





MONDAY 16.07.07

# REPORT ON BUSINESS

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|             |  |       |             |
| <b>S&amp;P/TSX</b><br>11,826.44<br>-39.32<br>Energy stocks lead first decline in four sessions | <b>DJ Ind.</b><br>11,069.06<br>-46.26<br>Interest rate worries undermine blue chips | <b>Nasdaq</b><br>2,262.96<br>-19.40<br>Chip stocks drop as Citigroup cuts recommendation | <b>Dollar</b><br>87.18c (U.S.)<br>Unchanged<br>Rate concerns in U.S. and Canada squeeze loonie |
|  |   |  | <b>Gold</b><br>\$556.60 (U.S.)<br>+2.00<br>Renewed inflation concern underpins bullion gain    |



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## VENTURE CAPITAL

### Exit Next Left: How to Drive Up the Value of Your Equity



SEAN WISE  
WISE WORDS

In the last twenty-four months we've seen MySpace sell for over \$500M, YouTube for \$1.6B and eVault for \$185M. M&A is once again "hot", which raises the question: What determines the final price (often referred to as the "terminal value") in a sale? And, more importantly, what can founders and funders do to drive such price up in advance? Well, let's start at the beginning. Venture Capital, like Angel Investing, is a four stage process designed to:

- 1) Attract deals;
- 2) Screen for the best and invest;
- 3) Grow the company (and the value of the investment); and
- 4) Exit to recover the investment plus return.

There are typically three ways an investor can exit and claim his winnings:

- 1) Sell the company
  - i.e., sell 100% of the equity to another company (known as an "M&A" transaction standing for Merger and Acquisitions); or
- 2) Take the company public

- i.e., sell some of the equity to the public (known as an "IPO" transaction, standing for Initial Public Offering); or
- 3) Equity buy back
  - i.e., the company buys back the investment.

By far, most investors prefer M&A over IPO, and IPO over buy back. The reason for this is simple – liquidity (i.e., getting paid). In an M&A transaction, the investor receives cash and/or highly liquid shares (usually publicly traded), thus allowing them to "get out" and make their returns. In an IPO transaction, the investor typically must continue to hold their shares in escrow for a period of time, but the shares have a "trading price" which allows the investor to mark up their investment, which makes it the second best option. An equity buy back is rare. After all, if the company can afford to buy out the investor for five times his initial investment, then it stands to reason that the company has large cash resources. That said, if it has large cash resources, it may be better to ride out the investment until some other exit, yielding higher returns. So how do you determine the terminal value of a company?

We all know that valuing privately held tech companies is an art, not a science. We all know that there is also a great deal of negotiation theory involved. Finally, we all know that there are several *prima facie* facts that often drive price, including:

- Current revenue
- Amount of proprietary, defensible technology
- Potential revenue, both today and in the near term
- Quantity and quality of user base
- Amount of capital invested to date

But what of secondary factors; those factors that aren't so obvious? What can management today do to maximize liquidity price

tomorrow? That's exactly what Ryerson University Professor Dave Valliere and I set out to determine.

#### The Research:

For the past two years, in conjunction with Na Ni from the University of Manitoba, we undertook a study of venture capital exits in Canada from 2000-2006, examining the non-primary factors and their influence on terminal valuation.

"The hypothesis of our study" explains Dr. Valliere, who conducts research and publishes extensively on the venture capital industry "was based on the theory of 'information asymmetry', where the price of goods in a marketplace is affected by how much prior information the buyers and sellers have about each other. When there is a lot of unknown or hidden information, the prices are lower. We wanted to explore the effect of prior relationships between buyer and seller: the direct effect of such relationships on information asymmetry, and how this affected M&A prices."

"The idea was simple, but was unproven." adds Valliere, "We explored the effects that prior relationships between the buyer and the target firm had on exchanging and verifying information, and which type of relationship made the buyer more willing to pay a higher price." The types of prior relationships investigated over the two-year research project included:

- Supplier to buyer,
- Customer to buyer,
- Competitor, provider of complementary products,
- Partner in an alliance or JV,
- Buyer previously invested in the target company,
- Buyer has a previous seat on the Board,
- Buyer previously employed the founder of the target company, or
- Management of the buyer is personally related to management

of the target company.

Board members were surveyed and the results were analyzed using an advanced statistical technique called "fuzzy set theory" to identify which combinations of prior relationship factors were most likely to lead to the largest terminal value (i.e., a high sale price). The analysis also made adjustments for conditions in the IPO and VC markets at the time of sale, which may have affected M&A prices in general (remember that most buyers of start-ups are public companies and thus M&A price is directly affected by poor public markets). This helped ensure we compared apples to apples.

#### The Findings:

The results were less than astounding, but do provide a good guide for those looking to maximize final sale price of your start-up. Setting aside primary factors (revenue, IP, etc.) the research showed:

- (1) Having many types of prior relationships generally leads to higher prices than having just one type of prior relationship (even if that one relationship goes back a long time).
- (2) Being a complement (selling a complementary product) is alone sufficient for getting a high price.
- (3) Being a supplier may be sufficient too, but the positive effect on terminal value is far less certain than being a complement.
- (4) Being a past partner helps, but only if also a complement or supplier. Otherwise, partnering adds little to the M&A price.
- (5) The same holds for being a past investee or a previous employee of the buyer.
- (6) The other factors (e.g., being a customer of the buyer) have no direct statistical effect on sale price.

#### The Real World:

Sounds interesting, but I

wanted to verify these academic results in the real world before I was prepared to sign off on it. To do that, I approached Leonard Brody, who was part of the founding executive at Onvia, which sold to Bell for an undisclosed amount, Tanner Philip from BC Advantage Funds who oversaw his fund's exit from BrightSide Technologies last year and Benoit Hogue from Propulsion Ventures, whose sale of Airborne Entertainment lead to it being named "Deal of the Year" by the Canadian Venture Capital Association.

"Anecdotally", says Philip, who's fund was the only institutional investor in BrightSide Technologies - sold to Dolby Laboratories in May, "I would say that it is easier to negotiate and close a deal with a buyer that has some type of synergy with the selling business, as your study indicates. Complementary products or channels, common customers or a direct customer relationship are at the top of my list for synergies."

This is something that Brody agrees with, "it is critical when looking at exit opportunities to be confident that there are shared outlooks between the two companies. This is particularly true for the founders. Almost all companies now are asking founding members to earn out their capital upon a sale. If there isn't a shared vision about the path forward, it is guaranteed, you will not realize the full amount owed."

Benoit Hogue, from Propulsion Ventures of Montreal (the group that sold Airborne Entertainment for more than \$90M) agrees with the importance of prior relationships but adds: "I believe that 'information asymmetry' may be reduced not only through prior relationship but also through strong due diligence. In M&A transactions, the buyer will most often have the expertise and resources to do high quality due diligence and pay the appropriate price.

Prior knowledge is just one way to solve this issue. A good mechanic will know if a used car is a lemon even though he does not know the driving habits and history of the previous owner."

#### The Bottom Line:

Founders and funders should keep their eyes on the prize. M&A is the exit method favored by investors nine times out of ten, and preparing for it early can help maximize the sale price. Based on evidence both anecdotal and statistical, start-ups should remember that, when it comes to relationships: **It is more important to be broad than deep.** When starting to prepare for sale, prioritize potential strategic buyers for your firm using these screening criteria:

1. Complement
2. Customers of yours
3. Partners
4. Previous investors in your firm
5. Former employers of your founder(s)

This will identify the firms that face the lowest information asymmetry, and are therefore willing to pay the highest price, yielding the best returns for all shareholders.

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