CHAPTER 1

Intangible Companies—Who are These Guys?

An intangible company is a real company, one with real employees, and with real products and services that it sells to its customers. An intangible company is just like other companies except for one thing—the company's value is strategic. The value is strategic because the company has strategic assets such as technology, software, intellectual property, and know-how. This strategic value might also be called intangible value; and a company whose value is intangible is termed an intangible company.

An intangible company can be any size, but most have less than $30 million in revenues. These companies are typically in the software, technology, and the service industries. More and more of these technology companies are providing services to their customers rather than selling technology to them.

In this chapter we explore the concept of intangible value and examine the reasons that intangible companies are sold, when they are sold, and what are their sources of value. We will also take a look at the nuances of selling an intangible company and how these deals differ from other types of transactions.

Many intangible companies sell early in their life cycles. Companies sell for a number of reasons including shareholder reasons, market reasons, and management reasons. In addition to the good reasons to sell, there are some bad reasons to sell; there are also bad reasons *not* to sell.

The best time to sell is when the market is hot and buyers are willing to pay top dollar. Many companies wait too long before they consider selling. The first company to sell in a particular market sector will have an advantage because there are more good buyers who need those strategic assets. Of course, the best situation is to have multiple buyers.

The nuances of selling an intangible company are interesting and we will explore several examples. Small transactions, those under $30 million, are different from large transactions for a number of reasons.

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WHAT IS AN INTANGIBLE COMPANY?

An intangible company has special sauce of some kind. Its strategic assets include items such as technology, software, patents, intellectual property, know-how, brand name, market position, customer relationships, development team, etc. For an intangible company, the value of the strategic assets is greater than the financial value that is based on the firm's profits. These firms are often young and have not had time to translate their technological edge and market insight into profits. To be exact, the company itself is not intangible, but rather its value is intangible.

A software firm is probably the most typical intangible company. Its primary assets are its software technology and its development team. A company that manufactures instruments incorporating proprietary technology is also an example of an intangible company. A shoe company that has innovative designs is an intangible company as well. A consulting company with proprietary best practices on how to convert manufacturing companies into 24-hour operations is an intangible company. The common thread among these types of companies is that they have significant value in their technology, know-how, and customer relationships.

Intangible Value and Elvis' Guitar

Intangible value is like the value of Elvis' guitar. How does one measure this kind of value? Is there an objective measure? What *is* the value of Elvis' guitar?

Intangible value is truly in the eye of the beholder. The value is extrinsic. The guitar's value is not a function of its "guitarness" but a function of how badly a collector wants to own it. The market for one of Elvis' guitars is not just collectors of Elvis memorabilia; it also includes people who wish to *become* collectors of Elvis memorabilia.

The value of technology depends on how effectively a buyer can incorporate that technology into its products and services and then sell those products and services in the market. The size of the market also impacts the value.

Similarly, value is extrinsic for an intangible company. If a company's value is intangible there is no objective way to place a value on the company. For most companies, tangible companies that is, value is a function of the company's profits, its rate of growth, and its risk. This value can be determined by comparison to other companies with similar profitability, growth potential, and risk. However, it is difficult to compare two intangible companies because there are too many differences between them. Even if two intangible companies are similar, valuation comparisons are difficult because the markets change too quickly. Chapter 7 will explore the concept of value in more depth.

By the way, Elvis' guitar sold for $180,000.

How Big Is an Intangible Company?

Most intangible companies sell for transaction values less than $30 million. Occasionally companies with revenues from $30 to $100 million will have significant intangible value and will sell for a price that reflects the importance of these intangible assets. Once in a while a company with revenue greater than $100 million will sell because of its intangible assets; however this is generally the exception.

Most companies with $30 million or more in revenue have been in business for a number of years and they likely are generating meaningful profits. A company with $3 million in operating earnings (earnings before interest and taxes) certainly has meaningful profits. Such a company will be of considerable interest to buyers from a financial standpoint. Its financial value will most likely be greater than its intangible value. This is the crossover point where the value shifts from intangible to tangible.

The Tech-Service Company

Software, technology, and other intangible companies have been shifting to become more service-oriented than in earlier years. This shift to service will continue. In my opinion, software is essentially a service. That is how most customers view it. It makes no difference whether the words and images that appear on their computer screens are delivered from their own hard disks or over the Internet from a provider's hard disk.

Two aspects of technology companies distinguish them from non-technology companies—invention and change. A technology company invents new types of technologies: hardware, software, and other varieties of technology. The second characteristic of a technology company is rapid change. By rapid change I am referring not just to the company's technologies but also to the company's rapidly changing markets.

Many companies invent and apply technology in a wide variety of industries and application areas—chemicals, instruments, biotechnology, plastics, automobile technology, and even clothing. It is important to think of technology companies not just with respect to computer-related technology companies.

More and more technology companies are providing their customers with the benefits of their technologies not by selling the technologies but by providing services that utilize them. A good expression for these companies is tech-service companies. A tech-service company is a technology firm that has a large service component to its business. Software as a service is the quintessential example of a tech-service company. Now it even has an abbreviation—SaaS.

The success of Salesforce.com underscores the escalating popularity of software as a service. Salesforce.com exemplifies the tech-service company because all of its revenues derive from the service aspect. The company is a leader in customer relationship management (CRM) services and has changed the way that customers manage and share business information over the Internet.

It has taken years for customers to get comfortable with the idea of software as a service, but it is catching on and will continue to become more prevalent. This business model also makes better sense for the software companies. It provides them with ongoing service revenue, which is preferable to the old model in which software firms regularly released new versions. Many software firms could not release versions fast enough to generate sufficient revenue. This model created grief for customers as well because they had to install new software on a regular basis. Software as a service will continue to gain acceptance because it is better for all parties.

Even IBM is a tech-service company. In recent years the service component of IBM's business surpassed the sale of its hardware and software products. IBM's Global Business Services Division, which includes technology services and consulting, now accounts for more than 50 percent of the company's revenues.

The Service Model

Selling a service is a more subtle and sophisticated business model than selling products. As the American economy matures, more and more companies will be providing services rather than just selling technology. There are a couple of reasons for this: one, services are what the customer wants. The customer wants their problem solved. Second, customers are gaining trust in service providers to maintain the accuracy and confidentiality of their data. A few years ago many customers did not want an outside company to be in control of their data. Now customers are more comfortable with this idea. In addition, the service provider can probably do a better job of keeping the data secure than the company can itself. The provider has better backup systems, better redundancy, and more sophisticated data management software.

A good example of this shift to service is an e-mail direct marketing company. Initially this particular company sold its software to customers so that the customers could perform their own e-mail marketing. The company

P1: a
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usually provided the service for the first six months to get the customers up and running. Six months later when the time came for the companies to take on the work themselves, they preferred to let the software company continue providing the service. At the outset customers bought the software fully intending to utilize it in-house. However, very few of the company's clients ever performed their own e-mail marketing; they continued to let the software company perform their e-mail activity. It was much easier to simply pay for the service.

WHY ARE COMPANIES ACQUIRED?

Let's look at the sale process from the buyer's eyes for a moment. An intangible company may be acquired for a price greater than $100 million or possibly greater than $200. However most of the time intangible companies will sell for less than $30 million; I regard these as small acquisitions.

Making a small acquisition can be an excellent strategy for an acquirer to gain a foothold in a niche market, gain new customers and new talent, acquire new capabilities and technologies, and serve as a platform to build upon. Small acquisitions are less expensive, easier to integrate, and often simpler to transact than large acquisitions.

A $5 or a $10 million acquisition will be important to a company with $175 million or less in revenue. To a $500 million company, a $10 million acquisition is usually too small to get their attention. Only if the assets or technology are highly strategic will a very large company acquire a small firm.

The market opportunity for small acquisitions is significant. Many small companies need to be part of larger companies in order to grow and thrive and to gain economies of scale in marketing and sales. Often the best firms are not seeking to be acquired and may be under the radar. The market for small acquisitions has not been picked over. The smart play for an acquirer is to make a small acquisition, get a foothold in a niche market, and then grow it.

The search for small acquisitions can provide a resourceful window into new growth areas. Even if an acquisition is not completed, the search process brings new market knowledge. Appendix A illustrates the beauty of small acquisitions in more detail.

WHY ARE COMPANIES SOLD?

A company that is thinking about selling needs to examine the reasons that it is considering a sale. These reasons may be shareholder reasons or market reasons. A primary driver for the sale of a company is that the shareholders desire liquidity for their shares. A second reason is that the company lacks the capital for effective marketing and sales and it can grow faster as part of a larger company with established sales channels. A third reason, although less common, is management problems. Timing is a critical aspect of the decision to sell. Some companies wait too long to consider selling and others sell for the wrong reasons. Let's examine the reasons to sell.

Shareholder Reasons

Shareholders include the founders, individual investors, and venture capital firms. Each group has both similar and different objectives in seeking liquidity. If the founders are the major shareholders, they may desire liquidity because they've been working for a long time and they would like to pursue other challenges or retire. This period of time may be as short as five or six years or as long as 10 to 15 years. The founders would like to cash in on their efforts; plus many are simply ready for a change.

If a company has been performing extremely well, the shareholders may think it is a good time to sell the company and realize an excellent return on their investment. They will likely hire an investment banking firm to assist with selling the company and negotiating a transaction. In some cases a buyer will approach the company out of the blue. The company may end up selling to that buyer or it might approach other buyers as well. A company with exceptional performance is in a strong negotiating position and it can command a top price. A top-performing intangible company with revenues from \$15 million to \$30 million might sell for a price of \$30 million to as much as \$150 million.

The second situation is one in which there are outside investors: either individual investors or venture capital investors. If individual investors are the primary shareholders they may desire liquidity because they invested a number of years ago and now it is time to recognize a return on their capital, even if it is not a stellar return.

In some cases companies have both angel investors and venture capital investors. The situation in which the company has venture capital investors is a little different than a company with only individual investors because venture capital firms tend to own a greater percentage of the company's equity than do individual investors. The result is that the venture capital firms will often have a greater influence on the decision to sell the company.

Venture capital investors seek liquidity for three primary reasons. First is that the company has achieved spectacular results and a sale enables the venture capital firm to cash out and realize a return on its investment. In this situation it is likely that the company was approached by a strategic buyer who made an extremely attractive offer to acquire the company. The second reason is that the venture capital investors do not want to invest additional capital in the company. They may be weary of the investment and do not see the company becoming a major success. The third reason is that the venture capital fund is at the end of its life and it must return the funds to its limited partners.

Let's take a closer look at these reasons to sell. The venture capital backers may have decided that they are unwilling to invest additional capital in the company. It is their judgment that the money will not generate a sufficient return given the upside potential and the risk involved. Investing additional capital raises the bar and requires the company to be even more successful in order to generate the required return to the venture firm.

Venture capital firms may have invested \$10 million in a company to develop its technology and now the company is seeking an additional \$10 million to build out its marketing and sales capabilities. At some point almost every company must become a sales- and marketing-driven company. This significantly raises the stakes to the venture capital firms because now they will have \$20 million invested in the company. This means that the company must be an even greater success in order to provide an adequate return to the venture capital investors. Now the company must sell for \$200 million rather than \$100 million, for example, to provide the desired return.

The venture capital backers decide at this point that they would rather earn a moderate return and not invest additional capital in that particular company. So, they instruct management to sell the company. If the venture capital backers own more than 50 percent of the company, they can dictate that management go forward with the sale. If the venture capital firm owns less than 50 percent, they can still have significant leverage. The terms of the shareholder agreement can also give the venture capitalists more clout.

A venture capital firm may also want to achieve liquidity because it is losing patience with the company. It realizes that the company will never be a home run. The venture fund may have maintained its investment in the company for five or six years and is becoming weary of the investment. The venture capital partners no longer want to spend time overseeing the investment and attending board meetings for a portfolio company that will generate only a mediocre return. They would rather focus their limited time and energies on portfolio companies with greater promise.

A venture capital firm may be closing down an older fund that has reached the end of its economic life. A venture capital partnership typically has a life of eight to ten years with an option to extend it for another two years. At the end of the partnership's life, the general partners are required to return the capital to their limited partners. A venture fund that is near the end of its life will seek to liquidate the remaining companies in the portfolio.

I have worked on a number of transactions in which the primary driver for the sale was that the venture fund was nearing the end of its life.

Market Reasons

Many intangible companies sell because the firm has reached an inflection point at which it needs to either expand its sales force or join a larger company that already has a sales and distribution infrastructure. The problem is that they don't have sufficient marketing and sales resources to penetrate their markets in an aggressive and meaningful way.

The most common situation is a company that has developed technology, often quite successfully, but does not have adequate sales capabilities. Cash flow may cover operating expenses but not much more. Any extra cash is spent improving the technology or developing new products. The company does not have the cash to hire additional salespeople, which is what it really needs to generate greater revenues. The company lacks the capital for growth. The firm may have spent $8 million to develop its technology and now it needs an additional $8 million to take it to market. Lack of growth capital is a good reason to sell.

Often these are one-product or two-product companies. The founder might be the sole salesman in a small intangible firm. It is not viable to have a large sales force with only a couple of products; there are no economies of scale. At some point in the company's life, management can become frustrated with its efforts to grow the company, to build revenues and profits. The alternative is that they must either sell the company or else limp along. Selling to a larger firm enables the acquired company to make deeper inroads in the market. The acquirer usually has capabilities that the target company lacks. The selling company can now take advantage of the buyer's greater marketing, sales, and distribution resources and dramatically boost its revenues.

When a company is acquired, its risk level changes. As part of a larger firm with greater resources the target's operating risk is significantly reduced. This can be very attractive to an entrepreneur who has endured a high degree of risk for a number of years. The entrepreneur has the opportunity to continue building the company as a division of a larger firm—a much less risky alternative.

Management Reasons

A third reason for a company to sell is management issues. Management problems can occasionally escalate to the point where the company has no other alternative but to sell. The founder may have outgrown his role as inventor or technologist and the CEO role is not being adequately filled. In other cases there may be a conflict between management and the venture capital backers.

In one transaction that I was involved in, the founder and the VCs were not getting along. Not only were there conflicts between the founder and the venture capital backers, there was mistrust on both sides and the parties had differing agendas. The founder wanted to build the company at all costs and did not want to consider selling. This was his baby and his ego was closely tied to the success of the company. Selling was anathema to him. The venture capital firm had been an investor for several years and did not want to invest additional capital in the company, primarily because of the problems with the founder.

Sometimes an intangible company will sell because it is an alternative to raising capital. Being acquired by a larger firm might provide the company with the same resources that it would have purchased with additional capital. In one case in which I was working with a buyer to identify attractive acquisitions, I contacted a company that just happened to be in the middle of raising capital. The amount of dilution that the shareholders would have experienced in the financing transaction was significant. In addition, the buyer had all the resources and distribution channels that the seller was seeking to build. The shareholders decided that they were better off being acquired than raising capital and continuing as an independent company.

Bad Reasons to Sell

The worst reason to sell is because the founders or shareholders simply desire a high price. The sellers will be disappointed most of the time. Such a sale is motivated by an external financial objective not by market conditions or the company's current growth situation. In addition, the desired price can be extremely high and often unrealistic. Of course, if a buyer makes an unsolicited offer, that is a different story. This situation is discussed in Chapter 9. Once in a rare while an offer may come in out of the blue that is simply too good to pass up.

WAR STORY: DANGEROUS MOTIVATIONS

This was an unusual company. It had excellent technology but the management team had some serious issues. The two founders were

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the majority shareholders. In the third year of operation the founders brought in both a new president and a VP of marketing and sales. The new management people made an agreement with the founders when they came on board. The deal was that if they could sell the company for at least 4 times revenues, then the founders would be required to sell the company. They even signed a written agreement to this effect. This situation could easily encourage management to take unnatural actions in order to achieve the threshold amount. I declined to accept this assignment. The last I heard the company had not sold. This kind of deal is fraught with danger.

Why Not to Sell

A company should not sell if it can create more value by continuing to grow as a stand-alone business. The company should continue on its own when the value being created outweighs the risks of staying independent.

Bad Reasons *Not* to Sell

On a related topic, there are also bad reasons *not* to sell. The primary bad reason not to sell is that the CEO has a personal agenda that is not aligned with the shareholders' objectives. He may enjoy running the company. He is getting a very good salary, nice perquisites, and he likes being in charge. Also, the CEO is not usually playing with his own money. At least most of it is not his money. His attitude is, "Just give me more money and a little more time. I can make it a success." The problem is, however, that he has already had plenty of time and spent plenty of money. He cannot bring himself to accept defeat or even mediocrity. Success is always right around the corner so he never wants to sell.

Another bad reason not to sell is the "lifestyle company." A lifestyle company is one in which management draws attractive salaries without regard to returning capital to the shareholders. I have run across a number of companies that fit this description. The shareholders either do not have the voting power to effect change or the value of their holdings has diminished to a point where they simply do not care. There is no impetus to change; management is happy with the status quo. I have suggested a sale of the company in situations such as this, however management usually responds with the same platitudes about greater revenues and profits being right around the corner.

Alternatives to Selling

A company almost always has alternatives to selling. It is important that a company recognize that it has options. Not selling and continuing down the present path is an alternative. Growth is another alternative. Existing shareholders can contribute additional capital to keep the firm alive or to grow it aggressively as the case may be. The company can raise venture capital and expand the business. If a single owner or founder wants to spend less time working, he or she can hire a professional manager and the owner can step back. There are always several alternatives to selling.

WHEN ARE COMPANIES SOLD?

Timing is critical when selling a company. It is one of the primary drivers for getting the best price. When is the best time to sell? There are two types of timing: internal timing and external timing. Internal timing is based on the company's specific issues, unrelated to any situation in the market. External timing is based on the market and the needs of companies in the market.

The pace of innovation and change is rapid in the technology industries and it is common for a technology company to be sold at an early stage in its development. An attractive return for shareholders may be realized before the company has invested significant dollars in sales and marketing.

As we mentioned above, a company should not sell when it can continue building significant value without taking undue risks. From this statement we can back into the right timing to sell. The right time to sell is when the risks associated with growth are escalating beyond a reasonable level. Another good time to sell is when the company is struggling to achieve growth. Temporary downturns and slack periods are one thing but when a company has a systemic problem with maintaining its growth it might be time to sell the company. A company should also sell when it has experienced a period of strong growth and can demonstrate additional growth prospects for the future. This is when the firm can sell for top dollar. One of the cardinal rules of mergers and acquisitions (M&A) is that a company should always sell before it needs to sell.

External timing is based on market reasons. The market dictates the best time to sell. The difficulty is recognizing the market situation, particularly if one is focused internally on the company's issues and problems. Markets are always in flux. As a result it is not an easy task to recognize the perfect time to sell from a market standpoint. Chapter 7 addresses this topic in more depth.

The best time to sell is when the market is hot—when buyers are willing to pay top dollar. The timing that matters is the timing of the potential buyers, not the timing of the seller. Are the likely acquiring companies at a stage when making acquisitions makes sense for them? Do they need the technology now? Will they pay top dollar now?

A good example is the acquisition of Skype by eBay for $2.6 billion. eBay's core auction business had flattened out and eBay was looking for a new growth area. Skype was only three years old with revenues of $7 million, but eBay was in the mood to buy. Skype was smart to sell early in its life cycle and capitalize on this market situation.

Think for a minute about the opposite situation. The market does not need this technology now because the technology is too early. Or, the supporting infrastructure has not yet been developed. At the other extreme, it could be too late. The likely acquirers have already developed or acquired substitute technology; they have found other solutions. This is the problem when companies wait too long to sell.

Market timing can be segmented into two categories—broad-market timing and the timing of a specific buyer. Broad-market timing refers to the overall situation in a market. In many markets competitors develop along similar time lines and experience similar stages of maturity.

For example, let's take a look at the market for software applications that run various aspects of municipal government. Historically this has not been an attractive market sector because there are significant barriers to entry and the sales cycle is long. For a software development company other markets are clearly more attractive. But for the software company that is willing to put in the time and effort to penetrate this market, the market is a good one. It is usually the smaller software firms that achieve early success serving this market.

After a number of years the more mainstream markets become saturated and competition increases. The larger players begin to look for additional market opportunities and now they may notice that the government software market appears attractive. This is a dangerous time for the smaller software development companies. The small firm can continue in this market and compete with the larger companies who are entering the space. However, the shrewd smaller company will sell, often at an attractive price, to one of these larger firms who is moving into the government software market.

The losing strategy is that of the smaller software company who goes head-to-head with the much larger competitor. In this case the smaller company has the mindset that they know the market better than the large competitor (which is usually true) and that their software is better and more on target with their customers (which is also likely to be true). However, in the long run the smaller company will lose out to the bigger company. The

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bigger company can simply throw more resources on a project and attack the market with significant sales and marketing power. The large company can also offer a bundle of products and services that smaller firms simply do not have. Municipal governments are more likely to choose the large company as its vendor of choice.

The second kind of market timing is the timing of a specific buyer. In this case the broad market picture is not as important as an individual buyer's stage in its life cycle. Regardless of what's going on in the market, if this particular company recognizes that it needs to branch out into new or adjacent markets, it will have an acquisitive mindset. This type of company is an excellent candidate to acquire smaller firms in adjacent markets. Chapter 5 discusses market timing and its correlation to selling at the optimum price.

WAR STORY: DO THE MATH—MAYBE YOU SHOULD SELL EARLIER

Sometimes an intangible company will sell early in its life cycle. Let's take the example of Lambda Medical Technology, a small firm that had developed great technology for solving a specific medical condition. The founder was a doctor and a well-known expert in this particular medical area. The product and technology worked quite well and the company expected to receive FDA approval within a month.

The company had spent $5 million to develop the technology and product. This capital had been provided by a Small Business Innovation Research (SBIR) grant from the National Institute of Health. Now the company was at a crossroads. Lambda calculated that it needed about $3 million to undertake a reasonable marketing and sales effort to roll out the product to the broad market. Unfortunately, $3 million is a difficult amount of money to raise. It is significantly less than what venture capital firms prefer to invest and it is a large amount to obtain from individual or angel investors. Initial meetings with angel groups showed promise but it did not look like the company could obtain close to $3 million.

I spoke with the founder about the situation. We both thought the company's current value might be in the $3 million to $5 million range. The company had told investors that its pre-money valuation was $4 million. The founder calculated his potential capital gain if he

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sold the company now and compared it to the gain he might achieve if he raised capital, grew the company, and sold the firm in five years. Here is how the math worked out:

- Current market value: $4 million.
- Founder owns 75 percent of the company. Founder's value: $3 million.
- Investors contribute $3 million at a pre-money valuation of $4 million. Thus, investors will own 3/7 or 43 percent of the company.
- After the financing the founder will own 75 percent of 57 percent, or 42.8 percent of the company.
- If the company is sold in five years for $12 million, the founder's portion will be $5.1 million. (This assumes the investors do not have any special preferences regarding liquidity.)

Even with great technology, generating market acceptance for a product is a long, uphill battle. The founder does not have a background in sales and marketing. There is also the possibility that the company might require even more capital for growth, in which case the founder would be diluted further.

The result of this analysis is that the founder's shares are worth about $3 million at the current time. If the company sells in five years for 3 times its current value, or $12 million, the founder's shares would be worth about $5 million. Should the founder cash out now for $3 million or wait an additional five years in order to achieve a $5 million payout? Is it worth waiting five years? Is it worth the risk?

At the time of this writing, the founder is considering his alternatives while he waits for the FDA approval. He is strongly inclined to cash out now, in part because of the timing and in part because of the risk.

Waiting Too Long to Sell

In my experience many sellers wait too long before selling. There is always some excuse that keeps them from executing the sale process. They just want to get revenues up a little more, get the latest version of the product developed, attend the next industry trade show, or whatever. There is always a reason not to sell. Venture capital firms are guilty of waiting too long as well. Most venture capitalists are in the business to hit home runs, not singles or doubles. So they typically wait too long to sell, waiting for that home run.

It takes courage to sell. It takes courage to change direction and make a decision and move forward with it. Perhaps the CEO does not really want to sell at all. Maybe he is afraid of going down a road that he is not familiar with (i.e., the sale process). In any case, companies often wait too long before selling. Here are some of the reasons.

Many CEOs and founders want to continue growing the company. If the company is performing well, the CEO wants to grow revenues to a higher threshold. If the company is performing moderately, the CEO wants to boost profits. If the company is struggling, the CEO wants to dig himself out of the hole and achieve break-even profitability. The company will always do better down the road. There is no shortage of optimism in the entrepreneurial environment. There is always a reason to wait. This mindset can be a problem.

For a company whose value is strategic these are not good reasons. The sale of an intangible company will always be a strategic transaction. The buyer is buying technology and capabilities, not revenues or cash flow. If a larger company needs your technology because it complements their products, there is a better chance at selling it for top dollar now, not down the road when you have improved your cash flow. Although better financial performance certainly doesn't hurt, the deal does not hinge upon the financial performance. The strategic asset is unchanged, even if revenues are slightly higher. Remember, the deal is strategic, not financial.

Don't milk the company dry. Do not try to wring every last dollar out of the market. Sell the company when there is still good growth left for the buyer to realize. This is how a company cashes out for top dollar. For one, buyers tend to be reasonably smart about the markets. Sooner or later the buyer will realize that the company has milked the market dry. If they do go forward and make an offer to acquire the company, it will be a low offer.

Do not try to sell at the top or even just before the top. Why not? Because you will never know where the top is. This is an impossible question to answer. It is similar to trying to sell a stock at the top of the market. Market timing is impossible to predict.

The other side of this coin is that the risk does not diminish. Markets are not static, they are always changing. As a result the price that a company might command at one point in time may be very different from the price it commands a year later, even if the company is unchanged.

Entrepreneurs and CEOs are optimists and they believe they can grow their companies to the stars. The most dangerous ones can be blinded by their optimism. The smart sellers are ruthlessly realistic about the market. They recognize early on when larger competitors are entering their markets

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putting pressure on prices and margins. The right time to sell is when the market is ready.

First Seller Advantage

First seller advantage is akin to musical chairs. In musical chairs, the last person standing loses. This concept is similar to that of "First Mover Advantage." I like to call it "First Seller Advantage" and "Last Seller Disadvantage."

The concept is this—the first company to sell in a particular market niche has a significant advantage because there are more buyers that need its software or technology. The first company to be acquired is likely to receive the best price because there is more competition among more buyers.

A good example of First Seller Advantage is Google's acquisition of YouTube, Inc. for $1.65 billion in stock. YouTube only had 65 employees and did not have a profitable business model. Analysts regarded the acquisition as a defensive move on Google's part. In other words, Google wanted to keep YouTube out of the hands of competitors. (There were rumors that Yahoo also bid for the company.) A Google vice president commented that the transaction's value to Google was not determined on a stand-alone basis, but was based on synergies with Google's existing business. This is typical for the acquisition of an intangible company.

In the technology markets it is unlikely that there will be 10 or 20 good buyers for a company that is seeking to be acquired. Typically there are between one and four truly good buyers for a target company. So, in the Internet video market space, other sellers will have a more difficult time finding good buyers when they decide to sell. Yahoo is a likely buyer, but who will bid against them? The next sale will likely be for a lower price.

The antivirus or security software market is similar. There was a time when few companies had antivirus software, then a handful of companies had it, and now of course almost all applications have some sort of antivirus or security software. Sometimes large software companies develop this software in-house but more commonly they will acquire a smaller firm that has developed specialty technology. The first company to sell has an advantage because there are more potential buyers in the market.

THE NUANCES OF SELLING AN INTANGIBLE COMPANY

If you are thinking about selling, the first task is to examine your company. What are your reasons for selling? Why are you considering it? Take a look at your sources of value. What are your key assets? A keen understanding of your company's strengths is imperative. What are the drivers of value in your company? Is it the technology? Patents? What people strengths do you have? What about development capability? Is your customer base a key asset? Can you quantify these strengths in any way?

What strengths will you bring to a buyer? What additional revenues will you contribute? What about recurring or maintenance revenues? Are there cross-selling opportunities? Does your technology offer key strategic value to a buyer? Can the buyer find similar technology elsewhere? Try to estimate the dollar value of incorporating your technology into their products.

In many cases it is difficult for an owner or management to be objective about these issues. That is why it is helpful to seek the advice of a third party such as an investment banker. A banker will have a broader purview and can usually offer practical advice about the depth or breadth of the company's components of strategic value. Management should make a point to listen to the advice, even when it may not be what it wants to hear. In Chapter 14 we explore the concept of using an investment banker to assist in the sale of a company and Appendix C discusses how to select an investment banker.

First let's discuss the sale of a *tangible* company. The value of a tangible company is real; the company's earnings are factual. The company has a record that cannot be altered. The historical earnings are the historical earnings, period. For a tangible company if the earnings are X, the value is Y. There is little opportunity for imagination or vision to negotiate a better price.

Let's consider a hypothetical tangible company. Let's say the firm has been in business for a number of years, its earnings have been consistent from year to year, and there are no surprises. This business is transparent as to what it is. There are no wildly optimistic projections for future earnings. It will perform in the future very closely as it has in the past and the price will be a function of its profits. The most likely valuation yardstick is 5 or 6 times operating income. So, if the company has operating earnings of $1.5 million, the value of this company will be between $7.5 and $9 million. This range will be narrowed further by examining the risk characteristics of the company. There is minimal growth so there is no premium paid for growth.

In contrast, selling an intangible company means selling a vision of what the potential growth *might* be. The value is not a function of its profits but a function of its technology and other strategic assets. It can be easier to get an exceptionally high price for an intangible company than for a tangible company.

The following sections explain a few of the other nuances surrounding the sale of an intangible company. A valuation is not necessary—the parties simply need to agree to a deal. Sometimes there are multiple buyers and sometimes there is only one good buyer. In addition we explore why small deals have characteristics that are different from large transactions.

Agreement is the Goal

The key to closing the sale of an intangible company is to get the parties to agree on the price and terms. The parties do not need a valuation; they do not even need to agree on value. They simply need to agree on the price.

If I trade you my bike for your skateboard, we do not need a valuation. If we are both happy with the trade then it is a successful transaction. Think of it as a barter economy. There is no money in a barter economy. All deals are done by trading one asset for another asset. There are no valuations. If someone wants to trade four pigs and one goat for two cows and each side is happy with the trade, then it is a successful transaction. A valuation is not required.

Similarly for the purchase of an intangible company—it is a trade. Unless it is a cash deal, the players are trading shares of one company's stock for shares of another company's stock. The buyer is trading 14 percent of its stock for 100 percent of the target's stock. Expressed in number of shares it may be something like trading 1.3 million shares of the buyer's stock for the 2.4 million outstanding shares of the selling company. There is no accurate valuation for either company (unless the buyer's stock is publicly traded). As long as the principals on both sides agree on the ratio of shares to be exchanged then a successful transaction can be concluded.

Multiple Buyers versus One Buyer

There are two situations to consider. The first—and best—situation is when there are multiple buyers. Having multiple buyers is the best way to ensure that the shareholders of the seller will achieve the best price for the company. The second situation is when there is just one viable buyer for the company.

When multiple buyers are in the picture it is possible to go back and forth to make sure that each buyer is offering the highest price that it can. Then the seller simply chooses the highest offer. The seller might choose the second place offer if the terms are more favorable or if there is a better management fit. Otherwise the choice to select the highest offer is an easy one.

When there is only one buyer it is a little trickier. I have had good success over the years negotiating deals when there was only one buyer. In most cases the alternative for the buyer is to develop the technology in-house. It is imperative for the seller and its intermediary to have an in-depth understanding of the buyer's situation. The seller needs to know specifically how important the technology is to the buyer. It is only through this knowledge that the seller can negotiate a top price.

Small Deals are Different than Big Deals

Why would a small transaction be any different than a large transaction? A deal is a deal. Some think that small deals are just as complicated as big deals. They can get complicated, but they do not need to be. Small transactions have a number of characteristics that differ from large transactions.

The buyers for an acquisition under $30 million are smaller companies with revenues between $15 and $175 million. For a large transaction there may be 40 or 50 potential buyers, versus 150 or more for a small acquisition. The universe of buyers is different. Small acquisitions are often made with market entry as a motive, so the search process can require more creativity to investigate adjacent markets.

Small technology companies are not usually fully developed, not "cast in concrete." A company with $100 million in revenue is fairly well-defined. A company with $7 million in revenue is much more adaptable. A young intangible company can fit with more buyers and its technology can be employed in more contexts.

The sale process for a sub-30 company is different than the process for selling a larger company. The two-step auction process used for large transactions does not work well for transactions less than $30 million; a negotiated sale is much more effective. Chapter 3 discusses the advantages and disadvantages of the two-step auction process versus the negotiated sale.

Not only are small deals less expensive, they can have simpler transaction structures. In many cases the buyer simply purchases the seller's assets and assumes selected liabilities. If stock is not being acquired, there is reduced due diligence and less concern about hidden liabilities. With a small acquisition there are fewer integration issues because there are fewer people to bring on board and no "culture" that must be integrated.

In some ways, small transactions can be more difficult. Deal structures can be more diverse with notes, earnouts, royalties, etc. A consulting agreement may account for a material portion of the transaction value. A small glitch can be a significant problem in a sub-30 deal. In addition, the participants are generally less sophisticated on small transactions. The buyer might have never made an acquisition before and it may not have an experienced investment banker or attorney advising it. For a more in depth examination of the differences between small transactions and large transactions please see Appendix A.

A Few Other Nuances

One of the problems with selling an intangible company is that management and shareholders do not know what it is worth ahead of time. Most CEOs and board members find this a bit frustrating. Generally the board of directors wants to have a clear valuation range in mind before they begin the sale process. This can be difficult to achieve. For one thing the selling company does not need a value range up front. There is no decision that the company will make or not make that depends upon the value range.

The decision to go forward with the sale process should not be based on an expected value but rather on strategic business reasons or shareholder reasons. In doing this, the company shouldn't try to outthink the market. The seller may decide not to accept an offer, but that occurs later, after it has gone through the sale process and generated offers. Even though the company might have an idea ahead of time about the price, it really will never know until it goes to the market and finds out. The price is determined solely by the market.

This is particularly problematic when an offer comes in out of the blue. The board does not really know if it is a good offer or not, as they have nothing to compare it to. Chapter 9 discusses unsolicited offers in more depth.

Intangible deals are usually not accretive. Accretive means that the seller has earnings and these earnings will increase the buyer's earnings per share. A selling company with excellent technology but minimal profits will not be an accretive acquisition. Most sales of intangible companies are not accretive. Publicly traded buyers will almost always state that any acquisition must be accretive. This is part of their acquisition criteria. However a buyer will break this rule if an acquisition truly adds strategic value or a key technology. A strategic acquisition may not add to earnings immediately but it will increase earnings over the long term by enabling the buyer to take advantage of new technologies or to enter new markets.

SUMMARY

Intangible companies are interesting creatures. In this chapter we reviewed the reasons why these types of companies sell and we noted that intangible companies may be acquired early in their life cycles. Many intangible companies sell because they need additional resources to reach the next level of growth. Since their value is strategic, the timing of the sale with respect to

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the market is more critical than it is for financially valued companies. The transaction dynamics regarding the sale of small intangible companies are different than those involving larger companies or companies with financial value.

There are a number of widely held beliefs regarding the sale of intangible companies that are more myth than fact. In the next chapter we take a look at these myths and discuss why they are not true.