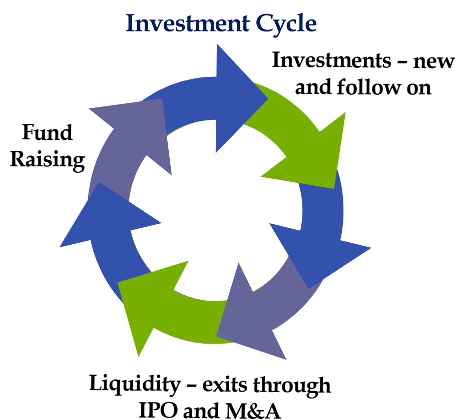
Sensei Partners LLC

CAPITAL MARKET TRENDS AND THE IMPLICATIONS FOR EARLY STAGE COMPANIES

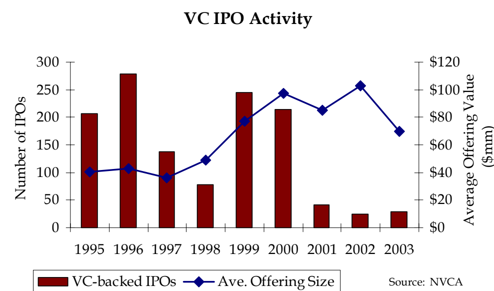
Company-builders should start thinking about liquidity from Day 1 of a start-up's life

The engine of innovation is driven by entrepreneurial spirit, but fueled by capital, both intellectual and financial. Venture capitalists have played a critical role in forming, allocating and managing financial capital for the creation and expansion of enterprises. This symbiotic relationship between the innovative enterprise and the VC has recently been tested, with VC funding plummeting since its high in 2000. While recent VC funding totals[1] suggest a sustainable investment level may have been reached, fundamental changes in the capital markets, brought on by structural and regulatory changes, have broad implications for future capital raising and liquidity options.



The three phases of investment activity, as illustrated to the left, are inextricably linked. During the recent capital markets bubble, strong exit valuations primarily driven by a very robust IPO market attracted record amounts of capital to fund developing private companies. This capital was, in turn, deployed at an unprecedented rate, driving increasing valuations on private rounds and funding marginal businesses. The subsequent collapse of the IPO and M&A markets meant investors could no longer realize liquidity from their private investments, which caused this interdependent cycle to collapse. While the perception within the growth company community was that there was a lack of capital, the reality was that investors were simply going through the agonizing process of readjusting their risk appetite to reflect the new capital markets reality: venture investing was once again highly risky.

Private investors typically have two options for investment liquidity: the IPO or M&A transaction. During the last few years, the IPO market has represented both the best of times and worst of times for venture capitalists. IPO activity has been highly volatile for VCs, though the average offering size of an IPO has shown an increasing trend over this period. This growing preference for larger offering sizes is likely to continue, and will have an important impact on the liquidity options for earlier stage companies.

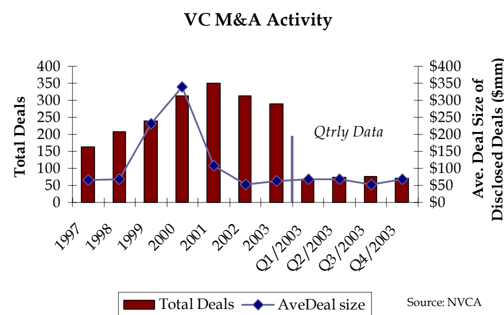


Although the IPO market is showing renewed signs of life following a cyclical downturn and will remain an important source of capital and liquidity for attractive companies, fundamental structural changes within the capital markets now require that the typical IPO candidate be larger and, by definition, more mature. These changes are the result of a number of factors, including a general decline of interest in small capitalization stocks. The 1990s bull market combined with 401k rule changes attracted large amounts of capital to the mutual fund sector[2], requiring investment managers to move increasingly larger amounts of capital into and out of a particular stock. Furthermore, consolidation within the brokerage/investment banking business eliminated many small cap–focused firms and reduced the number of research analysts covering public companies, which has only been exacerbated by recent regulations such as Sarbanes-Oxley and regulator focus on research/investment banking conflicts. In addition, the bubble market allowed more companies to go public: in 1985 there were 1,121 public companies, while today there are over 9,000 (6,000 of which do not

[1] *2003 total VC funding of $18.2 billion represented a decline of 15% from 2002 levels but is consistent with pre-bubble financing activity.*
[2] *Assets grew from $162 billion in 1986 to $2.8 trillion in November 2002.*

have research coverage). These factors together have acted to increase the minimum size of a company seeking to tap into the public equity markets.

So what are VCs and management teams to do? While the investment cycle is dependent on an attractive liquidity option, the IPO market is fortunately not the only alternative. M&A activity among VC-backed companies is becoming increasingly prevalent and, due to a number of solid fundamental drivers, this trend is likely to continue. M&A transactions are strategically motivated and generally less sensitive to size parameters, though companies that have achieved critical mass undoubtedly command premium prices. Since critical mass is an important value driver, mergers among private companies are an increasingly common manner in which to rapidly create meaningful size, though this strategy does create complicated operating and integration issues. Also, the M&A market represents a much more stable source of liquidity for innovative companies when compared to the IPO market, though there is some cyclical fluctuation. In addition, there is a substantial amount of flexibility in structuring M&A transactions by adjusting such components as the mix of consideration (cash, stock, notes, earn outs, etc.), the timing of the transaction and the percentage of the company to be acquired. Finally, unlike IPOs, M&A transactions are generally designed to provide stockholders of the target with liquidity but without the restrictions imposed on insiders in the IPO process (although executive management may be required to remain involved in the business for some period of time).



If the M&A transaction represents the most likely exit scenario for most growth companies, then what should management do to better prepare the company for a suitor? The elements that make a company appealing to an acquirer vary by market, industry and buyer, but following are actions that can be taken to make most companies more appealing to likely buyers:

- *Build a successful company* – the liquidity event should not dictate the strategic direction of the company. Buyers typically want to acquire successful, well-managed companies with attractive growth characteristics and a defensible market position. Developing a plan to create that type of company, building a team to execute on the strategy and driving the company to success should be the primary focus of senior management.
- *Prepare for an eventual transaction* – while building a successful business is most important, management should also get ready for the company's exit much like it plans for success against its competitors, by anticipating changing market dynamics and consistently reviewing the company's strategic positioning. Additionally, companies should review their infrastructure and internal controls. Many earlier stage companies tend to be less disciplined when it comes to documentation and governance issues. However, in the post-Sarbanes Oxley era, buyers are very focused on acquiring "clean" companies with rigorous controls in place. While most buyers now require a closing audit prior to funding, it is probably not necessary to incur the added expense of annual audits until a transaction is imminent but the financial controls and practices should be in place so the audit can be concluded quickly with minimal surprises. In addition, thorough documentation related to IP, board meetings, and open or pending litigation will smooth the due diligence process.
- *Know the leaders in your industry* – since most acquisitions of growth companies are concluded for strategic benefits (rather than financially driven transactions), larger public and private companies in the relevant sector are the most likely acquirers. Management should be aware of the strategic objectives of these companies. More importantly, these leading companies should be aware of your business, since a seller is generally in a better negotiating position if a potential acquirer makes the initial approach in a merger discussion. (Management can use industry gatherings, trade shows, conferences and the like as opportunities to introduce the firm to potential acquirers, not for the purpose of teeing up M&A discussions but simply to create awareness.)
- *Identify thought leaders in your sector* – whether they are research analysts, investment bankers or technology gurus, management should try to win the support of impartial industry leaders and create awareness of their company by publishing research reports and speaking at conferences.

The investment cycle is highly dependent on strong liquidity options to generate attractive returns. Structural changes within the capital markets have forever altered the parameters for a successful public company. While the IPO market will always remain an alternative to highly attractive and growing businesses, the M&A market will continue to provide the most predictable and viable exit alternative for most growth businesses. Management has a significant amount of control over the exit option since buyers are generally motivated to acquire companies that have been successfully built by strong management. By taking concrete actions to prepare the company for an inevitable exit, management can maximize shareholder value in the long run without detracting from the company's focus in the short run.

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