How to Sell a Startup

The most common way to get rich from a startup is to sell it. Paul Graham describes the ideas that yield buyable startups, the stages at which they can be sold, and what founders should do, and not do, at each stage.

Timeline

1993
Wrote On LISP, Prentice Hall

1995
Wrote ANSI Common LISP, Prentice Hall

1995
Co-founded Viaweb with Robert Morris, the first web-based application

1998
Yahoo buys Viaweb

2002
Develops the first Bayesian spam filter

2004
Wrote Hackers and Painters, O'Reilly

Abstract

Most people who start startups do it to get rich, and the most common way to get rich from a startup is to sell it. Investors call this an "exit strategy," and they won't even consider a company that doesn't have a fairly clear one. In this case the founders and investors' interests are aligned: you should be thinking about exit strategies before you even start a company. Paul Graham describe the kinds of ideas that yield buyable startups, the different stages at which a startup can be sold, and what you should do (and not do) to make it happen at each stage.

Biography

Paul Graham is an essayist, programmer, and programming language designer. In 1995 he developed with Robert Morris the first web-based application, Viaweb, which was acquired by Yahoo in 1998. In 2002 he described a simple Bayesian spam filter that inspired most current filters. He is currently working on a new programming language called Arc. He has an AB from Cornell and a PhD in Computer Science from Harvard, and studied painting at RISD and the Accademia di Belle Arti in Florence. His web site paulgraham.com got 3.7 million page views in 2004.

On May 4, 2005, Paul Graham spoke to an SDForum audience at PARC in Palo Alto, CA for a hour, sharing his insights on selling a company, and took questions for 15 minutes.

Introduction

There are two reasons why companies buy startups, for their revenues and for their strategic value. You would buy a trucking firm for their revenues. But you would be willing to buy a new way of search, long before it was profitable, for its strategic value. About your only real concern would be that the company wasn't a huge money pit, that it was close to being marginally profitable.

As a startup seeking to be bought, you need to convince the potential buyer that not buying you would be a mistake — the most powerful motivator in a deal is the fear of loss.

To do this, you need to be a company that more than one acquirer would want. For example, deciding to do a new word processor would be a mistake, given that their is only one buyer, Microsoft, who has the market locked up with Word.

In thinking about what to do, ask yourself about what a big company would want? And than look for things that are being done badly. Vermeer with its Front Page product, enabled people to easily create web pages, with the ultimate result that Microsoft bought them.

What opportunities are there for software startups today? Open source is very powerful and is going to be hard to fight. You want to adopt a strategy that incorporates and leverages it. If your competition is using open source, and you aren't, you better hope that they go out of business!

Increasingly, thinking of a new business model is very valuable, for example a novel way to do price discrimination.

Now the other strategy you can take is to threaten the competition, like Netscape did with its browser, to Microsoft.

Selling an Early Stage Company

To an acquiring company, buying an early stage company means that they can save time versus doing it themselves. Typically a large company will be behind a startup by one or more years. As such, it is the equivalent of paying someone a hiring bonus to join. For Viaweb, we were offered $3M early on. Our CEO said that for $1M, they could have an option to buy us for $20M in 6 months. They walked.

It is completely unpredictable when someone will offer to buy your company. We retained a freelance investment banker, who had an office in Rolling Stone magazine, to try and sell us. He was very good at introducing us to many people who weren't interested in buying us. Going around and asking, "will you buy me?" results in your talking to the wrong people.

You want to get cash or stock in a public company because you lose control when you sell. At the end of the day, what matters is your net worth.

Selling a Company with a Product

We interviewed a MBA whose we quickly nicknamed Darth Closer. He saw himself as the chariot driver, driving the Viaweb horses towards the IPO gate. Needless to say, we didn't hire him.

Instead, we divided ourselves in half, with a VP business development who was focused full-time on selling us. It turned out that the people in a company who do joint ventures and licensing, typically are next door to the M&A guys.

For myself, I focused on writing software and finding customers, with my primary focus being to build our business.

Even when you think that you're in the final stages of an acquisition, you're not.

Making Your Company Valuable

The number of users that you have are critical. Most investors can't evaluate your technology, but they sure can count! This is also true for analysts, reporters, and potential customers. As such, our mantra became, "get users."

Now the other objective was to be the best in our market segment. Users are not as stupid as you might think, from the prevalence of Windows on desktops!

Now you have to be careful about having too many entanglements since they make you less desirable to an acquirer. On the other hand, Google by licensing its search engine to Yahoo and Microsoft, it prevented them from working on search engines themselves.

Funding Considerations

How did you do your initial funding? None of the founders took salaries. We were always close to broke, it was always a question of how much pain we were willing to endure. When our CFO walked in the door, we always said, "Let's go Dutch with Hutch," since he managed to pay our creditors 50 cents on the dollar.

Angel investors are underrated, fundamentally money is money. Yes, for the very top tier venture capitalists, they do have valuable relationships and contacts. But for everyone else, its just money.

Investors look to obtain the maximum ratio of return to risk. As such, they want a veto over founders, making them buy back their shares and take options for them.

We joked that one of our original founders had a $2M Saturn, from selling stock early on to buy a car for his wife.

Due Diligence

Now sometimes, a potential acquirer is actually looking to pick your brains. Big companies are not a danger, you could give them your source code and they wouldn't be able to do anything.

How much do you say during due diligence? What we did was to provide a lot of information, but not to tell a few critical secrets. You tell them about the wheel, but not about the cotter-pin that keeps the wheel on the axle.

Who Will Buy?

How do you find potential acquirers? If you're in the business, you know who the players are.

Other technology companies are going to be the most comfortable in buying you. Established industries where everyone is working for salaries will resent a purchase where you wind up being richer than you.

We had one handshake deal where we had agreed upon the terms and price. But I should have known that a CEO who wears pale green suits would welch! Not to mention that a merger between two startups seemed weird. There seems to be a direct relationship between how paranoid and dishonest a person is.

Doing the Deal

The key to success is closing a deal. In general, deals tend to fall through. People need to be pushy, never relaxing pressure until the deal is signed. As such, it pays to be pessimistic about doing a deal.

Having competition for doing a deal makes for more interest. There may be many companies circling around you, but once one starts to talk, the others will get much more interested. *(This is the same reason why the first customer to a restaurant is typically seated by the front window.)*

In 1996, Yahoo only had 100 people, and it wasn't clear that search was going to win. But by 1998 when Yahoo bought us, they had a golden aura over them, similar to what Google has today. The money that they paid to buy us, was a good indication of how much they wanted us.

Parting Thoughts

There is a lot of value in using an investment banker. They are a neutral party, accustomed to conducting an informal auction for a company. Its just like using a real estate broker, it is why they exist, they smooth things out.

Before selling yourself, you need to decide who is willing to move. Typically the acquiring

company will want you to relocate to their facilities. When Yahoo bought us for $50M, ten of our twenty people relocated to California. And we got additional stock options from Yahoo for staying.

If I was a dealmaker, I would probably say that I left money on the table. But as a craftsman who creates software, I feel that I provided them with something of value.

Questions and Answers

Would I ever do another startup?

A startup is too much work, you do it to make money. Once you have made enough money, why work? That's why I became a free lance web pundit.

How do you deal with the "Not Invented Here" syndrome?

You have to frighten them with competitors adopting your technology.

What's the difference between a merger and acquisition?

In a merger, people that are duplicate get fired. This is why it is preferably to get bought for cash!

But remember, only 1 in 20 startups will do an IPO. Mergers and acquisitions are how most startups are going to exit.

Any general words of wisdom?

Hire as few people as you can. When you get into trouble, if you have to fire people, the word will get out fast. When someone says, "we're ramping up," to me it means, "our expenses are going up."

Give stock to your first employees to keep them motivated when it is hard to get money.