

LAST IN A THREE PART SERIES

This way out

Venture capitalists look to public offerings or a company sale — known as an exit strategy — to realize a profit on their investments

BY MICHAEL GURAU

Imagine that your business has found a venture capital investor (as described in part one of this series, "The venture equation," Feb. 20) and you've negotiated a deal you can live with (part two, "The right price," Mar. 6). That means you're now enmeshed in the hard and good work of building value in your business. So what should you expect from your investors going forward? How involved will they be in running your company,

and how and when will that relationship end?

There's a joke that goes: "Why do venture capitalists enter rooms backwards? So they can see the exit." In a real sense, these investors consider how they are going to get out of an opportunity at the same time they're discussing how to get into it. By necessity, venture capitalists consider the so-called "exit strategy" — the means by which they'll eventually make a profit — a key factor in their investment decisions.

Private sale or public offering?

	MERGER	IPO
Access to exit proceeds	Fast: Usually cash or liquid company shares	Moderate-Slow: Investors and owners are restricted for a period of months from selling shares after an IPO
Ability to retain independence	No: Company typically obliged to assimilate into acquiror's culture and organization	Yes: Even with shareholders, the company can retain control of its destiny as a public entity
Complexity and expense	Low: Merger/sale typically offers company owners straight cash or stock plus employment agreements for a short period (one to two years)	High: Cost and regulatory overhead from initial and on-going public filings makes for an expensive and complicated process

To get to a deal, you've committed to build the business toward just such an exit, which lets investors and owners capitalize on the (hopefully) increased value of their stake in the business. Typically, the exit of choice for investors is either an initial public offering, the sale of the business or a merger with a larger company — the latter two the means by which the vast majority of venture investors and the owners realize value. For some of you, these strategies are consistent with your own desires to cash out; for others, accepting that you will eventually have to sell the company you've built may not come easy, and is something to consider carefully when pursuing this type of investment.

Before the exit, though, you can expect a four-to-seven-year marriage with your VC investors. Venture investors manage pools of capital in a 10-year partnership. The first five years are spent investing, the second harvesting. On average, then, the average holding period for a single investment is four to seven years

During that time, you'll work to grow your business and typically get some added value from your venture partner. Venture funds often differentiate themselves by offering their experience (financial, marketing, strategic, legal, etc.) in a given domain, coupled with contacts and connections that can help companies find customers, employees and partners. Each fund brings a unique character and style to the relationship, but at a minimum an investor should be able to help with financing and issues of gov-

ernance, such as forming a board of directors if one is not already in place.

As you successfully grow your business, you'll likely start seeing evidence of exit opportunities, with offers and inquiries coming from prospective buyers. Somewhere along the line — usually after the second year of real market traction — you may begin to do the math to gauge what the company might be worth in a sale. No doubt your investor is doing the same.

As it becomes evident that your company is beginning to achieve meaningful value for all stakeholders, your company's board of directors — on which the venture investor sits — will develop a process for evaluating incoming offers and for pursuit of an exit strategy.

Finding the right exit ramp

In some instances, the company can be built for a particular type of exit, such as an acquisition by a specific buyer. Indeed, the early part of a venture investor's analysis — when not mulling the possibility of taking the company public — consists of listing prospective buyers for the future. For example, if a company perceives that Microsoft's Outlook does not have a particularly robust contact management feature, it might build a product using Microsoft native software code that plugs in to Outlook, with the hope that Microsoft will prefer to buy them rather than building its own version from scratch.

When company owners agree it's time to start the sale process, your company's board of directors typically will hire an investment banker to consider strategic alternatives, which include going public, a sale or a merger to seek recapitalization —

whereby new investors buy out old investors. The investment banker helps organize and manage the sale, serving as the go-between that screens prospective suitors or works through the public offering evaluation process.

But the driver of the process tends to be the group that controls the ownership of the company. If investors have a controlling stake, they can have a strong voice in deciding who can acquire the company. However, management and owners have quite a bit of power even if investors control the company. Why? Because buyers often want a motivated team to go along with the company. If team buy-in is critical to the sale, then management's voice and preferences must be well considered in the process.

That's why, in positive selling scenarios, all parties walk away happy, economically speaking. Management and owners can realize tremendous value for themselves. Moreover, though the company may be sold, management may have the opportunity to stay on with the acquirer.

While a much less common exit, an IPO offers a company the promise of continued independence as a standalone entity. However, if you are fortunate to have the choice between an IPO and a company sale, there are a few key considera-

*"Only one in three investments
work out for the investor.*

It is high risk capital, after all."

tions, including the complexity and expense of the IPO process and the fact that it can take owners longer to cash in on the public offering than on a company sale. (See "Private sale or public offering?" previous page.)

Naturally, the daunting IPO process or the idea of giving up control of the company won't appeal to all entrepreneurs. During the early discussions with a venture capitalist you may ask whether it is possible to buy back your shares from the investor rather than having to sell the business. The investor doubtless will tell you that this would create "non-aligned interest" — you looking to buy back shares as cheaply as possible— while the venture capital investor is looking to achieve the best return on those shares.

In an ideal world, everyone in this process — founders, managers, investors and the community — finds value in the exit. Unfortunately, venture capital statistics indicate that even for well-managed, early-stage funds, only one in three investments work out for the investor. It is high risk capital, after all.

Don't let this dissuade you from growing your business and considering outside capital. You may be the lucky one in three that makes it. Even if you are not, venture investors value managers who have experienced failure so long as they understand what went wrong. In any event, while the exit is the financial reward for hard work, the adventure and excitement of building a fast-growing business is, for many, an experience worth the risks. Don't let fear of failure stop you from chasing your dream and working to build value for yourself, your co-workers and your community.

Michael Guras, president of CEI Community Ventures Inc., can be reached at