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When the Time is Right to Sell a Company

Software CEOs and acquirers should factor in the value of "promise" when determining the best opportunity to make a deal.

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Everyone agrees that the best time to buy a stock is when it's reached the bottom and is at the beginning of an upswing. If only it were that easy to predict.

Buyers of technology companies are looking for the same opportunity. They want to buy at the lowest cost possible with the potential to significantly grow. On the other hand, those looking to be acquired naturally wish to sell at the maximum value attainable, and believe that they should be rewarded for superior: 1) intellectual property; 2) competitive advantage; and 3) overall quality.

Business owners and/or major shareholders have to work hard to determine the optimal timing for selling a business based on when it is most likely to garner maximum value. There is a key ingredient to determining value that is commonly overlooked, and that is what I call "promise". Here's how to incorporate the value of promise when deciding when to sell or buy a software company.

Case Studies of "Promise"
A company has maximum promise to prospective buyers and will obtain the highest price when buyers believe it is on an upswing. An "upswing" can be based on merely potential revenues or profit, and not necessarily on actual results. In fact, this perceived potential can be even more important than actual results.

Below are some examples of technology companies where the promise of success has determined, or could determine, a much higher price for a company.

In 1996, Sun Microsystems bought Lighthouse, a small company that made software tools based on Sun's groundbreaking Java technology. Lighthouse's technology had the potential to enable Sun to compete against Microsoft Office products. Sun and at least one other major computer company saw the possibilities of the new Lighthouse product and got into a bidding contest. Sun "won" the acquisition paying over $20 million, but then never released the Lighthouse product suite. The question that must be asked is: what would have happened had Lighthouse waited until after they released their product? Would the product have had the traction expected and could it have increased the value? Or would it have shown that there was little interest from customers and taken the value much lower?

In early 2001, Resonate, a small public software company with 500 customers primarily in the financial sector, designed and was about to release a monitoring and control product that was getting the attention of IBM, BMC, and Mercury Interactive. Each of these companies and others came to Resonate to discuss "a business relationship" which led to M&A discussions. The revenue potential of the new product was great and the company believed it would make Resonate a leader in the software monitoring market. The board of directors was divided on whether to sell the company to one of the suitors, or go it alone. The hope was that the new product line would increase sales significantly and would boost the value of the company.

The board voted to wait and see what the new product would do and believed that customer count and "new product buzz" would raise the value of the company significantly. That was in early 2001, just at the beginning of a major downturn in the market, better known as the "dot com bust". At the beginning of this major setback for Silicon Valley most thought it was going to be just a "blip" in the upwards demand curve for technology. Resonate's customers began to pull back on purchase size and in many cases froze all spending on new technology. The NASDAQ lost almost half its value. By the time the new product was ready for release, the economic environment took another unexpected turn with the World Trade Center attacks. This cataclysmic event, coupled with the release of an immature product, resulted in slow sales.

Resonate struggled to reach profitability and was sold a year later at a much lower price than had originally been offered. Events aside, Resonate had a great deal of potential before the product was actually released and, at that time, commanded a commensurately high value based on this "promise".

The third example is that of a privately-held technology company. For reasons of confidentiality, we'll call it "InfoWarehouse". InfoWarehouse has been selling software for over a decade has finally hit its stride and landed a strategic partner. The new partner has contributed to the acquisition of new customers at an increased rate. However, InfoWarehouse has not developed the strong infrastructure to support the increased demands and diversity of such a significant customer base. They have begun the upward climb of the success curve, but will they be able to survive? Even though the founders are dedicated and smart, they do not appear to have the experience or the capital, to serve the new customers with superior support. Customer requests are increasing and time to market with fixes is slowing. The company seems to be headed for a crash. Once customers begin to look for other solutions or a competitor makes headway because of better customer service, this company will look less attractive to investors. This case is slightly different than the two above in that the promise for this company lies in the exponential growth of the customer base, rather than the product potential. And the risk lies in its ability to have the funds and infrastructure to support the high growth.

A Simple Equation

The examples above may seem to be different. They are in diverse markets and occur at different times over the last 10 years. However, there is a common thread, which is the "promise" of their worth and their ability (or not) to sell when that worth is at its optimum. I've come up with an equation to represent this phenomenon,

$$\text{Promise} = \frac{\text{Potential}}{\text{Proximity}}$$

Potential is defined by the perception of the acquirer in regards to the product offering. The drivers are:

- Time to market advantage
- Defensive play (e.g. beat the competition)
- "Everyone is doing it" (e.g. market consolidation)
- Financial (e.g. expand customer base)

The perceived value to acquirers is strongest when the potential is highest. This can change over time with the introduction of new competitors or a sharp downturn in demand.

Below is a chart showing how the promise of a company is highest around, but just before, a major event (usually a product release). This is referred to as "proximity". The chart assumes that the potential of the product is constant because it is in demand and a market exists.

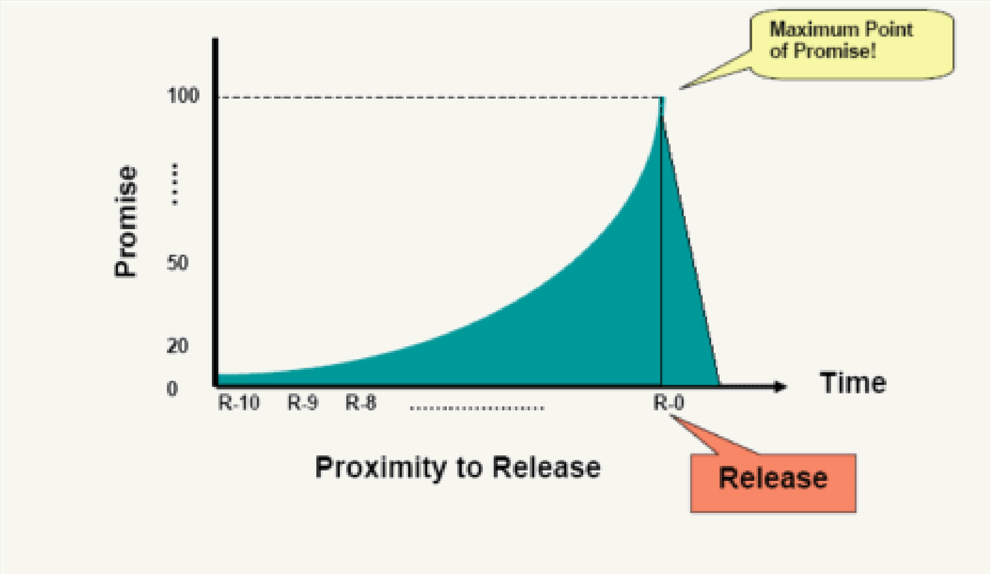

Figure 1 - The Value of Promise

For example, in the case study on Lighthouse above, its product, which was still in development when Sun purchased the company, had the potential to capture significant new business replacing legacy programming tools (in the millions) with the new Java-based product. The adoption rate of Java was very promising. Both Sun and IBM saw the future in Java and were set on this first mover opportunity.

Statistics - How the Economy Affects Acquisitions
In the current economy, buyers are aggressively looking for acquisitions that meet their criteria *now,* while the sellers are hoping that waiting and proving their value is the best strategy. Regardless of the source, there is general agreement that we've reached bottom.

There are countless statistics available from many sources. In a report by Thomson Reuters, dated May 28, 2009, they predict that global technology acquisitions this year will be about the same level as after the dot com bust of 2002. However, the average transaction size in 2002 was at about $90M and in 2009 it is estimated to be almost double that amount.

In June of this year, the Wall Street Journal published statistics by Dealogic for the last 6 quarters of tech acquisitions in the US. It shows that values peaked in Q2 of 2008 at almost $40B, bottomed out in Q4 last year and Q1 this year, and are now on an upward trend.
What does this data mean? It can be good news depending on the situation. Successful acquisitions happen even in a "down" year. The total of technology acquisitions in the US to date is about $25B. There are significant opportunities and funds available for the lucrative sale of any successful business.

The Difference between Corporate Acquisitions and Private Equity (PE)
Acquirers can be divided into two primary categories: strategic and financial. ***Strategic*** or corporate buyers usually look for acquisitions to complement or expand their existing product lines. A buyer is often willing to pay a premium price if, it perceives that the target acquisition will provide one or more of the following benefits:

- Access to a broader, more diversified market
- Incremental customers
- An edge on the competition

In fact, one of the greatest motivators that drive M&A values is the promise of leapfrogging ahead of the competition by virtue of making the right acquisition at the right time. Most often, a sale to a strategic buyer will mean that a business is subsumed within the large company in order to take full advantage of the forecasted synergies. Occasionally the smaller company remains intact as a branch of the larger company but more typically it is fully integrated, leaving the old company's infrastructure (and management!) behind.

The other type buyer is ***financial,*** usually in the form of a private equity fund. Being acquired by a private equity firm can develop into a variety of outcomes for the target company. Many private equity firms are looking for a fast turnaround (i.e. within 3 to 5 years) while others have a somewhat longer time horizon, depending on their fund structure. Their goal is to find a company that has a track record of success, an established market and the opportunity to grow significantly with the right investment and management team. The team can be the existing one or a new team the PE firm hires. Private equity firms range from modestly funded and focused on specific markets, to much larger with significant diversity of investments. Some PE firms hire entrepreneurs, known as 'executives-in-residence' who have a track record in a specific industry / market and who can help them source as well as manage acquisitions within their sphere of expertise.

Evaluating Your Company's Position
When considering selling your company, you should evaluate your position by assessing the following attributes:

1. Does your company fill a void in a market?
2. Could your product offer a competitive advantage for certain strategic plays?
3. Is there significant growth or trend in customer acquisition?
4. Does potential of growth or product adoption lead to great promise?

When Jerry Seinfeld decided to end his successful series, he chose to do it when the series was at the height of its popularity. The media interviewed Jerry and asked him why he was leaving when the show was doing so well. He responded that he wanted to go out while still being viewed as a success. Today, Seinfeld is one of the most successful syndicated rerun series (and possibly one of the most lucrative). Selling your business when it's successful and has the perceived potential to be even more successful will get the best price for the seller and the best value for the acquirer. Hence, if a company has promise and M&A is a possible exit scenario, it's never too early to begin planning for it.

Typically a good M&A firm can act as an advisor in helping to assess the potential for success and will lay out the opportunities beforehand, thereby allowing the entrepreneur to make informed decisions.

Plan Ahead for a Successful Outcome
The timing for receiving maximum return for the sale of your company is important to determine. As discussed above, it involves a range of criteria and judgments, which can be factored together to estimate the "Value of Promise".

Many sellers think that once they begin to investigate a possible sale, they must consummate one in a short timeframe. This is not necessarily the case, as no sale can be done without complete approval of the seller. It is better to begin the analysis and investigation for potential buyers early, if only to test the market and gain valuable feedback on valuation and buyer interest. Planning ahead and going to market earlier rather than later can mean the difference between an unsuccessful and a successful outcome.

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