Exit Strategies – IPOs vs. M&As

Exit strategies are plans for how investors will "cash out" of a startup. Over the past decade, the IPO (initial public offering) has obtained the most media attention. But historically, M&As (merger and acquisitions) have been far more frequent and successful than IPOs.

In the October 8, 1998, SVASE meeting, a panel of three experts provided their insights on IPOs and M&As.

Peter Astiz

Peter is a partner with Gray Cary Ware & Freidenrich, http://www.gcwf.com. He has extensive experience in representing acquiring or acquired companies in mergers and acquisitions.

"I used to get into an argument with my father. He could never understand why a baseball pitcher couldn't hit. Dad, I'd say, the odds of being a great hitter or a great pitcher are very low. Finding someone who is both, is almost impossible."

In the same context, there are a lot of odds against a company going public or being acquired. There are very few business plans that are actually followed, things change too fast.

In taking a company public, I look at three things:

- What is the business model of the company? There are some companies who want to OEM to major customers. The problem is that they hit the wall when they try to sell to the OEM's competitors.
- What are the key dynamics that make the business successful? Are you going to be able to grow the business in a predictable manner? Many small businesses are overly dependent on a few key customers.
- Do you have the basis to be a successful company in the long-term?

One problem in taking a company public, is that the insiders are restricted from selling much of their stock, without regulatory permission.

How do you maximize your value? When assessing a M&A offer, you need to weigh this against the potential revenue from a future IPO. If the company is expected to double in revenues over the next year, you would realize much more by an IPO.

A third issue is what do you personally want to do? When you're a private company, you're in control over operations, where you're going, and the technology. But when you're acquired, the company may decide to put your technology on the shelf, and do something else.

Royal Farros

Currently the CEO of iPrint, http://www.iprint.com, Royal Farros experienced the acquisition of T/Maker by Deluxe in 1994, of which he was a co-founder with Heidi Roizen.

- Prior to 1994 and our insane stock market, cash deals were valued at 50% more than stock. But you had to keep in mind that you were going to turn around and pay 40% of that in taxes, so only 60% of the money was really working for you.
- From the standpoint of the founders of a company, M&As are much easier than IPOs. They are a nice gig, providing an easy way to ease into retirement. Now you do need to remember a few things. While employment agreements, preventing you from working in your field of ex-

pertise, are usually illegal in California, they are enforceable if they explicitly compensate you separately. So when you get into negotiating with them, keep in mind that the shorter the contract, the better. At the same time, make sure that your team has a big incentive to stay.

- IPOs have a fantastic upside, but they can be tough on your family, put tremendous pressure on you to meet the expectations of the public market, and they cause you to be tied to the company for both the foreseeable and unforeseeable future.
- Keep in mind that having a lot of stock means that you're not going anywhere soon, due to the lockup periods. It is going to take you a long time to cash out slowly, and during that time, your stock's value can disappear. The roller coaster of the stock market can make you lose your hair. But fundamentally, you can become very wealthy.
- With respect to venture capitalist, keep in mind that they're looking for a rocketship. When you're trying to get funding, emphasize the IPO, since they're less likely to fund a company whose exit strategy is to do a M&A.
- There is a movement by venture capitalists today to get back to the fundamentals of the past. In the past, investment bankers would only take a company public if it had at least $20 or $30 million in revenue and been profitable for six quarters.
- You should focus on an IPO is you have a solid business, with good growth plans, that is very competitive and growing rapidly. Otherwise you should think seriously about doing a M&A.

Rod Howard

Rod is a partner with Gray Cary Ware & Freidenrich, http://www.gcwf.com. He has managed the Bay Networks-Nortel merger, 3Com-U.S. Robotics merger, Ascend Communications' acquisitions of Cascade Communications and Stratus Computer, and the merger of Network General and McAfee Associates.

- In a software M&A, the buyer wants the people in the company. In such deals, there is a lot more similarities between M&A and an IPO than first meets the eye.
- In an IPO, you typically can't sell off all your stock. In a M&A, the buyer wants the seller to stay and build the business.
- In a M&A, the pooling of interests favors the buyer, in that stock lockup restrictions are placed on the seller. If you are lucky, these volume restrictions are only for a month. If you are unlucky, they can be for four months or more.
- Although venture capitalists favor companies with IPOs, they realize that M&As often provide good valuations and offer a plausible exit strategy.
- People sometimes think that if they do an IPO, they'll be living for the analyst community, whereas with a M&A, they'll be have to walk away with the money. In fact, you'll probably be sticking around and having to report to the M&A's company management, and you'll have many of the same pressures.
- In doing an M&A, you'll sometimes get increased resources, distribution, and the ability to execute a business plan.
- But fundamentally, you should really focus on the people issues when doing a M&A. There have been cases where a company that took years to build up, was an empty building in 6 to 12 months after a deal was closed.
- Who is going to buy you? Someone in your industry is the most likely acquirer. They either want you gone or they want something that you have.

- There are a bunch of things that can mess up a pooling of interests. Once you begin discussing it, you can't change the equity or options. Sometimes there is basic company housekeeping that hasn't been done. If options granted, can be accelerated due to an acquisition, it forces the buyer to have to issue new options in order to retain personnel. A pooling of interest is in contrast to a cash deal, where everything is up for grabs. In a pooling of interests, the seller is also the buyer. You need to ask yourself if this merger makes business sense, is the whole greater than the parts?
- There are some real pitfalls in the due diligence process. You can have all the non-disclosure agreements in the world, but you can't erase what is in people's heads. You need to be judicious and not show too much, too early. The last thing you want to do is to have shown everything behind the curtain, than have the deal fall apart.
- In an M&A, the buyer typically wants to dribble out stock over time. As the seller, you want to get regulated stock, as opposed to unregulated stock that is distributed over time.
- Keep your escrow to less than a year.

Question and Answer

Dave McClure, the moderator for the evening, noted that making payroll every two weeks put a lot more pressure on him, than any amount of analyst expectations.

The speakers noted that in an M&A, it is desirable to make yourself the most important person in the company, its heart and soul. This gives you the most flexibility, control, and influence in negotiating terms and conditions.

You need to balance the collective good of the company versus what is good for the individual. You need to keep people together as a team. Now, it is not unreasonably to bump up stock vesting by 25 or 30% in a person who has been at the company for a couple of years. But at the same time, these people often believe that their shares will be valueless if the founder departs.

It is very difficult to unwind a merger. The honeymoon is over once you sign the M&A agreement. It is very rare that you'll see a LBO or spinout after a merger. And invariably, the company never comes out the same way that it went in.

Exit strategies came out of the venture capital community who have to liquidate their funds after 7 or 10 years.

Not taking a company can cause a lot of morale problems, since people see their stock and options as being valueless until that event occurs. Bill Gates is known to have said that the only reason he took Microsoft public was to set a value on employee stock options.