

Inside the Mind of a VC

Exit, Stage Right

As an entrepreneur, you are the lead actor in a play that only you can write. Be ready for your lines. Know your position on the stage. And above all, know when and how to exit.



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That said, when we meet with a start-up, this is one of the first things we tell them: Lose the term “exit” from your business plan and your PowerPoint pitch. This is about liquidity, not an exit. “Exit” implies an end—that you can neatly wrap up the package and be on your way. Not so!

If the liquidity event is an initial public offering (“IPO”), it is not an exit. In fact, it is just the beginning. The scrutiny you face from accountants, regulators, and shareholders in a post-Sarbanes-Oxley world can be daunting. It requires nerves of steel and a commitment to the company for the indefinite future. Don’t let your new public stakeholders down by looking for a quick exit.

If the liquidity event is an acquisition by a public company, it may look like an exit, but do not be confused. The acquiring company expects to receive value for its cash or stock. That value is measured not just at the time of the closing, but going forward. You should expect to join the acquiring firm and be locked into an employment contract for a number of years. You should expect to have some portion of the purchase price tied up in escrow—to be released only if what the acquirer “bought” turns out to be what you “sold.”

Remember, in a play the only time an actor doesn’t make it to the end of the performance is if he gets killed off en route! Be ready to go the distance.

Start With a Clean Script

Great playwrights know how the story will end before they write the first scene. There isn’t a lot of scrambling around at the end of the performance to tie up loose ends. A similarity for start-ups is to keep your financial house in order from day one. Realize that there will come a time when you will need clean financials, a clean capitalization table, and clean contracts. If you never let them become “dirty,” you will have little to do when it comes time to prepare.

So what does “clean” mean? First and foremost it means doing everything in your power to be not just on the right side of the line of legality and ethics, but so far on the right side of that line that it is not even in view. It means evaluating every transaction using the test

that you would not be embarrassed if the details showed up on the front page of your local newspaper. It means being a company you would want to invest in even if you weren’t part of it. In the area of capital structure, this means

a simple, straightforward equity model, with investors few enough in number that you can name them all. As one of my colleagues once said, sagely, “With three or four individual investors, you have angels. With a dozen, you have hell.” The same holds true for VCs—except cut the numbers in half.

Timing Is Everything

On stage, good timing makes the difference between lines falling flat and a play coming to life. In exits, timing has every bit as much to do with those providing the liquidity as it does with what you are doing. The “right stage” is in the eye of the beholder. So we have a house rule: “Sell when the customer wants to buy.”

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EXIT

There are two great points to realizing liquidity in a start-up business: first, when the business is all promise and no problems, and second, when the business is all progress and proven promise. The difficulty is that the period between point one and point two is often measured in three to five years. Once the initial promise period is past and the problems that all start-ups encounter are evident, there is often a sustained drop in the perceived value. So the best period might come when you have made your initial sales and customers will provide testimonials for your product, but before the reality of building a complete sales channel stares you in the face. The second point of time might come with clear traction and sales ramping and a clear path to profitability.

The external world matters, too. Every four to five years, the public markets will pay you just for showing up. When the IPO window opens, you should go through it. That low cost of capital will probably not be repeated in a relevant time frame for you. But don't confuse going public with being successful.

There are also times when market consolidation is in vogue, and large public companies will be eager to take you off the street. This is a game of musical chairs, so it is best to grab a chair early. The longer the game goes on, the less likely you are to get a chair with large sums of cash attached. Usually the first and second players to get consolidated (i.e., acquired) get paid well. The rest don't.

The Plot Thickens

We all know how tension rises as a play nears its climax. For your investors and yourself, liquidity certainly qualifies as a climax point.

So now the stock is in your investors' hands. What happens? Studies have shown that the best returns have been gained by VCs that sell "blindly" after the IPO or merger lockup expires (often 180 days) versus those who think they can outsmart the public markets. Now, blindly doesn't mean stupidly—as

in dumping all the equity at once. The best model seems to be a 25-25-50% pattern in which the VCs initially sell or distribute their holdings in segments, without upsetting the stock price.

This notion makes sense for entrepreneurs, too. Once your lockup or restrictions have been lifted, you can expect strict "trading windows" that allow you to buy or sell your company's security only during specified times. This avoids both the reality and perception of any insider trading behavior. But be forewarned. If there is material information that is not public (and materiality gets measured retrospectively!), you might not be able to trade even within the approved window, or the next, or the next.

For that reason, I recommend the Bill Gates model of liquidity for entrepreneurs. Long ago, Bill announced that he was going to liquidate his Microsoft stock position very slowly and systematically, selling a reasonably
(Continued on page 6)

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Inside the Mind of a VC (Continued from page 5)

fixed amount every year. He's adhered to the program. At first, there were comments like these in the press: "Gates is selling. It must be a bad sign for Microsoft." Over time, however, he continued selling and Microsoft continued growing, to the point that now his sales don't even raise an eyebrow. Bill made sure that his character's role didn't get in the way of the play's success.

Take a Bow

With a lot of hard work and a bit of luck, you'll be looking at a good exit (oops, liquidity event) down the road. If you build something of lasting value, you will get to share in that value. If you go into your start-up not for the exit, but for the journey, you will find yourself facing liquidity with a sense of satisfaction that transcends cash. But take the cash anyway.

Break a leg!



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