance and advice from other Angel associations around the world. in 2008 the Australian Association of Angel Investors (aaai.net.au) held its inaugural conference. At that time there were over 10 formal Angel Groups which belonged to the Association with more being formed all the time. Even small groups can quickly go public with the help of an internet based angel group administration software package called Angelsoft which is provided free to all angel groups worldwide. This software provides facilities for organizing meetings, submitting investment proposals, soliciting investment from members and tracking investee firms.

For entrepreneurs seeking Angel finance, the difference in the last few years is remarkable. For the first time there is a range of Angel Groups who have a public presence. Not only can entrepreneurs now find a local Angel Group but they can contact them directly, find out what type of ventures they are interested in and submit an investment proposal. No longer do they have to work their network to find an Angel, they have the ability to connect directly to 20 to 50 local Angels. Even if the entrepreneur is in a highly specialist field, chances are they will find a local Angel with an interest in what they are doing, or perhaps, actual experience in the same field. Since Angels are now better networked themselves, they can also connect with other Angel Groups to tap into experience, raise additional investment or find an Angel who wants to take an active role in some part of the investee's development plan.

This public presence has considerable benefits for the Angels themselves. No longer do they have to hide what they do for fear of being approached for investment by people they don't know. They have immediate access to a range of specialist skills from other Angels, can share the due diligence activity and can spread their investments over a much larger number of investee firms. If they wish, they can be passive investors in some ventures and take an active role in others. They can tap into a resource base of standard agreements and have Group access to IP, legal and accounting services. Perhaps the greatest benefit of Angel Groups is to allow novice Angels to participate in investing while learning how successful Angels select, negotiate, manage and harvest their investments.

If you consider the impact angel investors have on job creation, wealth creation and export income, it should be great news for our policy makers. That being the case, lets hope that they get some Government support to make it happen more.

VALUATION

How to value the business

Whenever I get into this specific topic I sometimes think that I am entering the world of art rather than science. Certainly, from what I have seen over the years, there seems to be more guess work in the process than science. Most business owners will be familiar with sales of businesses in their own sector and will know what the typical valuation formula is. Generally this is some multiple of profit (normally referred to as time EBIT, earning before interest and taxes), but some sectors will be a multiple of revenue or a value per client or per member. Few will, however, understand why a specific multiple applies in their sector.

When I have asked for clarification of the specific multiple which is being applied, I usually get the arguments that it is 'typical' in the sector, that it reflects industry volatility and risk or that it includes adjustment for industry growth. The truth of the matter is that most business owners, business brokers and business advisors don't know why a specific multiple applies. They just know what norm has been established over many years and many sales. When you ask 'How can I get a higher multiple?' the answer will be 'grow faster!'. "How much faster? – well more!! Not very useful and certainly not very scientific.

Excluding liquidation or break up value, there are only two fundamentally different models for establishing a value for an operating business. The first is based on the future stream of free cash flow generated by the business and the other is the strategic value of the business to a large corporation.

Most conventional businesses, such as retail, wholesale, transport, property, and services businesses, achieve value by producing profits (EBIT) for the new owner. It is the size, duration, growth and likelihood of that profit stream that creates the value. By the way, it is only ever future income streams that create value never past ones. You don't put money into a savings account to get the interest rate the bank paid last year, the only relevant rate is the one they are going to pay. Thus, it is only projected future profits that are relevant. While past profits may give you some indication of the likelihood of future profits, you can dramatically improve your valuation by creating a different future.

Conventional valuation theory can be applied to business valuations. This is based on Net Present Value (NPV) of a future stream of income relating to the initial investment. Once we know the income streams and the discount (risk rate) to apply to them, we can calculate the value of the investment (or the business in this case). It then follows that conventional valuation using EBIT multiples should be able to be expressed in a NPV formula. Thus 2 x EBIT is a 50% discount rate, 4 x EBIT is 25% and 6 x EBIT is 15%. A business valuation can therefore be improved by reducing the applied discount rate and improving the visibility and probability of future income streams.

You reduce risk by improving recurring revenue, account penetration, customer and employee churn and by implementing better systems and processes internally to set and monitor performance. Visibility of future income streams is improved with long term contracts, greater recurring revenue and deeper account penetration as well as establishing good competitive advantage around patents, brands, trademarks and deep expertise. This should gradually improve the EBIT multiple. Further increases in valuation will come from increasing sustainable profitability and building income (EBIT) growth in the business.

This process is fairly conventional. Now comes the clever part! To gain a premium on the sale you can build growth potential into the business which the buyer can exploit. Can you identify how a much better funded, more skilled, more able buyer could grow your business and can you provide the framework or template for that growth? Where you can set out a path for higher growth and profits and clearly demonstrate how that can be achieved, it is possible to gain some of that increased profit in your valuation. You will need to find the right buyers and you will need to put the business into a competitive bid in order to extract that premium however.

A business which has underlying assets and/or capabilities which a large corporation can exploit is a very different proposition. These are business based on patents, brands, copyright, trademarks and deep expertise. The valuation in this case is not based on what your business can generate in future profits but how much profit the buyer can generate by exploiting your underlying assets and capabilities. Imagine a very large corporation which has a customer base one hundred times yours which would be highly receptive to your product or service. The large corporation may be able to quickly sell your product or service into an existing customer base reaping ten times your revenue, or greater, in the first year of the acquisition. Therefore, what would your business be worth to a large corporation which had a ready market for your product or service? The value of your business is based on what they can do with your business not what you can do with it. In fact, your own revenue, profits, customers and numbers of staff may be quite irrelevant in putting a value on your business. It is now all about them and not you.

Working out a valuation based on strategic value is very difficult but not impossible. What you have to do is estimate the revenue and profits that the acquirer will generate from your business. Thus, if they have a customer base one hundred times yours, then it might be fair to say that the value is one hundred times your conventional valuation. Will you get that for your business? Probably not but you will gain some portion of that value if your set the deal up correctly with the right potential buyers and ensure you have a competitive bid running when you come to sell. With strategic selling the task is to work out what you have or do which could be of interest to a large corporation, identify the potential buyers, set up a relationship to educate them on your potential and then manage the final competitive bid. Generally strategic buyers are prepared to pay many times the conventional value of a business.

If you compare these two models, what you will see is that the value of your business is solely in the eyes of the buyer and especially in the manner in which the buyer can exploit its potential. What this should be telling you is that the identification of potential buyers is one of the most critical aspects of gaining the best price for your business. The best buyers are the ones which have the experience, willingness, capacity and capability to best exploit the potential in your business. Your task then is to create that potential and then find the right buyers.

THE ELEVATOR PITCH

Getting the message right

This is the advice you should be providing to entreprenerus making an investor pitch.

An investor pitch is actually not that difficult if you stick to the basics; what problem do you solve, who for, what is your competitive advantage and how do you make money? Obvious you will be saying but it rarely comes out that way. I have sat through numerous presentations where I have asked at the end ‘So – tell me what you do? Sometimes, I have asked them if they have shown it to their mother!

The fundamental problem which entrepreneurs have with pitching to investors is that they forget who they are talking to and why they are there. They are talking to investors – not customers, suppliers or professional service providers. Investors want to know why they should invest and how they are going to get a good return on their money. Are they really interested in the product, market or background of the entrepreneur – not really. They don’t need to know about every feature and function. If fact, if you told them you had already sold 1,000 of them, they would happily skip that part of the presentation.

Then there are the problems of the jargon, the TLCs, those long unpronounceable chemical and biotech words and lists of competitor companies which no one outside the industry has ever heard of. Within an Angel Group, half the audience are retired bankers and accountants and the other half are cash-up entrepreneurs from ever sector of commerce. Chances are you may be lucky and find one person in the room who understands your technology.

I have sat though countless business plan presentations where I was struggling from the first 30 seconds to understand the business and thus missed the rest of the presentation. I have watched a lot of product demonstrations and got lost in the detail. I know a lot of entrepreneurs who talked about their product, business strategy and competitors for the full presentation time and neglected to say what funding they sought or how the money would be used.

Fortunately for most entrepreneurs, Angels are smart enough to see through the maze and spot the potential. But if time was pressing and the potential investors needed to leave, those unprepared entrepreneurs may have thrown away what could have been a lifetime opportunity. If they had simply taken some advice, read some literature on investor presentations or practiced the presentation in front of a non-technical audience, the end result may have been very different.

So back to basics. Whether it is 2 minutes or 20, the entrepreneur needs to put together a presentation which answers the fundamental questions which the investor needs answered. You can find these on many Angel websites. This information needs to be delivered this within the time available and to a non-technical audience.

An Angel Group should assign someone to advise the entrepreneur and check the presentation because the Group does not want to waste their members' time. The entrepreneur may have to do the presentation several times as the Angel Group gains a better appreciation of the investment opportunity and wishes to involve additional members in the due diligence and investment process.

Advise the entrepreneur that they need to prove everything. Don't allow them to make any claim unless they can back it up with evidence. Don't let them fall into the 'We can secure x% of the market' trap. You need to have the data to show exactly where the sales are going to come from, how they are going to secure the business and why they will get the business rather than your competitor.

In my entrepreneurship classes I would have every student present a one minute elevator pitch. I would close down the presentation exactly at 60 seconds. The first time they would do the pitch was always a disaster. The next time, after some coaching, they would usually be outstanding. Almost anyone can get it right with a little bit of coaching. They simply need to know what to do, try it out, get the feedback and improve. A very simple

THE EXIT DISCONNECT

When do we consider the exit strategy

I will admit to having a bias towards exits and focus my review of a potential investment on the exit potential but I do sometimes get impatient when the investment proposal has little or no information on the exit path. Even where an exit path is nominated, the proposals demonstrate either limited information about what it will take to structure the exit or look like a last minute addition to the plan to ensure that that box is ticked.

Without exception, the normal business plan is built on a revenue and growth model where the substantive part of the plan deals with how the venture will develop market traction, acquire and support a growing customer base, develop strategic partnerships and so on. However, such a model drives you either towards an IPO, a very high hurdle indeed which very few will make, or a financial exit (an EBIT multiple) which has relatively high risk, long timescales and, on average, a low ROI.

What I look for is high growth potential which will support a strategic value exit. These only occur in a small percentage of ventures but they stand out because they have a unique set of attributes. They have a product or service which satisfies a high compelling need, focus on very well identified and reachable but large niche market, demonstrate good scalability and have a strong competitive advantage when fully deployed by a large corporation. However, when I see the strategic exit possibility, it is rare that the entrepreneur or their business advisors have even considered the possibility.

Our business community has limited knowledge of strategic exits and very few know how to construct a robust strategic exit strategy. What this means is that while you see the possibility, you are confronted with a lengthy conventional growth business plan which usually requires a significant investment to develop it into a solid business suitable for a financial exit. While the conventional plan may be interesting, the strategic exit path will normally generate a significantly higher ROI, has considerably shorter investment timescales and usually a much reduced investment requirement.

Now comes the hard part – how do you shift the focus of the entrepreneur the highly detailed plan for growing their baby to constructing an entirely different plan where the strategic exit may occur in months but usually less than 2 years. The focus will switch from building out the business to building strategic value. If the buyer has the distribution channel, organization and funds to fully exploit the strategic asset or capability, they may not need your sales force, customers, distribution channel or management. Your resources will focus instead on creating additional IP and scalability, making contact with potential buyers and building the deal team.

In my experience few angels have been down this path because few have experience of putting together a strategic exit as part of the investment evaluation. The ones who have this experience have mixed opinions on how to move the entrepreneur from a financial exit to a strategic exit. Some prefer to allow the entrepreneur to present their business proposition and then, through discussion, shift their focus to a strategic exit. Others prefer to have the entrepreneur understand and evaluate the possibility of a strategic exit before the first presentation.

My preference is to allow the entrepreneur to consider the possibility before the first presentation so they are more open to a major change in direction. I achieve this by sending them a document on 'Investor Pitch".

I ask them to read the document and revise their proposition in light of the exit possibilities. Since the document covers both financial and strategic exits, this gives them the opportunity to consider both exit paths. It has the additional advantage of showing them that the investment decision will depend on the exit strategy. Those who then take the strategic exit path are much more open to major shift in focus. The higher exit values in strategic exits also makes the discussion of valuation easier as there is potentially much more harvest money to spread around.

What we do know is that the focus on exit informs the business development strategy. If we work back from the exit, we can establish a very specific set of actions and milestones to be achieved to correctly position the business for the identified buyers. Funding can then be directed towards specific activities to ensure investment funds are only used for exit critical expenditures.

An informed entrepreneur who understands the nature of angel investment and the critical part which the exit plays in the process is much easier to work with.

With strategic exits this is critical to ensure that entrepreneurs and the investors are aligned on strategy, the use of the funds and timescales.

PART TWO: SELECTING INVESTMENTS

Most Angels select investments based on their knowledge gained in the industry in which they worked. Outside that area most are not willing to take on an investment. Few have a systematic process for selecting investments and few focus on the exit as a key criteria. Also, what is missing in their analysis is a clear view of what creates both growth and exit value. Without such a framework they tend to fall back to what worked for them in their prior life. However, few have ever undertaken a strategic exit and most have only gained wealth over a long period of time - not a god basis for selecting new investments.

INVESTMENT CRITERIA

We are asking the wrong questions!

I recently reviewed a set of investment ready criteria published by a respected Angel Group. All the usual factors were there; what problem was being sold, the extent of competitive advantage, the experience of the management team, size of market and so on. You could quickly infer from the questions that the objective was to find a high growth potential venture to invest in. No doubt the intention was to fund the investee firm to establish a market position, growth market share and then somehow harvest the venture. What I found remarkable was that the question of possible exit path was not on the list.

Perhaps I shouldn't be that surprised. I recall undertaking a research study some 5 years ago when I and a US colleague reviewed several hundred VC websites to ascertain the extent to which exit strategies were discussed or requested in investment proposals. Even then I was surprised to discover that over half the sites had no mention of exits and not one had an explanation of the various forms of exit and an indication of the what information the VC firm would like to see on the proposed exit strategy. Five years on and I had hoped that we would have gained a much better appreciation of the importance of the exit strategy to the investment evaluation. It seems I was wrong.

What I find distressing is that we still seem to be locked into a business concept from the 70's and 80's where the dominant VC model was to grow a business to a point where it could be taken to an IPO. The pent up demand for computer hardware and software applications meant that any reasonable product could fuel significant growth so an IPO was a real possibility. Then along came the internet boom followed by the biotech boom and that simply reinforced the conventional wisdom. However, it is very clear now that the days of easy IPOs are gone and so is the conventional VC model.

Our harvest options now are very limited, basically the best path is a trade sale. If that is the case, then why are we still fixated on building out the business. Surely the question we need to ask is – what form of trade sale is the best harvest option for this venture? Only then can we deal with the other criteria. Is it not the case that the exit method drives the development of the business?

Before we get tied up in legal and financial due diligence we should be working out the exit. We should be ascertaining how the venture will create value and what type of acquirer wants what they have? Since there is a fundamental difference between a trade sale based on inherent revenue and profit generation from one based on exploiting an underlying patent or other form of IP, these are critical to an evaluation of whether the venture can be prepared for sale.

Asking about market share, distribution channels, management experience, R&D pipeline and so on, before ascertaining the exit path is clearly asking the wrong questions.

HIGH GROWTH

High growth potential is essential for investment

Even if a business has an outstanding unique product, a significant competitive advantage and high growth potential, it does not mean the entrepreneur will be able to exploit its potential. Few businesses can generate the surplus cash flow to fund a growth exceeding 10% per annum, thus without external finance, the potential will never be realized. Access to external funding is a necessary component of the high growth potential venture. Since banks are not in the risk business, the vast majority of such businesses need to access business angel or venture capital finance to fund their growth.

Most early stage ventures are only suitable to business angels as their funding requirements are not excessive and they are often not sufficiently developed to satisfy the requirements of the venture capital funds.

High growth potential in itself is only a starting point for a conversation with an Angel Group. What you really want to know is whether the business can be developed for an Initial Public Offering (IPO) or sale to a larger enterprise, a trade sale. An IPO exit is somewhat unlikely as only about 1 in 10,000 early stage ventures achieve a successful IPO, unless you find yourself in the middle of a stock market boom such as those which were experienced in the internet and biotech bubbles. For the average high growth potential firm, a trade sale is a more realistic exit. An Angel investor will want to know that such a sale is highly probable within a few years of the investment as this is the only practical means by which they can liquidate their investment and achieve a healthy return on their funds.

While Angels focus on high growth potential, few businesses can grow organically at the rate required to meet their hurdle rate of return. Angels generally expect to achieve over 20% on their investments but since they experience some failures, the hurdle rate is set much higher, say at 35-40%. Only an exceptional business can organically generate a return on an Angel investment above 40%. So does this exclude Angel investment? Usually, but not if the venture presents a strategic exit opportunity.

High growth potential can be expressed in two forms; growing the existing business or selling out to a large corporation which can execute on the potential. The latter I refer to as a strategic exit. In a strategic exit, a large corporation exploits an acquired product or service by utilizing its large customer base and market power to exploit the acquired asset or capability. It is the power to rapidly scale or replicate the product or service which can generate significant revenue for the acquirer. Such an opportunity for the acquiring corporation can be worth many times the conventional value of the acquired firm. It is these strategic ventures which Angels Groups seek.

A business with high growth potential thus has two choices, go it alone or seek out Angel investment for a strategic exit. Given that the value achieved in a strategic exit is based on the revenue anticipated by the large acquiring corporation and not on the revenue capability of the selling firm, a strategic exit may achieve a value on sale which the business alone could never achieve.

The key to a strategic sale is to have a product or service which, in itself, has the product/market position to generate a very high level of sales if sufficient resources can be devoted to its development and marketing. Next, the entrepreneur has to work out which large corporations have the capability and capacity to achieve those results. The premium on sale is achieved by putting the firm into a position where multiple large corporations, each which can fully exploit the potential, bid for the right to be the successful acquirer.

Angels seek out such ventures because they know that such businesses can use their funding and expertise to achieve a strategic exit. They also know that the ratio of the exit value to their investment is quite high, thus they have little risk in the deal. Since strategic exits are based on a product or service which the buying corporation will exploit and not the revenue and profit achieved by the seller, the focus of Angel investment is on structuring the product or service for exploitation, not growing the investee business. Not only is this easier operationally but the investment risks are lower and the time to exit is often relative short – an ideal investment profile for an Angel investment.

This is very good news for the entrepreneur. Instead of slowly growing the business over many years to generate wealth, the entrepreneur can shift gears and concentrate on developing strategic value. With the help of some Angel investment, the entrepreneur can readily capture the true potential of their venture, often in a relatively short period. Even businesses with significant growth potential will normally be better off selling out than taking the risk they can realize the potential themselves. With the sale proceeds, the entrepreneur can start a new business, acquire one to develop or join the local Angel Group and participate in many more successful ventures.

HIGH GROWTH INNOVATION

Innovation vs. execution

Historically our angel investment criteria have always focused on the ability of a management team to prove they can deliver on a high growth business concept. Our return on investment has been tied to the entrepreneur's ability to produce the revenue and profit growth needed to create enterprise value. Our exit has always been seen as some multiple of the net profit which the venture can generate, whether this be immediate past or near future, captured in an IPO or trade sale – but always through the efforts of the venture itself.

What we have failed to do is to see two different paths to value creation, one from high growth potential itself and the other through the execution of that potential. In fact, we would have walked away from many deals where the product or service itself was capable of generating high growth but the entrepreneurial team was judged inadequate to execute on the potential. Without the team, there will be no proof of concept, therefore no value creation and thus no chance of a good exit.

However, high growth potential itself has value in its own right separate from high growth execution. Basically, we just need to go find someone else who can execute on the potential. In the case of most high growth potential products and services, this would be a strategic trade sale. We should position these ventures for a trade sale to a large corporation which had the capacity and capability to readily exploit the underlying asset or capability and thus execute on the potential. To prepare the venture for this type of exit might be as simple as sorting out the IP. In other cases, we would have to establish some reference sites and collect some market data. What we don't have to do is grow a reasonable size enterprise. Rather than walk away from the venture investment, we should see it as a chance for the entrepreneur and the investors to capture value through an early strategic trade sale.

An entrepreneurial team capable of high growth execution is rare. All too often we have undertaken an investment based on high growth potential hoping the team will be able to learn quickly and, with our knowledge and support, overcome any deficiencies in their experience. Our track record of failures would suggest that this model is somewhat suboptimal. We end up with most ventures either failing or delivering small returns. It is only the exceptional ones which result in the 10+ multiple of capital injected.

The other problem we face is that high growth execution, by its very nature, often requires additional rounds of funding. This usually dilutes the original investment, often at lower valuations, but also puts the venture at risk through funding delays or inability to raise additional funds.

We should, in the future, embark on a two pronged approach to investment. Of course, we still want to focus on high growth potential. However, instead of excluding those where the entrepreneurial team is less able to execute, we should fast track those to a strategic exit which can usually be readily achieved by putting a deal team around the venture and limiting the funding to exit activities. Those few ventures which are capable of high growth execution can then be treated very differently and a full growth plan developed with an IPO or longer term trade sale as the exit.

The advantage of this approach is that we will end up funding more ventures with many of them being smaller investments with low execution risk and short exit horizons. Our success rate on high growth execution ventures will improve as we limit investment to those which have both high growth potential and the ability to execute on that potential.

WHICH PROBLEM

You need a compelling need to buy

The greatest hurdle in business is to extract the money out of the customer's pockets. It is not sufficient to have a great product, lots of energy and passion for your business and do lots of marketing to reach your target audience. In the end, you have to push them over the line to make that purchase decision. What you have to avoid is a situation where they can delay or avoid making the purchase. Thus all your effort to get in front of the right customer can be frustrated if you don't have a 'compelling need to buy'.

You can use up lots of company resources spinning your wheels chasing business. Your conversion rate will depend on your ability to get to the right customer, your competitive advantage and the degree to which they recognize that they need your product or service. If can't find a way to increase your need solution, you will end up with long lead times, low conversion rates and be driven to discount your price to push customers over the line.

Start with need not desire. What does you customer need to do – not like to do? What problem do they have which would drive them to look for a solution rather than wait for you to present yourself? The key to a compelling need is to satisfy one of the following problems: your product or service resolves a serious physical or psychological pain, saves a life, protects a reputation, if that is important, prevents or mitigates or reduces penalties and risks associated with compliance requirements and keeps the customer out of jail.

The reason why pharmaceutical companies and biotech companies do so well is that they satisfy one of more of these conditions. They have little price pressure, very short lead times and have customers coming to them for solutions. Companies providing audit services or tools to meet compliance requirements don't have to convince their customers to buy. You don't buy, you go to jail.

Peer group pressure associated with brands and designer labels are a form of psychological need. Thus celebrity endorsement is used by companies to increase psychological need.

Most of us in business are not so lucky. We have very ordinary products selling to very ordinary customers. However, you need to examine your product line and your customer needs and reposition your business around higher needs. What problems could you solve which are more urgent and have higher compelling needs? Lead the sales effort with products which satisfy compliance needs and then cross-sell the complementary products in the follow up. Create uncertainty, fear and doubt around problems which increase psychological need. Look for products to distribute which can act as door openers because they have shorter lead time and higher closure rates. Once you have a customer relationship it is much easier to sell in other products and services.

There are many things you can do to facilitate growth but solving the compelling need to buy will have a greater impact than any other improvement you might undertake.

SUSTAINABLE COMPETITIVE ADVANTAGE

Growth overtime requires a sustainable competitive advantage

While it may seem that I am preaching to the converted, we often forget just how important competitive advantage is and how critical it is to sustain this over time to achieve growth momentum. Unless you want to exist in a stagnate state where you are frustrated in your attempts to gain market traction and you face a future of slow death, you need to find some dimension in your product or service offering which has greater appeal to a segment of the market than your competitors. In the end, competitive advantage is the only game in town.

However, you need to careful not to become mesmerised by a single dimension of competition. Too often suppliers focus on product or service specification without taking into account that customers value many more aspects of product or service experience than simply solving the targeted problem. By taking a holistic approach to the customer's needs, other dimensions of value can be tapped into and the commodity supplier can move to a differentiated higher margin offering. Markets are simply not homogeneous. When you break the buying and usage process down into stages and impact, you can choose parts of the product and service delivery where you can make a difference and move away from your competitors, even with a commoditised product or service. Thus providing outstanding information for product evaluation, better availability, a more interesting shopping or usage environment, easier payment terms, better packaging, environmental support, easier upgrades or maintenance or lower risk in usage are simply other dimensions of the customer experience, to name just a few.

Some suppliers establish competitive advantage through strong intellectual property protection while others focus on deep expertise to make a difference. But there is nothing stopping any supplier from spending time with their targeted customers finding out how they can improve their value proposition and where they can make a difference compared to competing products. A competitive difference should be driven by supplier creativity and market evidence. The aim should be to discover areas of need which are unmet by competitors and to bring forward products and services which tap into that market gap. Only by moving away from competitors and meeting a different need can the supplier improve their price position and margin.

The next challenge is to put this on a sustainable basis. Clearly the regulated IP protection afforded by patents, trademarks, copyright and licenses help but the supplier should look beyond these to other forms of protection. Customer entanglement, loyalty schemes, long term service contracts, control over distribution channels and supplier inputs can all help shore up a longer term position. The supplier then needs to build an internal process of continuous renewal of competitive advantage and sustainability. Any competitive advantage at a single point in time will ultimately be eroded by new inventions, new entrants and expired IP rights. The smart business builds innovation and the creation of new customer value into their DNA so that competitive advantage can be sustained.

LOOK FOR DEEP EXPERTISE

Deep expertise can allow you to own the customer solution

What happens when someone steals your idea and then competes with you? I recall this happening to me with an ERP software product. One of my distributors reported that a consultant had copied our software and was intending to reverse engineer it. My immediate reaction was 'good luck'. We had spent many years developing the software, building a distribution channel and establishing good reference sites. Anyone who thinks they can acquire deep expertise overnight is fooling themselves.

What I have come to recognize is that deep expertise can be as effective as the protection offered by a well established brand, trademark or even a strong patent. We keep thinking that we need registered intellectual property (IP) to provide us with a competitive advantage, but knowing what to do and when can be a real winner. You only have to think of the years of training that professionals have to undertake to qualify to know that expert knowledge is hard won.

If everyone has the same knowledge then clearly there is no competitive advantage. You need to use this attribute of competitive advantage properly for it to work in your favour. That means going after a niche market, working on nasty problems and building up experience so that you can solve the problem better and faster than anyone else. You need to find an area of need where few people are prepared to put in the hard yards to build knowledge and experience. The best problems are those which require a lot of knowledge gained over many years or across many customer projects.

If you have a niche market with nasty problems, especially those which have a high compelling need, one strategy is to tie up the available source of that knowledge. If you build up a team of experts and therefore control most of the available source of supply of the knowledge required to deliver a solution, you basically own the market. Anyone who needs a solution has to come to you.

Premium prices are paid to people who solve nasty problems in niche markets, especially if the cost of delay or not solving the problem is very high. If you have a fire on an oil field, a ship which needs to be rescued, a security problem in your on-line payments system or concrete cancer in your apartment tower, you are not going to be overly price sensitive but you do want the best solution you can find. These types of problems often have very few suppliers as the knowledge and experience required to be effective takes many years to acquire. However, a great place to be if you have the solution.

This type of advantage can be acquired in many sectors. You need to identify nasty, complex problems which have a high compelling need and develop an expertise over time. If you are lucky, you may already have such a situation already but perhaps you haven't been marketing it enough. Just remember that deep expertise is a great competitive weapon if used effectively.

SCALABILITY

Rapid deployment into the market is essential

When we are evaluating a possible investment, it is easy to neglect to consider how the strategic value premium will be determined and how this impacts on what we can expect as an exit value. Our initial focus is generally on target need, customer and competitive advantage but while these protect the business they don't guarantee high growth rates. It is high growth rates in the hands of the buyer which will determine how large the strategic premium will be.

I recently evaluated a high tech software business which ticked all the normal boxes. It satisfied a critical need, targeted a very addressable corporate market, had a proven integrated solution with considerable deep expertise in its functionality and a proven management team. No question that the business would be successful and they would capture a reasonable market share. However, the key to a high strategic value premium is in the ability for the buyer to rapidly scale the solution in the first two years after the acquisition.

I put myself into the shoes of the buyer and asked the question 'how rapidly could I deploy the solution?' Even if the acquirer had access to the prospective customers and the funds to ramp up the marketing, sales and support effort, I could not see how they could scale rapidly.

The problem in endemic to a lot of application software ventures. A highly technical solution requires the business to recruit and train very specialised sales staff, pre-sales consultants and implementation staff. This alone tends to inhibit growth rates. In this case, the solution was also customized which would slow down the sales and implementation processes. Sales cycles in high value integrated applications are slow because of the evaluation and approval cycles and there is little the vendor can do to speed up the process. At best, I could see the acquirer doubling the business each year in the first two years after the sale but it would be a stretch to grow faster. If that is the case, the strategic premium would be relatively low.

If the growth rate is limited by the length of the sales cycles and the rate of adoption, the business will increase in value slowly. Thus, it will take many years for an investment to achieve 5 times investment on exit. If the growth rate is constrained in the hands of the acquirer for similar reasons, the value to the buyer is not much greater than if the business were sold as a financial exit. The key to any strategic exit is that the buyer can rapidly exploit the business through their own organisation. If that is not possible or is limited, the strategic premium will be small.

An outstanding strategic value investment demonstrates the capability of very rapid deployment within a short period after the sale. Not only do you want the compelling need, the highly targeted niche market and the strong competitive advantage but you want short sales cycles and very low marginal cost of sales. Standard products which can be sold through the internet or easily installed or distributed via high volume channels are what you look for.

I prefer to seek out investments where the acquirer can scale the business 20, 50 or 100 times after the sale. If the strategic premium is generated from revenue in the first two years after the sale, it is the rate of growth in this period which is critical to a high strategic value premium.

With any exit, we need to focus on what the buyer will do with the product or service being acquired. Just because something has a market leadership position does not of itself mean that it will generate a high strategic premium on exit.

TRANSACTION VELOCITY

The length of the sales cycle is critical to growth

We can easily overlook the level of demand pull when we are assessing strategic value. Just because a product has a patent, deep complexity and an obvious competitive advantage does not mean that it can fly by itself into the market. In fact, very few products have the ability to establish market leadership out of the box, most have to be supported with established distribution channels or complementary products.

I had two occasions recently to review products which had clear market leadership. Each solved a difficult problem in their sectors and each had reasonably strong competitive advantages. They both had impressive testimonials from major corporate customers and clearly delivered good value for money. Both said they had a long list of prospects and that the reports back from their prospects indicated sales in the future, however, their closure rates were relatively slow.

Closure rates and the length of the sales cycle are great indicators of pulling power. A product which meets a strong and compelling need has a high closure rate and relatively short sales cycles. Also these products typically have strong referral rates and usually good viral marketing. Products which have a significant competitive advantage and also meet a compelling need can often push their way into a market, opening up new revenue channels and quickly capturing market share for the acquiring corporation. I call these high growth potential products.

Products which have significant competitive advantage but do not satisfy the high compelling need test are low growth potential products. These products struggle because clients and consumers put them lower down the list of need to have solutions. Perhaps, they fall into the category of ‘nice to have’ which explains why the conversion rates are so much lower.

In seeking out strategic value investments we should focus on high growth potential products. The evidence which you need to produce for the strategic buyer to show market traction and pulling power is usually easy to assemble and normally obvious.

However, there are opportunities for low growth potential products for a strategic sale but the technique for establishing strategic value is different. In the case of high growth potential products, market demand is established directly with the product itself. With low growth potential products, the market potential is established in relation to a set of existing products for which the new product provides complementary value.

We can see this situation occurring often in software applications where a new module can be sold back into an existing customer base and then add incremental value to new sales. However, the new product is not sufficient strong to pull the other products into a new sale. In fact, this relationship accounted for much of the small software firm acquisitions throughout the 70’s and 80’s.

In the case of low growth potential products, we need to position them for sale into large existing customer bases where the selling effort is low and the customers are open to additional add-on products. The strategic buyer will pay a strategic premium because they can see an immediate short term method for recovering the acquisition cost.

High growth potential products which have the ability of driving new sales should be directed at the strategic buyer which has the capability and capacity to launch the product into the market and support a rapid growth activity. High growth potential products can be sold back into existing customers but, importantly, they drive new sales.

PART THREE: MANAGING THE INVESTMENT

The real work starts once the investment is made. Most early stage management teams are inexperienced with products which are often untested in markets which are still evolving. Systems and processes for performance setting and evaluation are unsophisticated and governance has yet to be implemented. The Angel acts as a mentor and coach during this period but avoids taking the role of micro manager. The main responsibility of the Angel is to steer the business towards the exit and to establish the structure, evidence and systems which will ease the path to a sale.

MANAGEMENT

Who executes the strategy

I know we all want the 'A' team managing our investee firm but we rarely expect to find one. What we tend to do is supplement the existing team with people with experience so that we have a reasonable chance of growing the business and avoiding the basic mistakes. We want to see a team with good leadership, strong marketing and operations experience and good networking skills. But aren't we simply assuming that there is one size fits all and that building revenue and profit is the only game in town.

I have been in number of investee review meetings recently where the intention was to build up the team to create a business which had a reasonable chance of meeting higher revenue targets. However, when the discussion has come around to positioning the business for an exit, a completely new set of requirements have been identified with dramatically different timescales. The question of who should undertake the exit strategy activities is a very different one from who could grow the business.

Once you focus on the exit, the set of tasks to be undertaken to prepare the business for, say, a trade sale are often very obvious and some will be of a specialist nature such as IP, legal and deal negotiation. Also you may find that instead of building up a sales and marketing force and establishing a customer base, you only need a couple of good customer sties as proof of concept. Instead of growing the business to 10, 20 or 100 people, you might just need a small team to complete a limited set of development and proof of concept tasks.

While your entrepreneur might not have the leadership skills to grow the business, he or she might be just right for building relationships to the prospective buyers. Alternatively, you might task the entrepreneur with getting the trial sites working and employ an experienced M&A corporate executive to set up relationships with prospective buyers and negotiate the final deal.

What is obvious from the many investee reviews which I have attended is that they have failed to work back from the exit to establish what needs to be done and who should do it. If the only business model you have in your head is revenue growth, you will always end up with a growth oriented team. If, however, you have a strategic exit in mind, the nature of the tasks to be undertaken are likely to be very different and it will call for a different mix of people. What you will also find is that the 'B' team you have is more than capable of participating in the exit strategy.

Strategic exits are much less demanding on resources, tend to have shorter execution times, lower operational risks and higher investment returns. What is also obvious is that it needs a different set of skills from a conventional growth oriented business strategy. Before you commit to hiring anyone, take the time to set out your exit strategy and then see how you would use the existing staff and what additional skills you will need to execute the exit deal.

EXIT ALIGNMENT

An exit is critical to a successful investment

The last thing we want in an angel investment is reluctance on the part of the entrepreneur and the venture management team to pursue an exit and yet we seem to put little effort into ensuring we all want the same outcome. Too many angels focus on the near term issues without appreciating that even these decisions need to be seen in the context of the exit. Far too many angels shy away from confronting the venture team about exit preparation seeing this as a confrontation issue rather than a collaborative activity. It is time to put the exit front and center and ensure there is an alignment of interests in a good exit.

We all have our own mental models for how we deal with issues in growing and developing a business but very few of us have the experience of multiple exits to guide us through an exit planning session. Unfortunately, we are trapped by an old valuation paradigm which places a value on a venture based on its achieved and near term inherent profitability and thus inhibits our thinking about how to get the best exit value. Apart from the fact that this is fundamentally wrong, it leaves our focus on growing revenue and profit rather than identifying the best buyers and packaging the business to give us the best exit value.

Without a framework to guide the discussion and to undertake the exit planning, we are left with a set of ad hoc experiences and half truths. Furthermore, you cannot rely on the commissioned business brokers and investment bankers to give you the best advice. They are in for the quick transaction and fast buck.

We have a number of issues to deal with in planning an exit; due diligence, change of ownership, selecting the best buyers and ensuring we get the best price. Each of these activities will require careful planning, often changes in the business structure and activities and a project plan with assigned tasks, timescales and costs to ensure we get the outcome we seek. Basically, a good exit does not happen by accident, it needs careful planning and an allocation of resources. Furthermore, you can't depend on circumstances becoming favorable just around the time you wish to exit. You need to manage and create your own circumstances to give you the best outcome.

We often forget that our highest value comes when the buyer clearly sees they can exploit the acquisition for significant gain. It is what the buyer anticipates they can do with the business which will ultimately determine the exit value. We need to construct a business at the point of sale where we reduce risks to the buyer as well as improve their probability of success on post acquisition performance. It would be naïve of us to expect we can develop the best post-acquisition results without the active cooperation of our venture team. Not only do we need them in the planning and construction of the business at point of sale, but we may well need them to be part of the post acquisition business which produces the results.

Our task as an angel is to gain the active cooperation of the entrepreneur and the venture management team in planning the sale and the post-acquisition potential. We want them to be active and enthusiastic participants in the process and we should ensure that it is worth their while to do so. The alignment we seek is to have the venture team as committed to the exit process as we are. They need to see that their best personal outcome is achieved when a great exit is achieved for the angels.

I have spent many years developing and documenting the exit process for high growth potential firms. This process deals with the alignment of interests, due diligence preparation, identifying the potential buyers and preparing the business for the best post-acquisition performance. I urge you to use this process to ensure exit preparation is at the top of your list for your investee reviews.

FOCUS

A clear vision drives decision making and productivity

How often have you listened to a presentation on a business to then ask yourself the question ”But what business are they in?” or “But what do they really do?” If you are confused just by being the recipient of the information, doesn’t it make you wonder how confused they must be? Try another test. Gather up a set of business cards at a meeting and then try to work out what each business does. You will be surprised how difficult it is. However, you don’t see this confusion very often with high growth SMEs. They seem to have a much better idea of who they are and what problems they solve. This simply comes back to having a really good focus on their mission.

You often see businesses which have multiple streams of activities in different markets with different products. While it is perfectly understandable that the start up entrepreneur will take on whatever they can do to survive, the established business really does not have that excuse. What is very clear is that they lose the opportunity of driving high levels of productivity by spreading themselves across too many activities. Unless you have some natural advantage stemming from a protected market position, the ordinary business is best served by concentrating on developing a competitive advantage through learning curve effects. By this I mean, getting better and better at one activity where they can build expertise, market reputation, customer loyalty and strategic relationships and, by doing so, leverage up their margins.

The biggest advantage of a clearly articulated focus, which defines not only who you are but what you do, is that it helps drive every aspect of the business. The difference between ‘we solve our customers problems’ to ‘we provide safety building accessories to high rise office developers’ is staggering if you are running a high growth business. A clear focus helps everyone in the business make decisions. Whether it is what to invest in, what opportunities to pursue, who to recruit or what marketing expenses you should incur, the better focused business has a much greater ability to empower decision making down through the organisation because every employee has a clear grasp on where they are going.

The productivity impact of a well articulated focus comes from the accumulated wisdom and intellectual capital developed over time in the business. Just like the medical specialist who sees 100 times more instances of a problem than the local GP and thus is quickly able to diagnose and treat even the most unusual medical complaints in his or her speciality, the same applies to a business. The firm which builds a deep expertise in a niche market is more able to correctly and quickly identify problems and appropriate solutions, more economically able to assist their customers and be more reliable as a supplier. This in turn drives higher pricing, higher margins and more sustainable growth. The deep expertise acquired is the foundation of their competitive advantage but also their protection from competitor attack. In a growth market, a tight focus will underpin the ability of a business to take advantage of growth opportunities.

IPO EXITS

Are you ready for an IPO?

Too many businesses see an IPO as a quick fix to underlying problems in their business. They think that if they could only raise sufficient funds, they could by their way out of trouble. This is entirely the wrong view of an IPO. While we know that the public market can be somewhat unpredictable, we do know that, with the exception of high risk ventures in mineral exploration or drug development, the IPO process especially suits ventures with high growth potential where the funds are being used to fuel that growth.

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

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

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

Knowledge of the IPO process itself by the management team is a major factor. This demonstrates just how important the roadshow to the brokers and the presentations to institutional investors are. Achieving significant share purchase commitments up front is almost a necessary condition for a float. Knowledge of retail and institutional investor risk and return requirements and being able to convincingly show growth potential is an imperative. Investors are typically risk averse and will quickly zero in on potential risks in the venture. The management team must be able to convincingly demonstrate knowledge of their business, their industry and how to mitigate possible risks.

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

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

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

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

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

Post IPO performance needs to be carefully planned. A comprehensive communication strategy needs to be put in place to keep shareholders, analysts and institutional investment funds informed of progress. Management must ensure that expectations are realistic and that they manage performance to meet their targets.

Also don't forget that the end game might be a strategic sale in which a short term listing might be used to prepare the business for the ultimate deal. If the business has a product which can be widely exploited by a global corporation but additional finance is required to prepare the business for sale, a limited fundraising IPO might be just the vehicle needed to see the business through to a significant global deal.

ADDING STRATEGIC VALUE

How do I move my business from a financial sale to a strategic sale?

Where are the big bucks in selling a business? If you think of those businesses which managed to reap many times revenue, then what you will see is a sale based on some underlying asset or capability which a large corporation wished to exploit. The reason they are prepared to pay such a large premium is because they have worked out how to generate many times the revenue and profit of the seller. They achieve this, typically, by selling the seller's product or service through their own distribution channel which is likely to be tens, if not hundreds, of times the size of the seller's.

Financial sales, on the other hand, only represent what the seller's business can achieve on its own. Even if this has significant potential, it will fall a long way short of what a national or global corporation can achieve with the same product or service. So the business which sells to a financial buyer is lucky to get several times EBIT for its business whereas the strategic sale can often generate large multiples of EBIT or many times revenue.

The key to a strategic sale is to provide a large corporation something which can generate large incremental revenue through the buyer's existing distribution channel or to enable the buyer to open up new markets for significant revenue. The basis of such an opportunity lies in exploiting an asset or capability which the seller has. The opportunity for the large corporation is to throw significant resources at leveraging the asset or capability where short term revenue can be readily generated. Even if longer term opportunities exist, the short term revenues are the ones which will justify the premium on sale.

The task of the business owner is to identify those assets (patents, trademarks, licenses, copyrights, brands, customer base, locations, specialized plant, deep expertise, etc) or capabilities (those things which you do which you do exceptionally well) which a large corporation could exploit. The target asset or capability then needs to be protected in some way so that the buyer has some reasonable time to exploit it without it being copied or eroded by its competition. Lastly, the asset or capability needs to be put into a form where it can be readily scaled or replicated to provide the revenue generating capability and/or capacity required for larger scale operations.

You need to imagine that you are building a launch platform and vehicle for the buyer. The buyer is going to provide the launch site, fuel, crew and landing site. Your job is to work out what it would take to generate significant revenue from your target asset or capability and then to construct a launch capability from which a new revenue strategy can begin. At the same time, you need to build protection through patents, brands, trademarks and expertise to slow down the erosion of the competitive advantage which the buyer is acquiring.

Strategic value does not depend on your profitability or growth. Even size may not matter if you can provide the right scalability capability. Many companies have achieved significant sale prices where they were not yet revenue generating or were in a loss situation.

INTELLECTUAL PROPERTY

How important is it to have intellectual property?

Intellectual property (IP) can form the basis of a competitive advantage in a conventional business which would be sold on its revenue and profit generating ability or the basis of strategic value for business sold to a large corporation. By intellectual property I mean those forms of rights embodied in patents, trademarks, copyrights and brands or those which stem from deep expertise. The business advantage which accrues from IP is the ability to exploit it for commercial advantage where competitors cannot readily match your products or services in your target market. Thus, IP typically allows a business to charge a premium for its products or services because customers are not able to find close substitutes.

When we calculate the value of a business we look to two different approaches to assessing value; the future stream of potential profits or the strategic value. In the case of a conventional business, the IP generally provides a greater level of stability and certainty to future profit streams. This has the effect of reducing the risk associated with the business as well as providing more certainty around future income projections. These two factors combine to reduce the valuation discount rate and generate positive present value for more distant earnings, both of which substantially improve current sales value for the business.

In the case of a strategic sale, IP is almost always at the heart of significant premiums on sale. The nature of the strategic sale is that the business being sold has some asset or capability which a very large corporation can exploit throughout their organization or their customer base. To have value, however, those assets or capabilities must provide a reasonable time for the acquirer to exploit them without being eroded or negated by competition. Also, to have value, the buyer must not be able to easily acquire, build, assemble or develop a similar asset or capability within a reasonable time period, say, two years. At the same time, the strategic asset or capability, in the hands of the buyer, must be able to be scaled or replicated quickly to generate significant revenue. All these characteristics are present in good IP.

Most business can improve their profitability and growth potential by developing IP to enhance their competitive position. In doing so, they will almost certainly improve their current valuation in a conventional financial sale. Those who are able to develop IP which would be of interest to a large corporation are especially fortunate because a strategic sale price would almost certainly be several times greater than that of a financial sale.

Entrepreneurs interested in selling their business would be well advised to examine their business to see what knowledge could be developed into registered IP. Alternatively, unique expertise may be able to be documented and prepared so that it can form the basis of a strategic sale. By taking the time to uncover and package such IP, they may be able to position their business to better advantage and thus gain a premium on sale of their business.

CREATE VALUE

Unlock Your Strategic Value

Many business are either unable to exploit the underlying strategic value in their businesses or are simply unaware that it exists. Most firms are focused on what they can do today and spend their efforts on those parts of their business which are easiest to leverage in the short to near term. Additional value which may be exploited from underlying assets or capabilities is left unrecognized or untapped. But this may be where the real capital gain on the sale of the business resides.

Acquirers are prepared to pay a premium on the purchase of a business where they can see assets or capabilities which they can leverage through their own resources. For example, they may be able to open up considerable potential for existing products where they complement the buyer's own product range. This may be because they have a large customer base, a well developed distribution channel or alliance partners which can utilize the products. The key to strategic value lies in releasing the potential of the acquisition. Existing vendor products could be used to open up new markets or underlying vendor technologies could be used in combination with their own capabilities to develop new products for an existing market or used to enable the buyer to enter a new market.

Most businesses are valued on the basis of the profits they generate from their current operations. While this is fine for those businesses which have limited potential, it seriously undervalues those businesses which could be better exploited by a larger entity which can leverage the business into larger markets or provide better funding for growth.

Many privately owned businesses are limited by their access to internally generated funds or by the capabilities of their owners. Most are reluctant to seek external finance as this puts them at greater risk or dilutes their ownership. Perhaps to reach the next stage in the development of their business they need to invest in new technology, specialized staff, new plant and equipment or a professional sales force, all very scary to the owner that has a nice tidy business that is generating a good income. But the business itself may be more than capable of expansion given an injection of more experienced management talent, sufficient funds or access to a larger market.

Often there is a gold mine of intellectual property or intellectual capital in the form of patents, unique processes or specialized knowledge lying dormant in the business which is not reflected in the current balance sheet or profit statement. The business might be sold in haste due to the ill health of the owner or due to a serious downturn in revenue without these underlying assets ever being noticed. In the rush to sell the business, the owners may not have taken the time to evaluate the potential of untapped assets or capabilities. In the end, the business is sold and the owners never benefit from the true value in their business.

Business brokers rarely have the opportunity to fully prepare a business for sale to a strategic buyer, a task which can only be done over an extended period of time. The key to unlocking strategic value lies in the preparation of the business for sale. Instead of rushing into selling the business, the owner needs to take 18 months to 2 years preparing the business for sale. During that time, the strategic value within the business is examined in light of how a buyer might exploit it; not how it is being used within the current business. The owner needs to answer the question 'Who can make more money out of this business than me? Most strategic buyers work within the same industry as the seller and are often working with similar products, services or technologies. Often it is simply that the larger business can readily exploit the potential.

Strategic exits usually achieve sale values many times those of conventional businesses. So slow down, take a real hard look at where the strategic value lies in your business and then take the time to prepare the business for sale to a company which will pay you a premium for the opportunity to exploit it.

REDUCE RISKS

How do I reduce risks to the buyer?

Many business owners rush around cutting expenses and pushing revenue generating activities just before a sale of the business in order to pump up the profits. Their objective is to increase the valuation at the time of sale, however, they neglect to reduce the risks in the business for the buyer which often negates all their efforts.

Smart buyers anticipate problems in an acquisition and set out to find them before they agree to buy and set a final purchase offer. They are looking at three areas of risk; inherent problems within the business, problems which they will encounter on integrating the acquired business into their existing activities and constraints which will prevent them from achieving their target return on investment. In order to protect the value in your business, these are areas which you need to address in preparing the business for sale.

Any corporation which has undertaken a number of acquisitions will probably have made mistakes and almost certainly will have acquisitions which failed to provide them with the anticipated benefits. They have been burned, probably more than once and so they are looking for problems. They will have a very long due diligence checklist of all the things which their accountants and lawyers tell them to watch out for and they will have their own experiences which will add to the list. They will sniff out every discrepancy, irregularity, missing information, potential liability and risk which they can before they agree to move forward.

Any extensive due diligence process takes time, uses up administrative resources and creates stress and disruption. It distracts senior managers from running the business and takes attention away from running the business. If the investigation uncovers problems, it normally leads to a reduction in the offer price and more delays as the due diligence is extended.

The only way to counter this negative impact on your sales price is to be fully prepared for due diligence. Probably the best preparation is to have your own accountants and lawyers undertake a vendor due diligence. This will examine your business through the eyes of a buyer and point out to you where changes are required. Once you have implemented those changes, keep your due diligence files up to date and your performance and governance systems working properly so you will be ready for the buyer due diligence.

Also think about how your business might be integrated with that of the buyer and what you can do to ease that path. Using standard industry contracts, documenting processes, ensuring the key employees are retained and putting in a succession plan are some of the activities you might undertake.

Next, think about how the buyer will operate your business after the sale and put in place systems and processes which will make managing the business easier for the new owner.

Really smart buyers purchase companies which are efficiently operated and are prepared for a new owner. The new owner can then concentrate on generating profits instead of fixing problems.

PREPARE THE BUSINESS

How long does it take to prepare a business for sale to maximise the value?

Business owners who wake up one day desperate to sell their business and move quickly to put it on the market throw away a lot of value on sale. With a little bit of preparation, the value of any business can be multiplied several times and, in some cases, many times. The key to securing the highest price is to work out how the buyer can gain maximum value from the acquired business and then to prepare the business so that the prospective buyer can see its potential and be willing to bid a higher price for the business as a result.

The basic theory underlying investment value is net present value. Future net earnings are discounted using a risk discount rate to arrive at the net present value of the investment (NPV). Providing the buyer acquires the business for a price equal to or less than the NPV, they should (on average) achieve their target rate of return. This suggests that the vendor can best prepare their business for sale by maximizing the future stream of net earnings and by having the buyer apply a lower risk rate to that earnings stream. Since the future stream of net earnings will be created through business productivity, revenue growth and business potential, any improvement in these components will impact the value of the business. For example, a 10% cumulative growth in net earnings will double the value of a business while a 20% cumulative growth rate will increase the value of the business by a factor of five. With these possibilities in sight, some attention to profitability and growth is worth the effort and certainly worth delaying the sale while the foundations for such growth are created.

In calculating the potential value of the acquisition, the buyer will also be considering how much risk there is in the business and how long it will take to get the business to a point where any growth potential can begin to be exploited. The underlying risk clearly impacts what risk discount rate the buyer will use. Thus a business which is well managed, has good internal systems for performance setting and evaluation and has good governance is going to present less risk to the buyer. A business which is efficient and productive and ready for a thorough due diligence review is going to be much more attractive and considered less risky by potential buyers. A business which is ready for new management and well positioned to take advantage of growth opportunities is also going to represent a more valuable investment by the buyer. Lower risk equates to a lower risk discount rate which in turn increases the value of the business.

Instead of running out to find the nearest business broker who will advertise the business to everyone, the entrepreneur should spend some time to consider what type of buyer could best exploit the potential in the business and how the business should be prepared to allow the new owner to manage the business to take advantage of that potential. Since not all potential buyers are capable of exploiting the potential in the business, the vendor should also consider how to attract the right buyers. It is only by finding buyers who are willing and able to exploit the business potential that the vendor will be able to extract the highest price in a competitive bid.

COMPETITIVE BID

How many potential buyers do I need?

It is very difficult to extract the maximum value on the sale of the business if you have only one potential buyer. Generally speaking, the only way you can do this is to be in a position where you don't need to sell but you are willing to do so if your terms and conditions are fully met. Simply by being hard to get, by having a business which gives you satisfaction and not having any great desire to do anything else will provide a basis where you force the keen buyer to do all the running. However, if your business is in trouble and the only potential buyer can afford to wait, you will almost certainly be a fire sale and lose much of the value of your business on sale.

So while one potential buyer is possible, common sense would suggest that several are much better. The question is how many is likely to create an optimum exit? The real issue here is how well you have selected your potential buyers rather than how many. A lot of possible buyers where none have a burning desire or need for the acquisition is almost certainly worse than one keen buyer. Thus an important component of preparation for sale is to ferret out those companies which have the highest need for what you can offer but are also in a position where they have the willingness and capability to go through the acquisition process.

There are some simple rules of thumb when it comes to identifying possible buyers. Most buyers are larger companies within the same industry; they typically have acquisition experience and deal with similar or complementary products. By doing some industry analysis and working with professional M&A advisors, it is not difficult to narrow down a list of possible suitors. The next stage would be to establish contact with them to ascertain their appetite for new acquisitions, especially for a business like your own.

In the end you need at least two keen, active potential buyers, each of which has a clearly expressed need to acquire a business like yours. However, sometimes timing does not always work in your favour. At the time you wish to sell, they might be involved in other projects, fighting internal fires, be subject to external threats or have used up their acquisition funds. Thus you cannot really depend on just a couple of potential starters. What you really need is at least 6 to 8 active interested buyers. With a little bit of luck you will be able to deal with most of them. In the worst case, you can be confident that you will have at least two left to negotiate with. However, your back up plan should be the ability to delay until circumstances bring more potential buyers into the process.

Also be very careful not to have too many potential buyers. The best ones may simply pull out or they may decide the costs of participating in the process are too high. In the end, it very much depends on your ability to help potential buyers understand what you bring to the table and in creating some level of competitive tension at deal time.

DOES SIZE COUNT

How big do I need to be to get the best price in a strategic sale?

Most people confuse a going concern business valuation with what the business might be sold for to a large corporation. We are constantly told that our business is valued as a multiple of our net earnings. The earnings multiple is determined by the industry with some adjustments for the quality of the business, as measured by its stability and efficiency, and the level of growth it demonstrates. Basically this is bad news for the business which is making a loss or those which invest heavily in research and development, market expansion or staff development. Basically, it is hard to get paid for potential.

However, when you look at value creation from the point of view of creating strategic value, you get an entirely different set of value creation characteristics. In this situation, profitability, size and growth may not matter. What matters is whether you have an underlying asset or capability which a very large corporation can exploit throughout their organization or across their distribution channel.

In my case, I sold a 30 person software business which, at the time, was facing insolvency due to a sudden shift in the market and was making a one million dollar loss, to Peoplesoft for six times revenue. What was clear was that the value to Peoplesoft was generated by their ability to sell my software products directly into over 1,000 of their existing customers. At about $500,000 a sale, this represented a very large revenue opportunity. The key to this deal was that our software products were well suited to exploiting this opportunity within their customer base. Furthermore, there was really no other alternative available to them within the near term. If they didn't step up to acquiring our business, they would walk away from the revenue opportunity but they also might be allowing a competitor to acquire us.

However, while profitability, customer base and growth may not be important to a strategic deal, size may mater. In order to deliver a platform from which the opportunity can be launched, the business needs to have the capability and capacity to provide the launch platform. The asset or capability which is destined to provide the source of the revenue opportunity to the buyer must enable the buyer to achieve the acquisition objectives. If the business is too small, or the asset or capability has not been structured for scalability or replication, the business may not be worth acquiring. Thus size matters to the extent that it allows the buyer to exploit the opportunity. However, beyond that point it may in fact reduce the value of the business. If the buyer has to discard parts of the business or close parts down, their may be costs, delays and risks in doing so.

Unlike a conventional business where profitability, growth and size matter, in a strategic sale the sale value of the business is entirely based on how quickly the buyer can exploit the strategic asset or capability. The seller's task is to prepare the business in such a way that the buyer can quickly exploit the underlying potential.

INVESTMENT FOCUS

Use the investment to build an exit

Remember the Christmas carol ‘Do you hear what I hear?’ There is a line which goes ‘Do you see what I see?’ I have been reminded of this frequently over the last few months as I have been asked to mentor some early stage ventures on the Gold Coast. Almost without exception, I have seen significant strategic value in these businesses which the entrepreneur hasn’t. While they appreciate the competitive advantage of their product or service, they only see the business in terms of its near term growth and are wholly focused on overcoming their growth constraints. With a little bit of luck they may be able to develop their venture to 5 or 10 or 20 employees over a 2 to 3 year period. What they fail to see is that a large global corporation would be willing to buy their business for millions of dollars to take their product or service to a global customer base and that there are investors who would be willing to fund such a process.

Most entrepreneurs I talk to are locked into a view of business value tied to generating revenue and profit growth and fail to appreciate that this view limits their ability to fully exploit their potential. Leaving aside the fact that early stage businesses have a high failure rate, the growth of the business will be limited by the knowledge, experience and finance of the entrepreneur. Developing a business to $2 million in revenue or 20 employees is achieved by less than 6% of all start-ups. Even after several years of growth, most businesses are worth less than $1 million. But in the hands or a larger enterprise, the same product or service could be worth many times that.

However, even if the entrepreneur recognized the value of their product or service to a larger enterprise, they usually don’t have the knowledge or the capacity to develop their business to create the maximum value of sale. Few entrepreneurs understand the process of preparing a business for sale. Even if they were interested in doing so, the advice they would get from the vast majority of business brokers and advisors would be based on a conventional EBIT multiple valuation and a local sale. Few brokers and advisors would recognize the strategic acquisition potential or even understand how to set up a global trade sale. The entrepreneur is surrounded by advisors and colleagues who only see enterprise value in terms what the business itself has achieved not what a potential acquirer could do with the business.

Even if the entrepreneur could see the potential of a significant sale of the business, they usually don't have the resources to prepare the business properly or to undertake the deal making activities to secure the best buyer. So even when they see a potential high value exit, they dismiss it because they don't have the ability to execute it.

This situation is not uncommon and yet few advisors or entrepreneurs seek out funding to undertake an exit project. Perhaps it is because they don't know that such facilities exist or it may be because they don't know how such an investment proposal could be constructed. However, not only is such funding available but it can come with the knowledge and access to individuals you can execute the deal.

I have recently seen a number of small businesses with well established products or services which could be sold for millions of dollars which only need funding for a preparation and deal making project. The project is likely to take less than 18 months and the finance needed is often only a few hundred thousand dollars. Even if the entrepreneur gives up a large minority stake to undertake the project, the return to the investors and the entrepreneur are significant. This is very fertile ground for an Angel Group investment. Not only can they provide the funds but they can assist with developing the sale preparation process and can source the executive talent to set up and negotiate the deal.

Preparing a business for sale at a premium is much more than cleaning up the accounts, producing an information memorandum and advertising the business for sale. A proactive approach to a trade sale identifies the potential buyers, sets up relationship with those corporations and then develops the business so that the buyer can exploit its potential. The business may be restructured prior to a sale, products may be modified and new trading relationship developed to better position the business for sale. A sale strategy developed in conjunction with an Angel Group would fund and resource that part of the strategy which the entrepreneur was unable to. Not only can the Angel Group find the investment funds, they can tap into their member experiences and networks to access the right resources and connect to the best buyers.

Where an entrepreneur has limited capability or capacity to develop the business and where the product or service has considerable market potential, selling out is a smart move. Tapping into the resources and connections of a local Angel Group to ensure that the best deal is secured is also a smart move. What is disappointing to me is that few entrepreneurs even know that this opportunity exists.

PART FOUR: EXIT STRATEGY

Begin with the end in mind! That should be the methodology used in Angel investing. You need an exit to recover your investment and gain a return on your funds invested. However, many Angels invest without examining the exit options believing that a good business will always find a home. But the truth of the matter is that this leads to inappropriate strategies, poor returns and often failure. If we start with the exit, we at least focus our investments into those ventures which have a higher chance of a successful exit. It also means the strategy we adopt along the way sends us in the right direction.

IDENTIFYING BUYERS

It pays to find the right buyer

When you are selling your business it pays to look at your business through the eyes of the acquirer. While it might look attractive to squeeze the last drop out of your buyer, you should try to avoid the naive buyer. There are some very good reasons why you might want to limit your selection of potential buyers to those companies that have a good track record of successful acquisition.

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

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

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

processes to deal with under-achievement.

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

Clearly successful acquirers rarely overpay for their acquisitions and so it would appear that your chance of generating a premium on the sale of your business would be minimal. However it is clear that successful acquirers also look for strategic value. They are interested in acquiring firms that can clearly add to their core business through extending the scope of their offerings or their ability to scale the size of their business through distribution capacity or customer base. The firm that can show how their products, processes or capabilities can be leveraged by the acquirer should thus be a good acquisition target.

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

There are some other good reason why you might want to look for competent and successful acquirers. Generally they understand what to look for, thus their due diligence will be thorough. If they find a serious problem they will request it be fixed, make an allowance to fix it or walk away. That means that there are unlikely to be hidden rocks which can catch you out later on. The last thing you want is for the buyer to sue you over something that could have been discovered during the due diligence process. You also want a successful integration for your business into the buyer's and you want them to achieve the benefits of the acquisition. A buyer that is making lots of money from an acquisition is less likely to worry about a few problems that they uncover. However a deal that goes sour will find the buyer going over every inch of the business trying to find how they can litigate to get their money back.

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

The message is compelling for the potential seller. Identify those corporations in your industry or adjacent to it that can leverage your assets and capabilities to create significant value, set up a relationship with them to allow dialog and then build a case to show them how the acquisition can work for them. Then you wait for the offer or decide when to make the approach to them.

STRATEGIC BUYERS

How to identify a strategic buyer

Few businesses are capable of generating a sale price of more than four times their revenue or forty times their net profit and yet it does happen. Furthermore, if your business has the right attributes, you can develop a strategy that has a high probability of achieving that size of a premium at the time you sell your business.

The key to a high premium on sale is to identify how a potential acquirer, the "strategic buyer", could leverage assets and capabilities that you have in your business to generate significant revenue. Basically the strategic buyer can take what you have or do in your business and place it into an environment where it can be exploited to generate significant revenue and profit, perhaps tens or hundreds of times what you could have achieved yourself. It is the size of that opportunity that justifies the size of the premium on sale.

Conventional valuation techniques are based on what could be called the independent investor model. That is, what could an investor generate as a return on their investment by buying your business and paying themselves a dividend of the free cash generated by the business. If the future uncommitted cash flow is discounted by the prevailing rate of return required by independent investor, a value can be assigned to the business. Entrepreneurs typically push up their market value by improving profitability and providing a platform for future growth. However this model fails to take into account the additional benefits that a corporation could achieve by leveraging the assets and capabilities of the acquired business into a much larger entity.

To find the strategic buyer you need to ask some key questions.

- What corporation has a large customer base that would buy my products?
- If I have a large customer base, what corporation has a set of products that could be readily sold into my customer base?
- Could my products or underlying technology be used to open up new markets for a large corporation that has the resources to fund the market development?
- Do I have products that could be easily modified or

extended to create new products that could be sold into an existing customer base of a large corporation?

- In conjunction with the capabilities and technologies of a large corporation, can my business provide the catalyst for a large corporation to break into a new growth market?

Most often the strategic buyer occupies a place in your industry. They are often competitors, alliance partners, customers or suppliers. They often sell to the same or similar customers and thus understand your market and can readily appreciate the opportunity if presented to them. The best acquirers will be experienced acquirers, have staff who undertake acquisition evaluations frequently, experienced executives that assist with the integration of new businesses and have acquisition processes that can readily evaluate an obvious synergistic opportunity.

However, significant premiums don't normally happen without some preparation. The premium can only be justified if the vendor's business can be rapidly integrated into the buyer's organization and the opportunity readily exploited. That also means that the business must be ready for sale. Underlying problems, risks and potential litigation need to be resolved in advance of putting the business up for sale. Internal systems for performance management, compliance and operational efficiency have to be in place and working. Key employees need to have incentives to prepare the business for sale as well as be willing to assist in the transition of the business to the new owner. Finally, the entrepreneur and the senior executives who are unlikely to go with the acquisition, need to be able to prove to the new owner that they have built a robust succession capability.

A proactive strategy for achieving a strategic sale needs to consider a planning horizon of about four years. The first two years are spent reducing risks in the business, identifying potential strategic buyers and building informal or trading relationships with those that have the highest potential. The two years after the sale include the period required to integrate the two businesses as well as the early stage of opportunity exploitation. The more revenue that the buyer can generate in the early days of the acquisition, the more value the seller can extract as a premium on the sale.

Of course, you do need to have more than one potential buyer at the time you come to sell. You need to create an auction among several potential acquirers where each sees a compelling reason to undertake the acquisition. You should also have the best professional advice you can afford. Professional advisors that have experience working with large corporations on acquisitions are very useful when they are in your corner.

Does this process work? Certainly! If you examine situations where high premiums were achieved by the vendors, you will always find that the buyer was after some underlying strategic asset and that the current revenue and profit of the acquired business had little relevance to the price paid.

ASK THE BUYER

Find out what you need to do for a compelling deal

I have sat through countless business strategy meetings where the only form of business value creation is growth in revenue and profit and yet it is clear that the highest exit value would be achieved by a strategic sale. By a strategic sale I mean a sale to a large corporation who can rapidly scale up the products or services created by the investee firm. Even when it is accepted that there is a near term exit objective, the discussion of the management team and their advisors has been fixated on proving the business model as if this is the key to closing the trade sale.

In a strategic sale, the business creates value on sale because the buyer is able to exploit an underlying asset or capability of the investee firm to generate new revenue. Clearly the best buyer is one which can rapidly scale the operation and use its existing extensive distribution channel to take the product or service to market. In that case, the major elements of the business model are already in place – the buyer has them right now. So if we are not setting out to prove the business concept – what should we be doing?

The key to a strategic sale is to provide the buyer with the evidence to allow them to make the acquisition decision in your favor. So we might start with the prospective buyer's acquisition criteria. If you don't know it, why not go and ask them. That may seem a bit bold but large corporations do have very well defined criteria for an acquisition. They also have what you might call preferred situations – that is, they can live with some issues but they would prefer to avoid them. Most M&A departments will share the information with you as it helps them in their final selection.

Another approach is to think though how a prospective buyer would exploit the acquisition. What could you do to enable the buyer to more quickly scale up the revenue generated from the acquisition or more easily integrate the new business into their own. What evidence do you think the buyer would want to see to convince them of the value of the acquisition? It may be patent registration, customer testimonials, quality data, expert opinion, marketing surveys and so on.

What you don't want to do is to undertake any activity which distracts you from the strategic trade sale strategy. If you don't need hundreds of customers, overseas distributors or a multi-lingual web site to prove you case – then don't do it. Keep in mind that you are building a business to sell to a large corporation which has the capability and capacity to rapidly scale of the activity. You are simply giving them enough information to allow them to make the acquisition decision. If you have selected your buyers correctly, they will know how to do the rest.

If in doubt – simply go and ask them what proof they would need to make the acquisition decision in your favor and what they would like to have in place to allow them to quickly exploit the opportunity. What you find out should determine your development strategy.

PATENTS ARE OVERRATED

What is important is sustainable competitive advantage

Far too many of my angel colleagues are fixated on patents as the source of sustainable competitive advantage. While these are often the source of competitive barriers they are by no means the only effective method for generating high growth. In fact, there are many situations where the patent itself provides little or growth momentum.

We need to see a potential investment in a business in more holistic terms and especially we need to focus on the way in which the business interacts in the marketplace with its customers and competitors. If you want to drive high growth then you first need a combination of a well defined large niche market, a robust channel to market and a product or service which satisfies a compelling need. The next critical component is to have something which give you a strong competitive advantage. It is this combination which drives high growth. A patent alone, which provides some level of competitive advantage is somewhat meaningless without the other attributes.

Competitive advantage is anything which give you an advantage against others attempting to satisfy the same need. But there are many points along the supply chain where you can gain such an advantage. You can control the point of purchase by ensuring yours is the only product offered. You might have an exclusive right to a geographical region for the only product which satisfies the need. If there is a unique component, ingredient or area of knowledge required to produce the solution, you might own or control the supply. Your objective is to own the customer solution and there are many ways in which that can be achieved of which patents are only one of many possibilities.

There are of course a number of more obvious barriers to entry including brands, copyright, licenses and patents. But being able to take advantage of significant economies of scale or learning curve effects might give you a cost advantage.

Patents are useful because they are an obvious source of competitive protection but in themselves really don’t drive growth potential. If we focus too much on the patent element, we are in danger of missing the real growth drivers which are resident in the problem being solved and access to willing and easily addressable customers.

Given that most of the Angel exits are via a trade sale, our focus on competitive advantage and growth potential should be from the viewpoint of the buyer not the venture itself. It is the ability of the buyer to take advantage of the competitive advantage position which results in the higher exit values. This is especially relevant where the venture itself is not able to fully exploit the advantage. For example, a weak open market competitive position may change dramatically for an acquirer which can position the acquired product alongside a strong complementary product or inside a product portfolio. Similarly, a product which can be sold directly into an existing customer base may be very attractive to an acquirer even if it not the best stand alone product in the market.

In evaluating a venture, especially for a strategic value exit, we need to take a broad view of competitive advantage and look at the revenue possibilities of the acquisition from the buyer's perspective given the buyer's ability to exploit the underlying potential. In this regard, the ability of the buyer to rapidly deploy and scale the acquired asset or capability is of much more importance than the strength of any underlying patents.

GROWTH

Is growth really critical?

I have frequently been heard to say to an entrepreneurial team 'Don't grow!' This is normally received with a chorus of exclamations and some strong objections. It is only as I set out how their value is created through strategic value rather than growth that they see the logic of putting their efforts into creating more strategic value rather than simply growing the business. In fact, further growth can sometimes decrease value.

Our traditional model of business value creation is all based on the 'proof of business concept' paradigm. That is, value is created through generating ever higher levels of revenue and net profit. Of course, this is certainly true for the vast majority of businesses but it is seriously sub-optimal for strategic value ventures. Increasing value in a strategic value venture is achieved by increasing the value to the strategic buyer not in generating higher profits in the business.

In a strategic sale, we create value by providing a product or service which the buyer can exploit, usually over a large customer base or extensive distribution channel. What we are doing is plugging our product or process into their business concept rather than developing our own. A global corporation hardly needs us to show them how to generate more customers or support products through a distribution channel. What they are looking for are ways to exploit the infrastructure they already have.

However, the strategic buyer needs proof that the product or process can be readily exploited through their business. This evidence may vary from situation to situation but can normally be expected to encompass things like evidence that the product or process works, the competitive advantages are strong and sustainable, scalability is able to be achieved, sales will be profitable and so on.

The strategic buyer's due diligence will focus on whether they can rapidly scale up operations around your product or process not whether you have been able to do so. This being the case, your level or sales or profit may be quite irrelevant to their assessment.

Once you have a proven product or process and can show that a limited number of customers want it, use it and are satisfied with the price and performance, you may have sufficient evidence to prove demand. A large corporation will soon establish whether their existing and prospective customers will buy it in large numbers. At this point, you will create greater exit value by concentrating on aspects of scalability and making the integration into the buyer's business easier.

My last business, Atlanta based Distinction Software, was sold to Peoplesoft for 6 times revenue. Peoplesoft was really only interested in the software modules. They had over 2 thousand customers at the time of acquisition, many of whom would be targets customers for our products. They were not interested in our customer base of 20, especially as most did not use Peoplesoft applications. They terminated all our distributor arrangements and made most of our administration and senior executive staff redundant. It was the scalability of the product suite in their hands which was attractive to them not our small customer base or distribution arrangements.

If the buyer has to unwind parts of the business, dispose of segments of the operations and terminate distributor and supplier arrangements, this can cost them money and time. Any distraction from moving the business forward to exploiting the underlying asset or process is at the cost of the vendor.

In setting up a strategic sale, we need to work backwards from the exit to ensure we are doing those things which contribute to higher strategic value. If we have additional funds or resources, these should be directed towards increasing our strategic value rather than generating higher levels of revenue and profits for ourselves, especially if this has little or negative impact on our exit value.

STRATEGIC EXITS

Strategic exits are different

Over the last few years I have written extensively on strategic exits and encouraged Angel investors to concentrate their investments where a strategic exit is highly probable. I have focused on strategic value investments as I have found convincing evidence to show that these have higher ROI, shorter investment periods and lower execution risks. I have observed that more Angels are now discussing strategic exits but I find that there is some confusion as to exactly what is a strategic exit.

I don't think there is any confusion that a strategic exit does not occur where a single individual buys a business to manage it themselves. There are no benefits which accrue to the buyer beyond the boundary of the firm. Any return the buyer receives on their investment must come from the revenues and profits generated by the assets and capabilities of the acquired business. However, we would anticipate that a smart buyer would bring additional knowledge, funding, networks and experience to the business thus improving the return on the investment. In fact, knowing they could generate higher profits from the business through their own contribution, they may be prepared to bid higher for the right to acquire it. This is clearly a financial acquisition rather than a strategic acquisition. Therefore, the sale is a financial exit.

On the other hand, a business which is bought solely for its IP by a corporation and which has no revenue history or sales capability and will never be managed as a stand alone entity is a strategic acquisition. The buyer anticipates bringing the acquired IP into their own organization and leveraging their extensive capabilities, funding and distribution channels to generate new revenue. This would be strategic sale.

It is the direction of the benefit which determines what type of sale occurs. If the benefits of the acquisition are to be generated from within the acquired firm, even if the buyer puts additional resources into it, this is a financial sale. So even if the buyer provides trademarks, IP, new processes, new management, additional funding or excess demand to improve the performance of the acquired firm, it still remains a financial acquisition. The return on their investment is received solely through the performance of the acquired firm.

We might also argue that costs which are outsourced to the buyer, such as head office and services costs, do make a difference to the profitability of the acquired firm but this hardly makes it strategic. The acquired business still operates substantially as a stand alone entity from a product/market interface and the ROI must be generated through its revenue stream.

Moving to a different scenario, I would classify any acquisition as generating strategic value for the buyer if the buyer's revenue, separate from that generated by the acquisition itself, was either protected (threat mitigation) or enhanced (opportunity exploitation) by the acquisition. Any situation where assets or capabilities are passed to the buyer to exploit within the buyer's organization and which changes the buyer's future prospects should be considered as a strategic value acquisition.

There are situations where the acquired business continues in operation, improved or not, with assets and capabilities passed back to the buyer's organization. This would still be a strategic acquisition as additional benefits are being derived by the buyer beyond those which can be generated within the acquired firm.

This classification is critical for preparing a business for sale. A business which achieves its highest value on sale through its own revenue and profit potential needs to be structured for a financial sale. The bulk of the sale preparation effort needs to be put into revenue and profit growth, risk reduction and identifying growth potential which the buyer can execute on within the business. Any marginal strategic value or buyer synergies enhances the potential sale price but the major thrust of the sale preparation strategy remains with revenue and profit growth.

Alternatively, a business which achieves its highest value on sale by providing a large corporation with a means of mitigating a significant revenue threat or exploiting a major revenue opportunity through the transfer of acquired assets or capabilities, should be prepared for a strategic sale. The value of the strategic acquisition to the buyer is mostly determined by the size of the threat or opportunity within the buyer's organization and not by the revenue and profit generating power of the acquired firm. In this case, the existing or even potential revenue and profit/loss of the acquired firm may be entirely irrelevant in determining what the business is worth to the buyer. You would prepare a strategic sale by concentrating resources on ensuring that your strategic assets and capabilities are structured so that the buyer can rapidly exploit them within their own organization.

We should not confuse the source and size of the value generated with the price paid to the sellers. The sale price achieved often has much more to do with positioning, preparation, negotiation and competitive tension in the deal. Any high growth potential firm suited to a financial sale, if handled effectively, can easily achieve 3 to 5 times a conventional (EBIT multiple) sale value. On the other hand, a venture suited to a strategic sale can often achieve a sale price equal to 20 to 100 times their net asset or revenue values.

A premium on sale to a corporation may be due to the inherent potential in the acquired business rather than synergistic or strategic benefits accruing to the buyer. Just because a corporation buys a business at a premium over the industry norm EBIT multiple does not make it a strategic acquisition. Rather it is only where additional benefits are achieved outside the boundaries of the acquired firm which determines it is a strategic acquisition and thus a strategic exit for the sellers.

STRATEGIC BENEFITS

Focus on strategic benefits to the buyer

We all know of small ventures which were purchased for more than 20 times revenue or 100 times EBIT. Whenever this would come up in conversation, I would hear people stating how lucky the founders were and what a difference luck and timing makes. But if you have seen a lot of these, is it just luck and timing? My own research into this phenomena suggests that you can set out to build a company which can have these huge exit values.

Just after I started my last business in the USA in 1995, a company called Red Pepper was purchased by Peoplesoft for 25 times revenue. Peoplesoft wanted to get into the manufacturing software business and needed an icon product to launch their campaign. Red Pepper had the market reputation to do that for them. A few years later, I sold my own business to Peoplesoft for 6 times revenue, even though at the time it was running up a $1 million loss. Since I had sold a prior business for $1 million which had never traded and an earlier business for US$9.6 million which was only breakeven, you might say I had a lot of 'luck and timing'. However, these exits did happen in periods of significant growth in the computer industry and so one should question whether they were anything but luck.

So if told you that I assisted a small sport travel business to get 40 times EBIT you would no doubt wonder if there was an underlying process which any venture could follow to set up a high value exit. The fact is that any business which has the potential to enable a large corporation to exploit a large scale revenue opportunity can gain a significant premium on sale.

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

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

The fuel for such an opportunity lies in the assets and capabilities which a large corporation can exploit, usually within an existing large customer base. How do you know if you have the right assets or capabilities to drive such an opportunity for a large corporation?

First you need to examine your own assets and capabilities. What do you have or do which could provide the basis for resolving a serious threat or enabling a large scale revenue opportunity for a large corporation? Often these are things which currently provide your competitive advantage but they may also be things which you are not exploiting in your own business but which some other business could. Products and services which typically drive high growth rates solve compelling needs, that is, solutions to problems which you must solve. Products or services which can be delayed, where there are many alternatives or which you can decide not to bother with, do not satisfy the compelling need test.

Next, you need to determine whether you can provide the buyer with some reasonable period within which they can exploit the asset or capability without it being copied, eroded or negated by an aggressive competitor. Something that can be easily acquired, assembled, developed or negated is of little interest to a large corporation. Thus you need a strong competitive advantage, perhaps build on intellectual property or deep expertise.

Lastly you have to have a proactive approach to the market. You can only do this when you pursue a well defined but large niche market of clearly identified and reachable customers who are willing and capable of buying your product or service.

If you can satisfy those attributes in your business you have the potential for a strategic sale. Now all you need to do is to identify which large corporations can exploit the opportunity. Your exit value is then based on what they can do with your product or service not what you are doing with it. Simply get them to compete for the chance to acquire you so that they can exploit the underlying revenue opportunity.

BEWARE

Buyer delays erode value

I know of many entrepreneurs who have lost value on the sale of their business when the buyer has strung them out through the negotiation and due diligence process. The disruption to the business due to due diligence activities and the distraction of focus caused by the tension in negotiations often leads to a fall in revenue and a lowering of profits. Where the sale price is based on a multiple of earnings, this downturn can seriously hurt the final sale price. Only by recognizing this impact, whether deliberate on the part of the buyer or not, can the entrepreneur mitigate the damage.

Not all buyers are honest and scrupulous and not all are well prepared for the buying process. Thus it is not uncommon for the sale process to be drawn out with a subsequent loss of focus on the business. This rarely works to the advantage of the seller. In fact, it is not unknown for potential buyers to use such tactics to wear down the vendor in order to get the firm at a lower price.

While some delays are unavoidable and tension and distraction are a normal part of the process, the smart entrepreneur prepares in advance for this eventuality. There is no question that it is hard to go through the sale process without significantly using up senior executive time as there will be some elements of the negotiation and due diligence process which simply cannot be delegated. Knowing this in advance, however, the vendor should put in place a succession plan so that essential operations can be undertaken by other than the senior management team.

Preparation for due diligence is an obvious step in selling a business. The last thing you want to be doing is hunting through storage cabinets looking for old documents or compiling essential employment or financial data which is standard in a due diligence checklist. The vast bulk of due diligence information can be assembled in advance and kept up to date for when a deal is on the table. While the buyer is busy doing the analysis, you can be back running your business.

By far the best way, however, to keep a deal in play and progressing is to ensure that you have multiple potential buyers. If you are well prepared, have good advisors and have done your homework to identify those potential buyers who would have the most to gain through an acquisition, you have much greater control over the timeline of a sale process. Those buyers who are not prepared themselves or not willing to meet the deadlines will simply drop out of the process, but you do need to have a number of potential buyers to play that hand.

If you can clearly see that a buyer is deliberately using delaying tactics to wear you down and reduce the price, you are almost certainly going to be better off by pulling out of the negotiation. That tactic alone may well bring them up to the mark. The greatest danger in any sale process is to be in a position where you have to sell, you are unprepared and you have only one potential buyer. Planning the sale well in advance, being prepared and having several potential buyers is the only way that you can really ensure you get the maximum value on sale.

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