Convergence – this year or next

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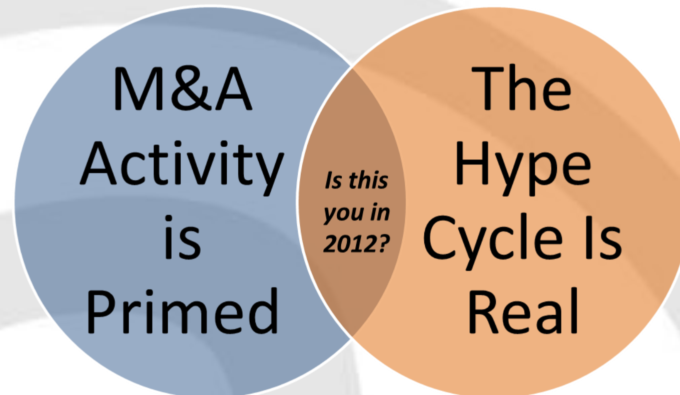
Welcome to 2012, we think you're going to like it here.

There's plenty of data showing that buyers are poised to enter a period of increased M&A activity. And, if you believe the hype cycle, many early-stage companies are entering their prime opportunity to sell at a strategic premium.



Much of the data I show here about 2012 and M&A is from the Software Equity Group, E&Y, and various web reports. Gartner introduced the Hype Cycle and some of what I show here comes from Mastering the Hype Cycle but the concept is now commonplace and others have elaborated on it as well (and I've tapped some of those elaborations). Suffice to say that this paper in no way changes the fact that I've not had an original thought in over a decade.

I find this to be a fairly complex topic and, in order keep this paper under a gazillion pages, I found gross generalizations and simplifications were needed. It's easy to find examples that run counter to my thesis; I'm presenting the middle of the bell curve for start-ups.

You'll be reading about the deals

The number of M&A deals in 2011 was flat from last year but deal value increased 18%. International events couldn't stop the pent-up demand from boosting the stats even with a lackluster recovery. We're coming off of three years of poor M&A activity and much of what we did see was distressed company sales (we participated in three such deals in that period). Why pay a premium when you can buy that target's competitor for much less because they had the bad luck of entering the recession with little cash? But the inventory of distressed companies is diminished and that alone will pull up the averages. More importantly, it means that buyers seeking companies with exciting technologies won't be able to take advantage of their crappy balance sheets as they have been.

Because of the poor M&A environment during the recession, many start-ups that might have normally exited are still private. We count a full dozen companies in our portfolio that have been held well past the historical 3.5 year average, have material traction, and are profitable. Without a recession, these companies would be outliers remaining private despite their progress and 5-year holding period.

Instead, these data represent the contemporary mean performance for start-ups still private. But that's going to change.

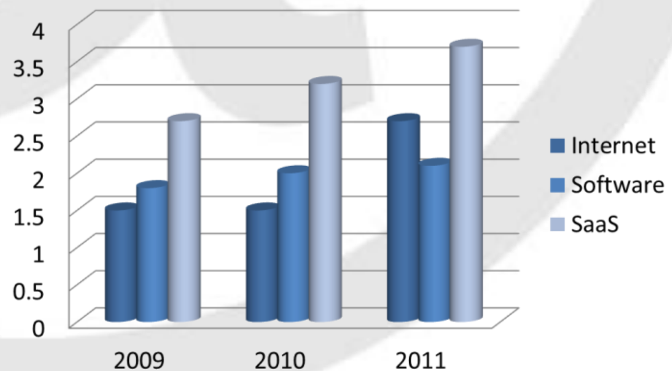
That pent up demand wouldn't be actionable if buyers weren't sitting on cash. But they are – the Fortune 1000 (your buyer is likely in there) has over $2 Trillion in cash and, if that's not enough, they have better access to capital than they've enjoyed in recent years.

Software: Median Metrics					
Measure	4Q10	1Q11	2Q11	3Q11	4Q11
EV/Revenue	2.6x	2.7x	2.7x	2.1x	2.2x
EV/EBITDA	13.7x	14.6x	13.4x	11.5x	11.8x
EV/Earnings	27.8x	27.1x	24.8x	21.5x	21.5x
Current Ratio	2.0	2.1	2.1	2.0	2.0
Cash & Eq ($M)	$109.1	$127.3	$118.5	$120.2	$111.5
Gross Profit Margin	67.8%	67.7%	68.1%	67.1%	66.3%
EBITDA Margin	18.8%	18.5%	18.7%	18.2%	18.6%
Net Income Margin	8.3%	7.7%	8.9%	8.9%	9.2%
TTM Revenue Growth	9.6%	13.5%	14.1%	14.6%	15.1%
TTM Total Revenue ($M)	$289.1	$302.5	$305.3	$321.1	$339.3
TTM Total EBITDA ($M)	$48.2	$49.0	$46.4	$45.9	$48.5
Debt / Equity Ratio	27.3%	26.6%	23.9%	24.1%	23.2%

SaaS: Median Metrics					
Measure	4Q10	1Q11	2Q11	3Q11	4Q11
EV/Revenue	4.2x	4.8x	5.2x	4.5x	4.3x
EV/EBITDA	33.3x	38.2x	40.3x	29.7x	36.2x
EV/Earnings	79.7x	124.3x	86.0x	78.2x	81.2x
Current Ratio	1.8	1.8	2.0	2.0	2.2
Cash & Eq ($M)	$61.0	$64.4	$66.3	$83.6	$81.0
Gross Profit Margin	68.1%	68.3%	69.0%	69.3%	69.5%
EBITDA Margin	10.3%	10.1%	8.7%	9.5%	9.1%
Net Income Margin	1.7%	1.3%	0.7%	1.0%	1.3%
TTM Revenue Growth	15.1%	20.5%	23.3%	24.9%	25.4%
TTM Total Revenue ($M)	$159.9	$170.3	$177.2	$187.1	$194.5
TTM Total EBITDA ($M)	$13.1	$14.7	$14.7	$16.4	$19.5
Debt / Equity Ratio	4.1%	3.8%	3.0%	2.8%	2.8%

Internet Median Metrics					
Measure	4Q10	1Q11	2Q11	3Q11	4Q11
EV/Revenue	2.9x	3.0x	3.3x	2.8x	2.6x
EV/EBITDA	14.8x	16.5x	17.7x	13.5x	12.4x
EV/Earnings	29.4x	30.2x	32.9x	28.4x	23.7x
Current Ratio	2.3	2.0	2.4	2.6	2.4
Cash & Eq ($M)	$87.7	$109.1	$104.2	$132.0	$139.0
Gross Profit Margin	64.5%	64.5%	65.0%	65.6%	65.6%
EBITDA Margin	15.2%	16.9%	16.4%	16.6%	15.8%
Net Income Margin	4.6%	5.9%	4.9%	5.0%	4.0%
TTM Revenue Growth	20.4%	24.0%	20.5%	21.5%	25.6%
TTM Total Revenue ($M)	$241.4	$290.4	$302.2	$338.3	$344.3
TTM Total EBITDA ($M)	$28.0	$36.0	$34.8	$34.8	$37.2
Debt / Equity Ratio	3.6%	4.8%	13.6%	9.4%	18.2%

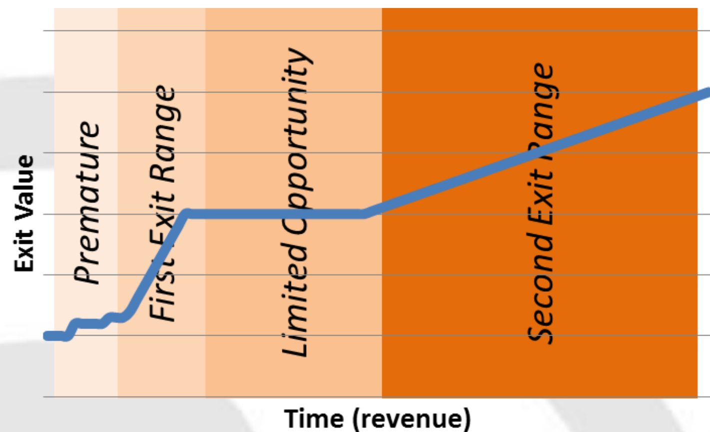
Also, deals are, indeed, getting better. Exit multiples are improving for nearly every tech category. All of this matters to you, Start-Up CEO, because 75% of the deals anticipated in 2012 are under $100MM in deal value. And buyers are not generally focused on your revenues at that range but, rather, your product and technology.



M&A Activity is Primed

Whether it's this year or next, you're going to see more exits and better exits than we've seen over the past three years.

The Hype Cycle



Last summer, I was having breakfast with a VC friend and lamenting that our largest investment didn't yet exit. "They missed the first window, but they'll enter the second window next year" Steve said. We started comparing notes and we found that there seemed to be two times to sell. First, when a company is in its rapid growth phase with revenues around $1MM - $3MM. Deals in this range are not sold at a multiple, instead the buyer is seeking product, market share, additions to the team or an infusion to its brand or culture. Our sale of the Coffee Equipment Company (maker of the Clover) for over $20MM with revenues below $2MM was a perfect example. The sale of AdECN, Photosynth, Gist, and GoToMyPC all fit this pattern – relatively early stage deals sold for a strategic premium. Our company generally had to achieve:

- Initial revenues (all had at least some third-party validation)
- A quality product (satisfied customers)
- A credible management team (at least one key executive could be relied upon to transition the business)
- A notable market presence (they were known to anyone with an interest in that category)

They generally were not profitable and, more importantly, their revenue levels were insufficient to matter to the strategic buyer.

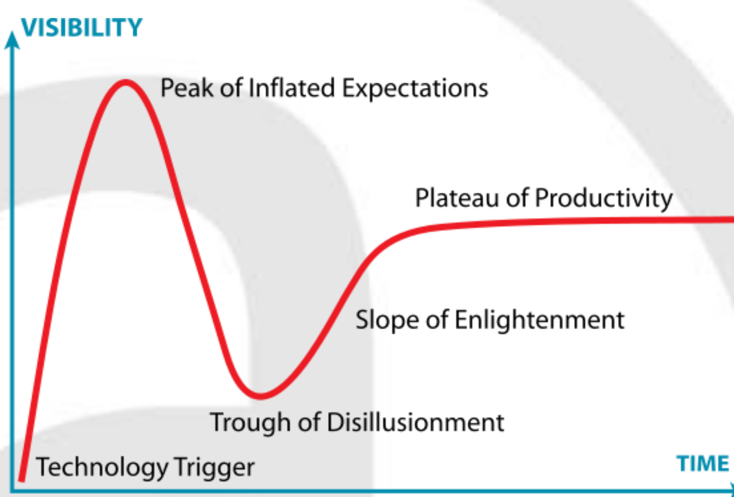
The Second Exit Range occurred, in our modest data set, after a business hit about $10MM in revenue. Mid-size buyers or division presidents with revenues of $100MM - $200MM find a start-up of this size an attractive target to boost their top line. The start-up typically has a stronger growth rate, different and maybe better technology and some quality additions to the team. Buyers see accretive value in efficiency improvements by leveraging their infrastructure.

But what happens in between? Sadly, nothing but agony and despair. Being passed over at the First Exit Range leaves you waiting, usually years, to enter the second range. And, when you enter that range, you'll find your value is unchanged from its potential years prior. Why is that? Remember what you accomplished in the first range – third-party validation, satisfied customers, at least one executive who could transition the business, and a market presence. These are all binary – you can't do more of them. They're accomplished. The only thing your delay has caused is a reduced IRR. The

variable attribute is revenue or profits and until you reach about $10MM on the top line, the addition of your P&L is just a rounding error to the buyer. So, you live with three years of sleepless nights fretting that you've risked your kid's college fund with your venture that can get destroyed due to technology changes, new regulations, or better-funded, faster moving competition. Bummer, dude.

Steve and I devoured our bacon and eggs and I was pretty sure we had just discovered a truly meaningful model.

My self-confidence on model discovery was trashed a few months later as I was talking to a smart-ass venture associate. I told him my theory and there Daniel was, looking at me like I was saying "I think this Facebook thing might really take off". "Uh, ya, Mike, it's called the Hype Cycle and we just talked about this at Voyager, want to see the slides?" "Sure, thanks, you punk".



I'll make some excuses about knowing the basic concept but not how it applied to exits… whatever. You won't have the same excuse. The thing is – the hype cycle is real. Start-up CEOs all need to know about it. Frankly, they should be obsessed by it. They should all roll in their beds, unable to sleep, freaking out about where their company is on the curve. So read on and sleepless nights will soon be yours.

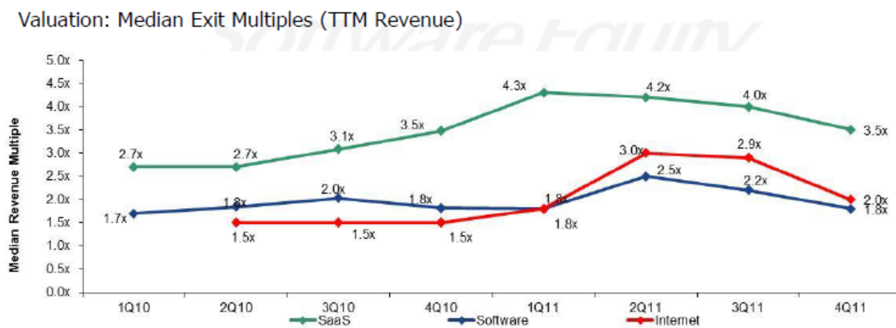
First, a quick primer on the hype cycle. The cycle develops in five stages. The first phase of a hype cycle is the breakthrough or product launch that generates significant press and interest. This one (the technology trigger) is an event, the others are phases. The First Exit Range that I mentioned above happens on the way to the Peak of Inflated Expectations. Here, a frenzy of publicity typically generates over-enthusiasm and unrealistic expectations. There may be some successful applications of a technology, but there are typically more failures. Note that our exit experience often included companies that were in a credible market with a functional product and beyond "hype". We found that these exits occurred within 3-5 years from the time we could see start-ups working on the technology and when market penetration was under 50% and, in some cases, under 10%.

Our "Limited Opportunity" relates to the Trough of Disillusionment. If the technology was "hyped", at some point the market realizes that the product (say, domestic solar panel

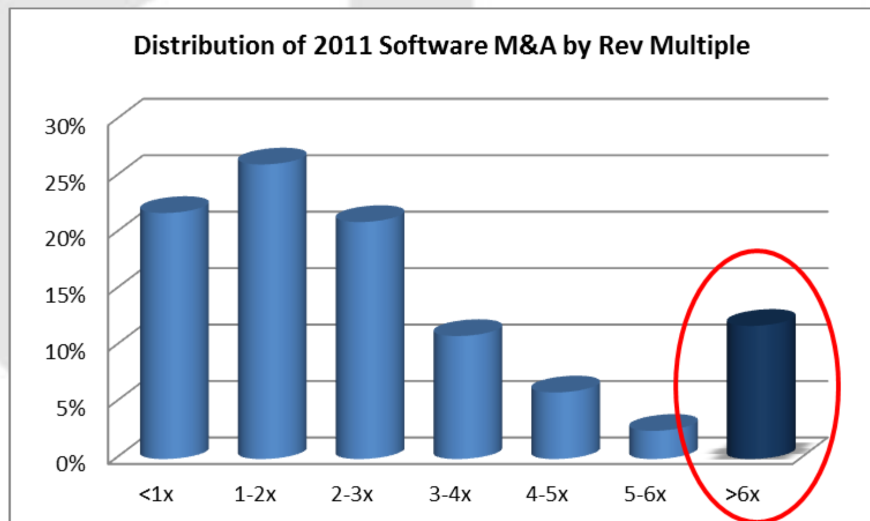
production) wasn't such a great idea after all (at least venture figured that out fairly early even if elected officials were slow) and valuations will drop. After some maturing, some businesses continue through the "slope of enlightenment" and experiment to understand the benefits and practical application of the technology.

The "Plateau of Productivity" is roughly comparable to our Second Exit Range. Here the technology becomes widely accepted, increasingly stable and evolves.

VCs have been directly applying the hype cycle for more than a decade. Here's why: average tech company exit multiples have hovered around 2-5x trailing 12-months revenue. I still recall a meeting with John Connors from Ignition who told me "the last thing you want to do is sell on a multiple". Indeed, the deals that sell in our first exit phase or on the slope up to the Peak of Inflated Expectations don't sell on a multiple and their top line isn't a factor.



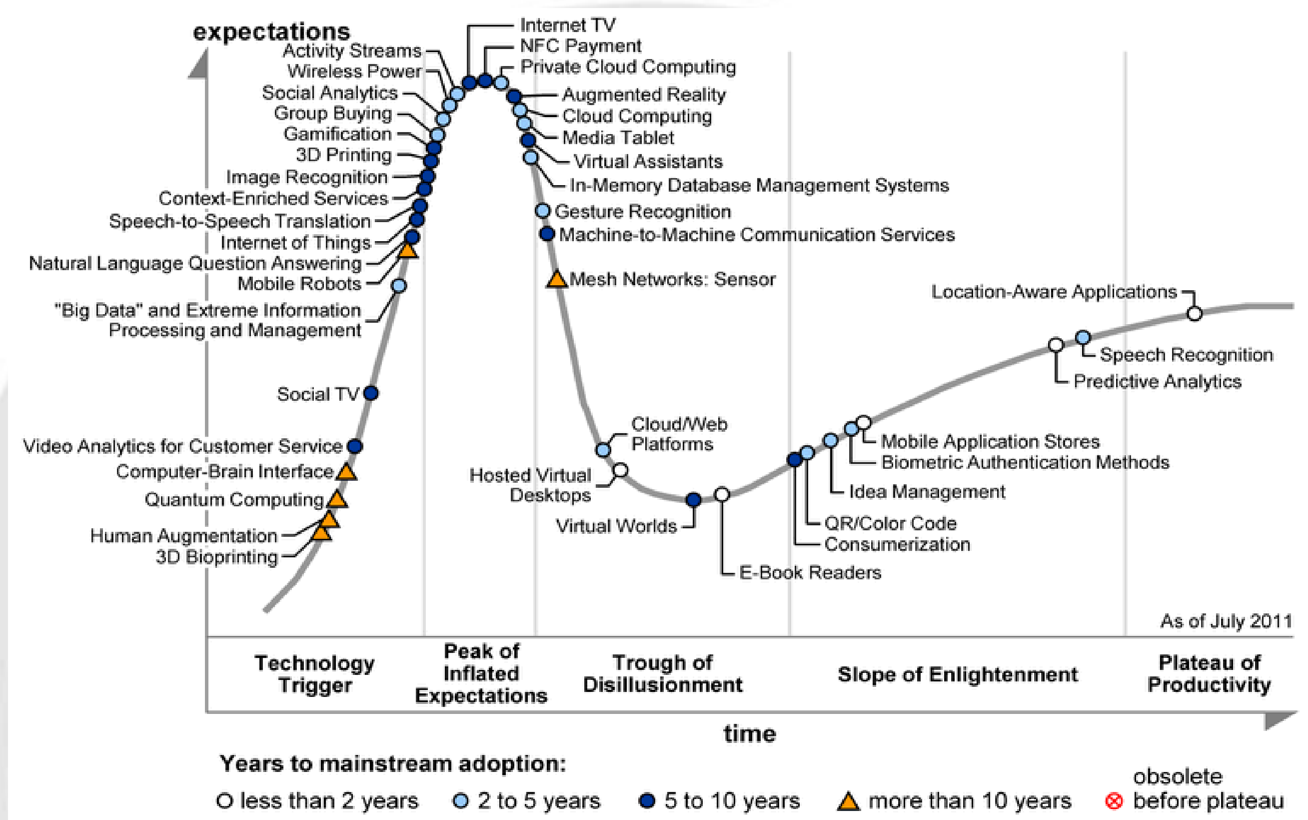
While the average software deal was done at an un-inspiring 1.5x last quarter, about 12% of the deals last year were done at over 6x. Those buyers were seeking more than a boost to their top line. They were looking for the hype.



Much of the hype cycle literature is targeted toward leaders in mature businesses who are deciding whether and how to invest in new technologies. A quick read may help you understand how your would-be buyers are thinking.

You can assess your position on our exit range curve with your co-founder over a beer and maybe that's one of the appeals of our approach. But to really understand the hype cycle, you'll want external data. Gartner produces reports to guide businesses and investors toward understanding the macro trends in technology and they do so by

sector as well as an overall report on emerging technology (the 2011 summary of which follows here).



The Hype Cycle Is Real

So, whether you like our simplistic approach developed over an hour and based on an insufficiently sized data sample or the rigorous and validated model from Gartner (they say tomato…"), the pattern is real. Your one best opportunity is to sell at an early stage when your deal is exciting. You'll likely have some revenue but probably won't be profitable. But you'll be noticed and tech executives will be talking about your base technology and know about your firm. This is your best shot at a maximum return with minimal risk. After that, your valuation will likely decline a bit and not begin to recover until your top line will be meaningful to a mid-market buyer or a division of a larger firm and maybe at a multiple of earnings instead of revenue. And you'll pay dearly for the miss, not only in a reduced return based on the time value of money but in real risk of failure. Maybe try a melatonin?

"Uh, thanks, so what the hell should I do"

That's an actual quote and a reasonable question from one of our CEOs. If we believe that we're entering a solid period for M&A and if we accept the reality of the hype cycle, then it's time to plan.

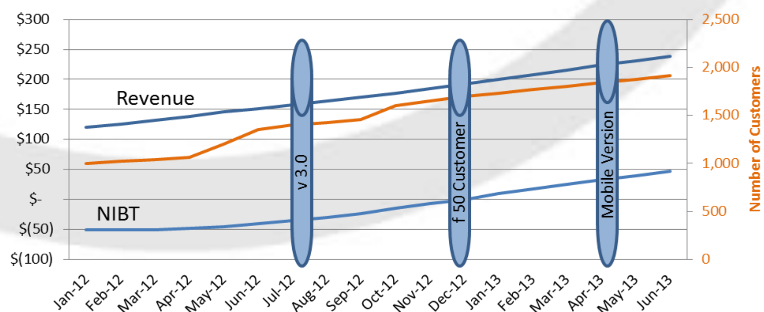
I used to say that the best M&A deals result from an inbound lead. To be sure, an inbound interest in acquiring your company will give you greater leverage than one you produce through outbound efforts, and the deal will have a greater likelihood of completion. However, this ignores the overriding rule of exit values:

The number one factor in a company's exit value is competition for the deal.

So, sure, you might sit back and see a good exit opportunity on your horizon. But to maximize your exit value, you're going to need multiple suitors and that will take more than waiting and you need to develop these relationships.

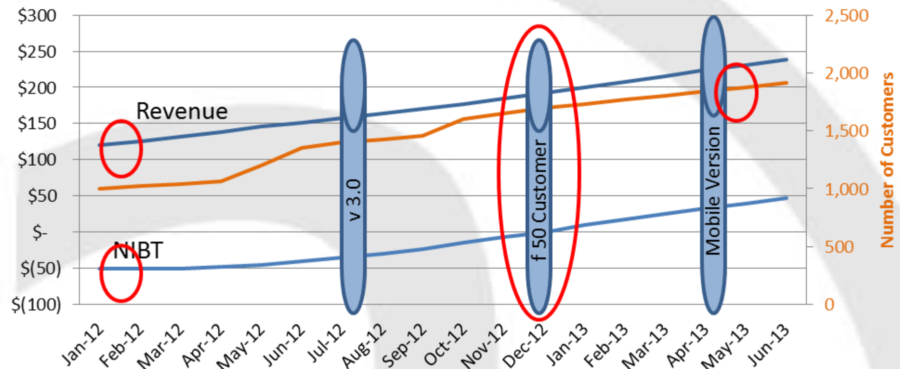
We're working with some of our portfolio companies on an active approach. This approach requires substantial modification by company and, frankly, it's new to us and not thoroughly tested. But if you believe action is needed to maximize your deal value then you need some kind of structure and we think this is a good starting point.

1. List Acquirers. Start by noting which industries contain potential acquirers. Then move to individual companies, including those which are less likely.
2. Determine Desires. What do these companies want? Start with a general brainstorming session on this. Then reduce the desires to parameters that you can measure.   It may take some creative thinking to reduce a suitor's desire for "credible presence in your market" to "sign a Fortune 50 client", but that's the idea. Distill the acquirer's desires into your KPIs. Then take note of the values associated with these KPIs that trigger the acquirer's satisfaction. Normally, these will vary by industry and may likely vary by acquirer. These "exit triggers" are important to understand.



3. Map and Adjust Timing. Chart your measurable KPIs against time. Some may be binary (like delivering a mobile version), others will be continuous (like revenue which you may use to measure your match to the desire for “substantial market presence”).

Once your KPIs are noted, go back to your exit triggers and mark them on your KPI chart. The exit triggers probably don’t fall in the same quarter. In the example to the right, the company assumes buyers don’t care about profits and need to see about $100 in revenue. The buyers (at least one set of them) would probably value the company much higher if it had a Fortune 50 customer and about 2,000 total customers. This is a simpler version that shows red circles for one set of suitors. Others suitors would suggest different exit triggers but let’s assume we have a uniform set of requirements.



Not only don’t our exit triggers appear in the same quarter but we expect to perform on one of them later than the rest; well, there’s always one point that’s to the right of the others. If we assume that at least some suitors will value the company more highly if we attain all the exit triggers, then we’re sub-optimizing our exit value if we fail to achieve all the exit triggers contemporaneously. In this case, the company might work to pull in the Number of Customers goal by sacrificing revenue or incur greater losses. In fact, it’s quite possible that raising more capital now to do so would have an accretive effect. Why? Because achieving all the exit triggers may develop competition for the deal – *the number one factor that will drive valuation*.

Once you have a plan, your job is to manage toward the ideal exit. That ideal exit won’t happen but visualize it anyway: a year from now you come into the office on a Monday morning to find one fedex and two emails waiting for you. All contain signed term sheets. This didn’t happen by accident.

Think of the carnival game with the horse race. Your job is to keep all the horses running along with about the same progress. Manage toward the goal of multiple term

sheets. The tactics of making and maintaining contacts will vary widely based on your familiarity with the market. You may want to hire a banker or have your CFO help – these are execution details beyond what we can reasonably cover here.

We often see CEOs with opportunities test the waters about an exit opportunity by letting a potential acquirer know that he's considering his options. Sure, you're casual about it because you don't want to seem needy. But to the recipient, there's nothing casual about it: "Why is that guy telling me about his options – holy shit, the company's in play!" Most of the time, you won't get a reaction but if you've met the exit triggers for that acquirer, you might get interest. Sounds great? Think about it. Term sheets come with an expiration date – generally a week or two. Sign it before it expires and you're obligated to a no-shop and confidentiality. That's to say: sign it and you're selling the company as long as the deal doesn't fall apart (they often do). So, you get a term sheet but you want to maximize your deal value with competition. Get on a plane and go see the other likely suitors and see if you can get a competing term sheet. Remember that time you drunk-dialed your ex-girlfriend in college hoping for a late-night hook-up? Ya, about as likely. Yes, it has worked but consider the planned alternative. Even if your carnival horses aren't all at the exact same place, you've at least kept them close. Now, when you tell one suitor that your timeline is accelerated they're not caught so early that your internal champion has to start from scratch.

The strategy works for those who have an investment option as well. Think of the venture community as another potential suitor with its own set of triggers. Competition from venture capital can be just as effective as another acquirer in boosting deal value.

Thank you, no, I'll pass on the financial shit-storm, I've had that before

This general approach would have worked before the recession and, assuming the recession is over, it should work now. Absent some terrible international developments, we're likely entering a fine period for M&A. Keep your fingers crossed and I hope you can plan to take advantage of it. I know that's what we'll be doing.

The Atlas Manifesto

Entrepreneurship is vital to our country but it is daunting. The courageous people who launch technology companies are challenged by limited funding and inadequate staffing. Their vision, tenacity and, sometimes, luck will allow only a select few to somehow reach their potential. It shouldn't be like this. The mission of high-quality start-ups should not be delayed or failed for want of resources. We envision a community where great CEOs can access affordable talent that leverages a long history of success to help make entrepreneurs' dreams come true.

Start-ups need resources on a less-than-full-time basis. They need a portfolio approach to services that aren't needed in full-time increments. They also need to spend less time recruiting, training, and managing these part-time resources. Companies also need flexibility to adjust the time spent on tasks and also to bring in trusted specialists for quick projects without the overhead of interviewing, contracting, and training. As the company grows, it needs these resources to grow with it and to help hire and train full-time replacements. And lastly, start-ups need to conserve cash and need a trusted partner with aligned interests.

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