Software BUSINESS
Strategy & Technology For Software Executives
a webcom publication

Software Business Executive Report **May 12, 2008**

Running for the Exit:

What Investors Want to See in Exit Planning

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If you're a software entrepreneur taking the temperature of the IPO market right now, chances are you're tempted to want to strike a match or two in the hope that things will heat up more than a little.

Yes, the sizzle is gone. For now. But, try to keep a cool head. You'll find that your best strategy is really to stay calm, manage everyone's expectations, including your own, and build a company with a long-term sustainable competitive advantage.

Making the Market Work for You

Talk to most venture capitalists and you'll discover that their expectations for their investments are pretty realistic these days. Once they've done their research and identified a company to back, they'll put money in with the idea of building the company for the long term.

What is the long term? Currently, the average length of time from initial equity funding to the liquidity event is approximately seven years. So, in terms of managing your expectations and developing a strategy, you need to realize that it's a long road.

For the venture capitalist that long road ends with a successful exit, which can be defined progressively as a) Good: Getting their investment back-nice and better than losing money; b) Better: Making money on top of the investment, certainly a plus in their eyes; and c) Best: Earning back 10 times the amount of the investment, a solid homerun, of course.

Now, you'd think VCs would be jumpy today, given the jitteriness of current market conditions, but experienced investors know that even a volatile market doesn't last forever. Things change, they always do; it's just that the "when" part is uncertain. And, even if we are going into a recession, those experienced and patient investors are still going to be in the game. In fact, in the past several years, we've seen the number of investment deals slowly growing from 2,234 in 2003 to 2,648 in 2007 and the amount of money invested also increasing to $29.9 billion in 2007.

But just know that even as they make more investments, VCs are going to be more cautious, exits will take longer and, most important for you, execution is going to be critical because investors and acquiring companies will be looking twice at everything they do. Your job is to make the most efficient use of capital and, as you navigate your company through its infancy, keep everyone's expectations focused and realistic.

In fact, this current market could actually be seized as an opportunity. Since investors are not going to be pressured to do a quick, immediate IPO, you gain more time to be strategic and consider what you need to accomplish with your employees, how to best service your customers and develop solid operating procedures for the company.

Creating a Company with a Sustainable Advantage

Just as the market doesn't stay static, neither will your company. Everything changes as you go from infancy forward. So, it's up to you to create a company with a long-term sustainable advantage, always with an eye toward a successful exit for your investors. This requires three critical tactics.

The first is assembling a management team capable of building a great company. It's essential that you recruit this team, not try to simply mold it from within. As the company leader, you have to make sure that the individuals you select aren't just talented in their particular area of expertise, but that they are a good fit with the team and the culture of the organization you're building. They're your foundation. Do they have the strengths

you need? Do they complement other team members' strengths and weaknesses? Can you smoothly execute your goals together? Consider this: one benefit of a down market is that it creates opportunities to hire and keep people who in a stronger market you might not have been able to bring in or who would cost you a fortune to get or retain.

The next critical move is to create a referenceable customer base. These are customers who think highly of your company and the product itself. Now, this will change as your company matures, but it will start off with investors wanting to know what pain point your product addresses. Is it a problem that a potential customer feels they need to do something about and your company's product can solve? Most importantly, is it something for which a potential customer is willing to expend capital to solve?

As you move forward with the product and a customer base, investors will be interested in your track record with your customers. It is then all about customer satisfaction. Have your customers used your product over a long period of time? Do they return to you for more solutions? Even as you start the exit process leading to an IPO, underwriters will want to talk to your customers about your product and your care of them. And, if the exit is acquisition by another company, those purchasers also will want to talk to your customers. So, you need to develop not just the building blocks of customer satisfaction, but a culture in which your customers will be enthusiastic about singing your praises.

Finally, you must create a company that is organized for success. This goes beyond your business plan. It's the nuts and bolts of developing reporting systems, how you assign responsibilities, where you designate levels of authority. It may not be sexy, but this structure is all geared to establishing effective and efficient operations and, frankly, it's to counter the classic start-up issue. A new entrepreneur has a tendency to want to create more of a democracy as a way to attract people. There's the euphoria itself of starting something new and exciting. Then it becomes all about sales. But, by staying in that mentality instead of maturing and moving forward as a company you risk everything you're building toward. Instead, focus on good organizational management that supports your long-term goals.

The Impeccably Managed Business Risk

Each of these critical tactics must be impeccably executed, understanding that they each represent a separate business risk that must be managed.

Again, most entrepreneurs don't think about it this way. They see their great idea as solely an opportunity-for investors, for customers and for themselves. But the head of a well-run company considers the inevitable risks and how they're to be managed.

There's the technology risk. Someone once said there are only two business problems in the world: either you can't make it or you can't sell it. Everything else is just a subset of that. So, you have to understand and organize around technology risks with the right people who can solve problems and sell the product, setting milestones and perhaps managing third parties who are needed to develop components of your solution.

There's the market risk. How do you develop a thorough understanding of your customers' needs and expectations? How do you meet them? Are you solving true problems for your customers or a problem people really don't have? How do you target the right first customers? How do you properly place and price your product? You and your team must learn how to express the essentials of your product to your customers so they understand its benefits to them. You must develop adequate training to help them use it to solve their problems (and not create new ones). You must build a holistic environment of customer satisfaction.

Then there's execution risk-developing process management. It always comes back to balancing limited resources against proper management techniques. You must define processes and then continually refine them. Set goals. Manage your people and monitor their progress on assignments. You've got to be willing and able to make difficult decisions quickly.

Accurately Managing Expectations Maximizes Value

As your company matures and you've shown an ability to manage risks, your ability to set and meet milestones creates value as you consider an IPO. Essentially, from the beginning venture-backed companies should be ready to go public at any time when the market conditions are right. If the opportunity is an acquisition, you've set up your company to be acquired at a higher premium, perhaps at the public price.

Your investors, after all, want to be sure that you all are on the same page. Your consistently accurate predictions of your company's performance will encourage them to continue to support your activities, enabling you to grow the company and move toward an exit. You set expectations and milestones, not just in terms of revenues, but metrics around new customers, the team you've created, your product's technological progress, and then you meet them. That's how maximum value is generated. It's certainly how Wall Street defines value.

Ultimately, the best prepared companies deliver the most value under any market scenario. It's easy to lose sight of the future in a bad market or even in a good one. But, the market is always changing. With everyone in the business environment being more cautious, you want to create a company that will be accretive to a buyer's earnings, not a detriment. That makes execution and properly established expectations critical. That's your ray of hope for the future.

Mark Jensen is well known in the technology and venture capital industries, with more than 30 years of experience providing audit and consulting services to venture capital firms and their portfolio companies. He is a frequent speaker on issues impacting the technology industry and early-stage venture capital-backed companies, a senior fellow in the American Leadership Forum of Silicon Valley and a member of the board of Joint Venture Silicon Valley.

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