

Walking in the room backwards — how VCs think about the exit

When talking about venture capital, inevitably the conversation steers toward exiting — the realization of value at the end of a venture capital investor's investment holding period, such as a company sale or initial public offering. Venture capitalists tend to walk into a room backwards so that they can see the exit. We enter talking exit — we think about how we're going to get out of an investment concurrently with the decision about whether we're going to get into the investment.

A venture capital investor gets capital from institutional investors, such as banks, pension funds, insurance companies, and university endowments. These investors, most of whose capital sits in "safer" asset classes of stocks and bonds, allocate a small percent of their capital to high risk, high return asset classes, which includes venture capital. Venture capital investors raise money from these folks with the idea that they will provide attractive returns during the holding period (five to seven years) of the fund. Venture investors have an obligation to give the original investors their money back within that timeline.

When we take their money and put it to work in high risk, early stage ventures, we typically end up with a portfolio of investments in which we've lost all of our capital on a third of the deals, broken even on a third and made (hopefully) a lot of money

on the remaining third. Given this portfolio dynamic, we need to structure and price our investment opportunities on the assumption that we're going to lose or break-even on two thirds of the deals we do. This explains part of the reason why our returns need to be as high as they do.

When we think about exit, we need to have the owner/founder understand a couple of things. The company

will only be financed by venture capital investors if we are mutually agreed that we will pursue a high value exit opportunity within the given investment holding period, which ranges from three to eight years. We want to be on the same side of the table as the owner/founder at exit. If the entrepreneur is looking to buy out the VC investor after that holding period, they put themselves on the other side of the table.

As part of our due diligence process, we look at how much a business in a given sector might be valued at time of exit. We look at publicly traded companies in similar or related sectors as a proxy for value through a public market lens and we seek evidence of acquisition activity to give us comparable value data. This helps us figure out at what price the opportunity must be valued to yield a fair risk-adjusted rate of return.

So, let's assume that you've taken capital from a venture investor. They are your business partners and, typically, join you on your board of directors. Depending on

their background (financial, operating, entrepreneurial), they ought to be working at a board governance level to do what they can to support you and to help you to reach your shared objectives of growth and value creation. Hopefully, this is a positive experience in which the investor is providing strategic and tactical advice and support, opening doors to business development opportunities and helping you work through key decisions.

Some years into the investment (typically three to four), the VC will begin to move the conversation to timing and opportunities related to exit. To a large degree, both the VC and the founder/owner will have agreed at some level as to what the likely and optimal exit opportunity will be. Often, there's specific discussion around "what buyer are we building this company for." With this understanding in place, the process of thinking about and moving toward exit is one that is driven by how the company is performing against plan. If things have gone well, then the process of moving to exit is one of deciding as a board whether to hire an investment banker to begin to shop the company to prospective buyers or to the public market.

If things have not gone well (company has missed plan, management difficulties), then the conversation shifts, often uncomfortably, to a different direction. Companies that do not hit plan, which is most of them, narrow choices for their owners in terms of possibilities and timing to exit. At one extreme, if things have gone poorly, the investors might determine, reasonably, that the

company's shareholders are best served by realizing value (what value there is) sooner than later. Clearly, this can be distressing for a founder/owner, even if they understand that they failed to deliver on their plan. Unfortunately, this is a one potential reality of partnering with venture capital investors whose fiduciary duty is to maximize value for their investors.

At the other end, companies that have "middling" performance (not to plan, but not a wash out) may have some choices to make regarding options for exit. While early sale of the company may be a choice, it may also be possible to consider a recapitalization, which involves bringing in new investors. Typically, if something is "still going right" with the business opportunity, then value may still exist for new investors to support a second try, typically with support of original investors. Often, however, recapitalization involves a re-pricing of the opportunity, inevitably at a lower valuation than the early investors and founder/owners would like. While not a happy situation for anyone (except newest investors), it often provides the company another shot at achieving an exit and some level of value for all investors and owners.

As a result of this need to exit and need to manage to highest value, venture capital investment is a high risk game for all parties.

— Michael Gurau is president of CEI Community Ventures (www.ceicommunityventures.com). He can be reached at mhg@ceicommunityventures.com.



Michael Gurau
Guest
Columnist