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12 STEPS TO A STRATEGIC EXIT

A GUIDE FOR TECH STARTUPS SEEKING AN ACQUIRER

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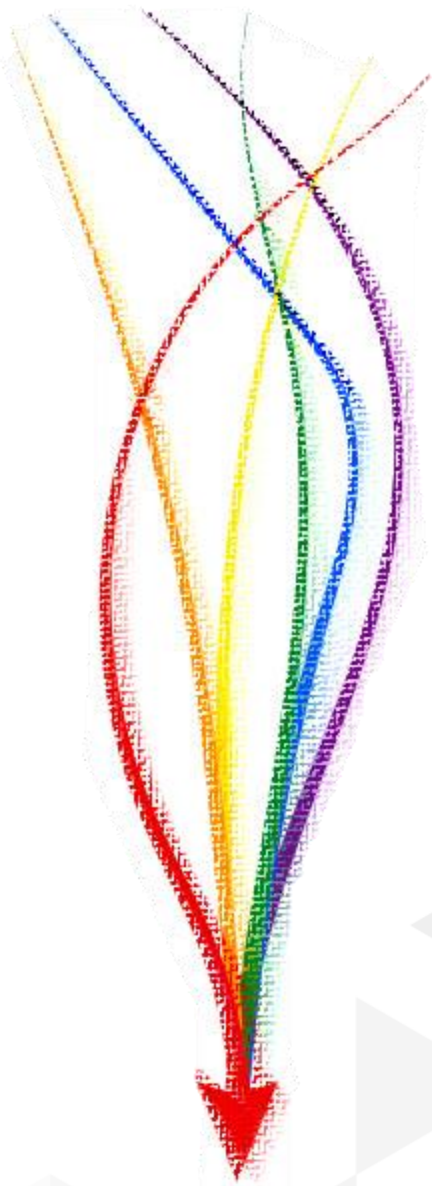
So you’re thinking about selling your startup?



Maybe you are at a point where it’s either raise capital or sell. Or you are about to run out of capital and need to sell. Or you are crushing it and simply want to sell while the going is good.

You have various options for exiting, and this guide covers one of them: strategic acquisitions. A strategic acquisition is when one company buys another company to fold into its operation.

A common alternative to strategic acquisition is independent acquisition – when a buyer takes controlling interest in a company with the intent of continuing to operate that company as a standalone business.

If you are profitable, you can consider both types of acquisitions.

If you are not profitable, strategic acquisitions are your best bet. That’s because your acquirer will be using your assets to bolster their business model.

The Inorganic platform was designed to provide the data and framework for this process. Learn more at https://inorganic.io
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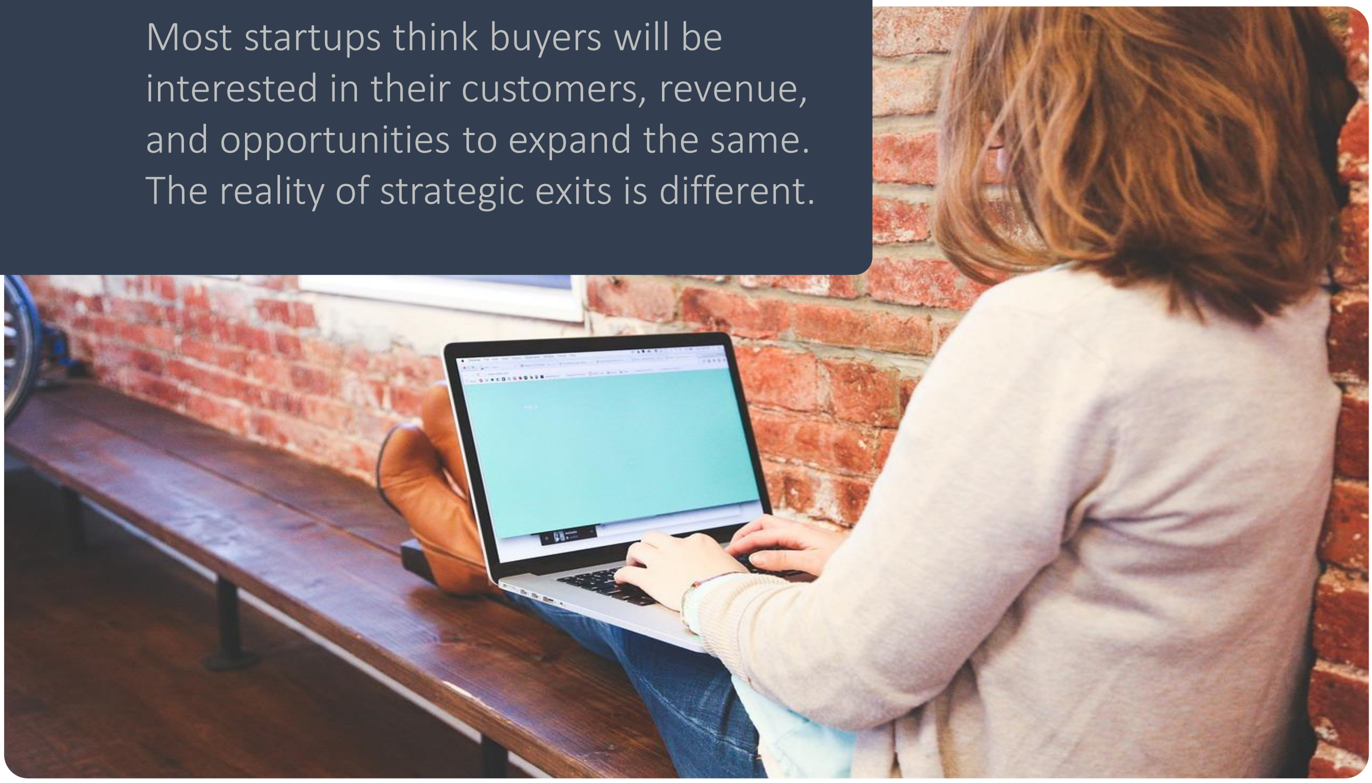
1 Adjust Your Focus

Most startups think buyers will be interested in their customers, revenue, and opportunities to expand the same. The reality of strategic exits is different.



In the case of early-stage strategic exits, the plan for your business is to fold it into something else.

Under the acquirer your startup might be a feature, a product extension, an internal operations tool, or an extension into a different market. The acquirer likely has a use case that doesn't involve the entirety of your business.

In other words, you are not selling a business so much as a capability (or set of capabilities).

The key to your positioning is knowing this capability and its value in the hands of an acquirer.

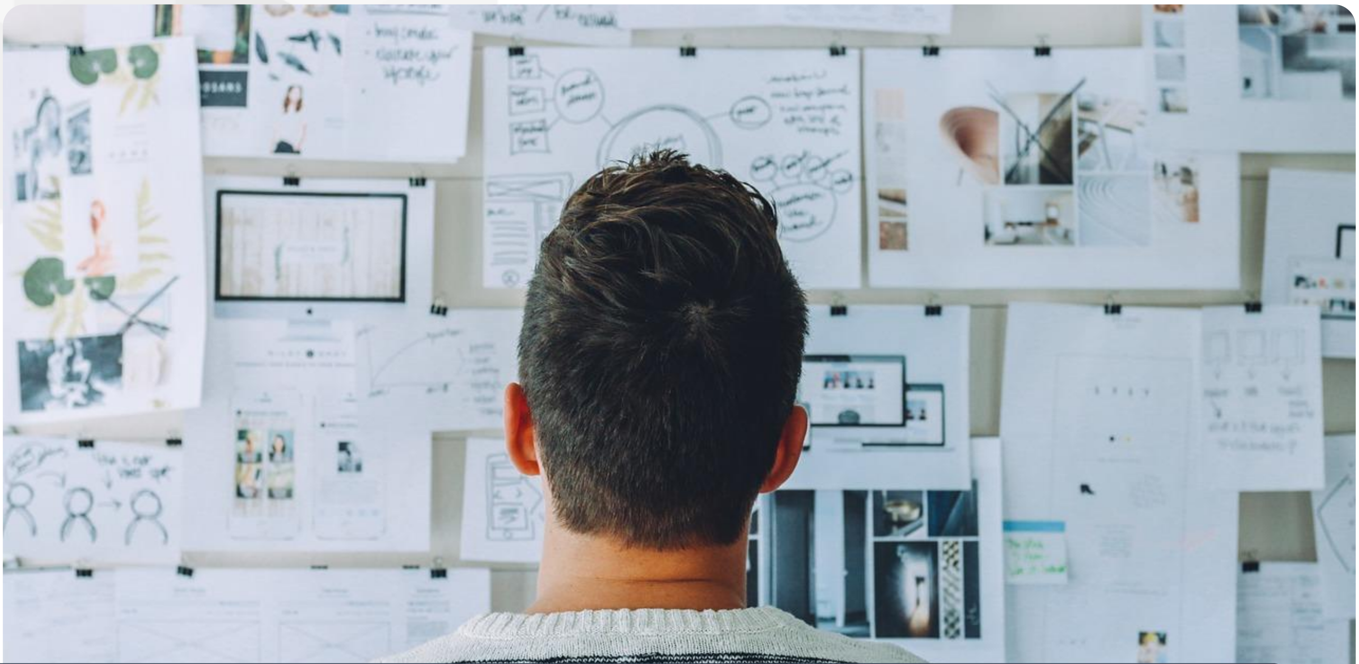
COMMON MYTHS

"Companies are bought, not sold."

Sure, the greatest exits happen when you are growing too fast to even think about exiting. But you can absolutely achieve good exits by shopping the company.

"It's too early to think about the exit."

While it doesn't make sense to obsess over unforeseeable details, you should be thinking about the type and scale of your potential exit from day 1. The exit should drive how you capitalize the company, so it's important to have it in mind, even if it's a moving target.



2 Identify Key Capabilities

What are the 3 or 4 functions that your product or team performs particularly well?

Valuable capabilities can be market-facing or internal, broad or narrow.

The test for notable capabilities are:

- Useful to a user. Having a “great company culture” is valuable, but not to a user.
- Have a direct path to financial impact, i.e. revenue potential or cost savings.
- Specific and differentiating. Being skilled at front end development, for example, is not differentiating enough since good front end development is available in thousands of places.

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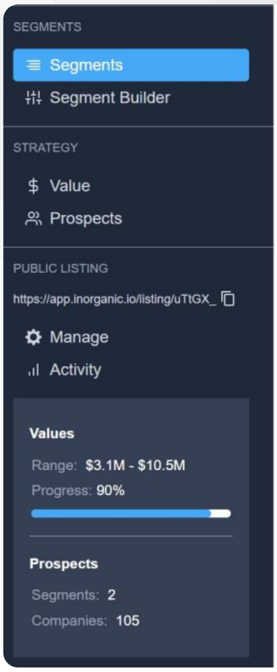
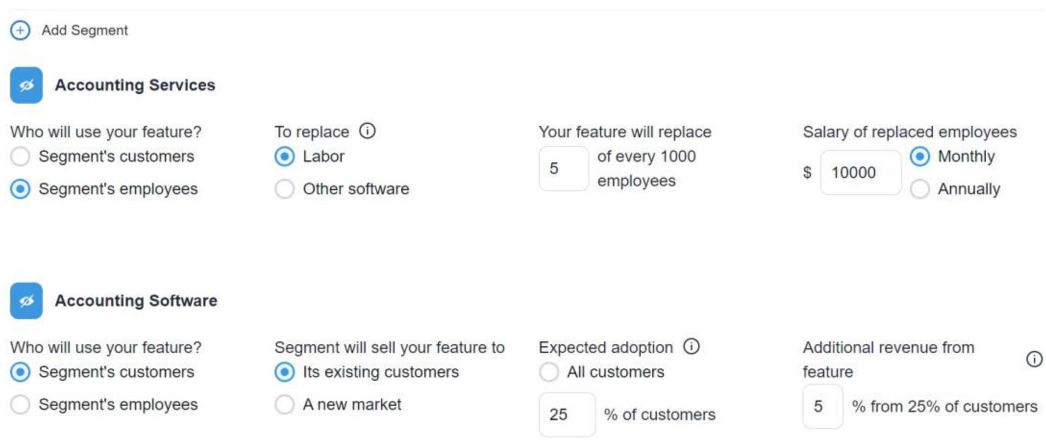
AN EXAMPLE

Say you are a company that offers sentiment analysis from inbound email. Your capabilities might be:

- Identifying customers that are close to churning
- Mapping sentiment to customer actions
- Deep integrations with all major email services

Notice that these range from broad market-facing features to internal know-how.





3 Identify Use Cases

How could an acquirer use your capabilities to generate new revenue, retention, or cost savings?

Having 3-6 use cases will help you identify prospects, quantify your value, and articulate your value proposition.

You can qualify your use cases by making sure they fit into the following format:

Using our [*capability*] an acquirer can [*business activity*] to deliver [*business outcome*]

Business outcomes can be increasing retention, operational efficiencies, add-on fees, or increased sell-though / win rate. It is key that you think outside of just selling your product to generate revenue, which has been the lens you have been looking through in operating your company.

AN EXAMPLE

In the example of the capability “Mapping sentiment to customer actions” used earlier, a use case might be…

Using our mapping of sentiment to customer actions (capability) an acquirer can identify cases where churn is likely (business activity) and increase retention (business outcome).

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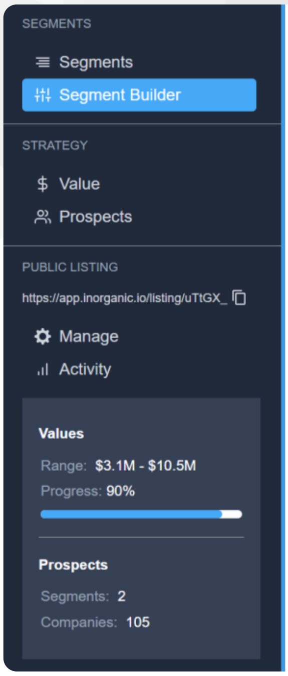

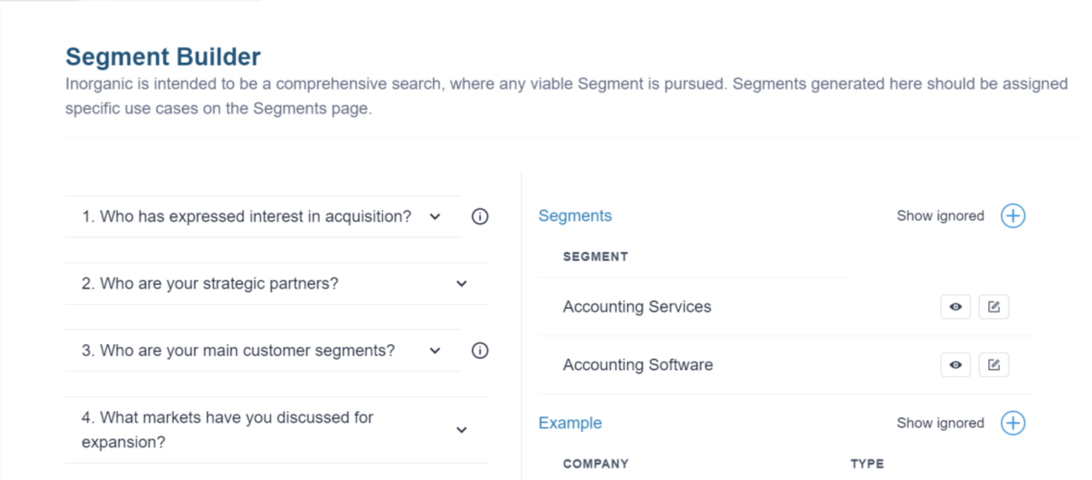

4 Identify Segments

What types of companies would have my use cases?

Brainstorm as many segments as possible. You can always cull them before outreach, or during outreach if you are getting a tepid response.

Going to market with anywhere between 4 and 12 segments seems about right.

Segments can be vertical categories, such as CRM software companies. Or they can be defined around firmographics such as multinational big box retail chains.

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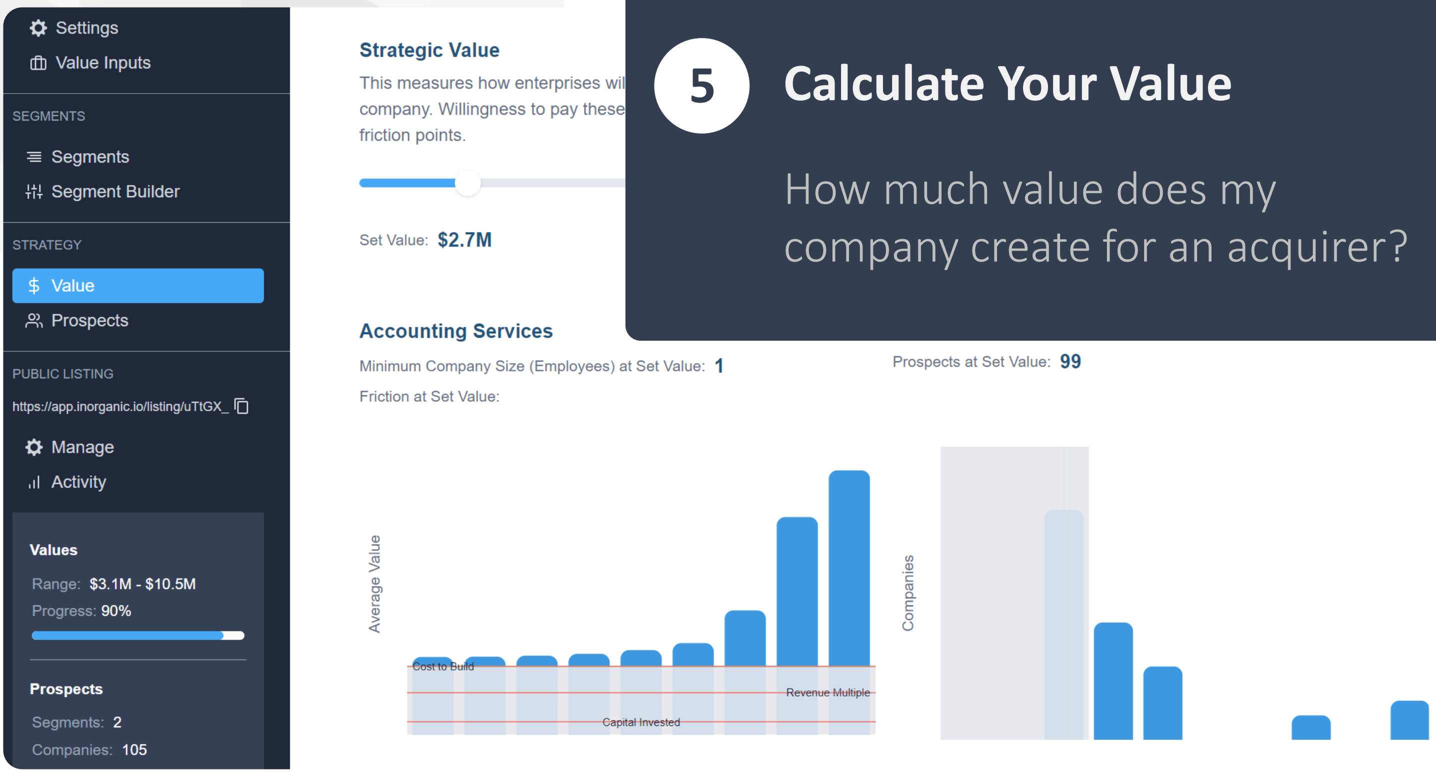
TIP

As part of your brainstorming, you can drill down through a line of questions for related segments that might not be obvious. Brainstorming a segment’s competitors, substitutes, suppliers, and business customers can often uncover segments with similar needs.

5 Calculate Your Value

How much value does my company create for an acquirer?



A key to strategic acquisitions that value is subjective, relating to the use case for a specific acquirer.

A subjective valuation is a mind-bender for most of M&A, which tends to derive value from multiples of revenue or EBITDA and apply those values to every buyer equally.

This doesn’t work for strategic acquisitions because the buyer is not interested in your business’ earning potential as a standalone entity. They are interested what your capability can do within their use case. The good news is, this value can far exceed any industry-standard revenue multiple.

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KEY ASSUMPTIONS

1. The value of a use case varies widely between individual acquirers. If Walmart rolls out your fulfillment optimization feature it could bring hundreds of millions in value. If a regional chain rolls it out it might bring far less in value.

2. Your tech can be replicated. Even if an acquirer truly cannot replicate your tech, they are not likely under that same assumption; they assume that their alternative is to hire and build it themselves.

3. Whatever value you calculate likely exceeds the price a buyer will pay. Use the calculation to unhook buyers from the “multiples” conversation, and to rank your attractiveness between buyers. See friction points in the next section for more details on the data points that will suppress your price.

5 Calculate Your Value (cont'd)

Your value is calculated using the formula:

Direct cost (DC) of building your capability
- Adjustment (A) for an external solution
*+ Time (T) to build your capability * Foregone $ (F$) during build*

Value = DC - A + (T*F$)

Let's break down these components.

DC

Direct cost of building your capability is just what the company would have pay to build the capability. Remember, their costs are not the same as yours. Big companies will generally pay their developers more and have more overhead associated with product management, QA etc.

A

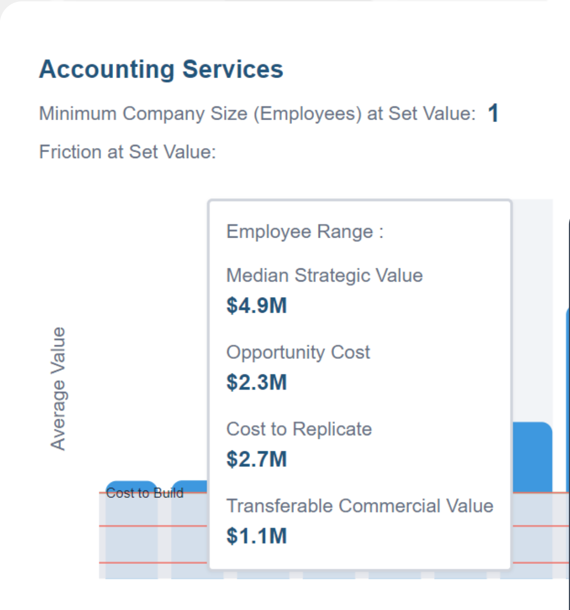
Adjustment for an external solution is to factor that code developed internally is easier to understand and maintain than inherited code. A quick adjustment in percentage terms is sufficient, with 10% at the bottom end if you use the same frameworks and quality control as the acquirer, and 40% at the high end if you are using a language they will have to learn or have technical debt.

T

Time to build your capability is how long it would take the acquirer to replicate your capability. As you map your build time to the acquirer's, don't forget the iterations you went through to get your solution working. And don't factor pivots or other directions before you started building the specific capability.

F$

Foregone $ during the build is the big one. This is the opportunity cost of building versus having an acquired solution available much sooner. This is driven by whatever business outcome is part of the buyer's use case – upsell, internal efficiency, retention, new market.



6 Understand Value Friction

The buyer will not be willing to pay the full value you calculate. That's partially because they are anchored to different figures.

Every purchase is discounted by risk (of value falling short of expectations), but strategic buyers are also watching another set of figures that will discount the value you can capture.

Revenue Multiple

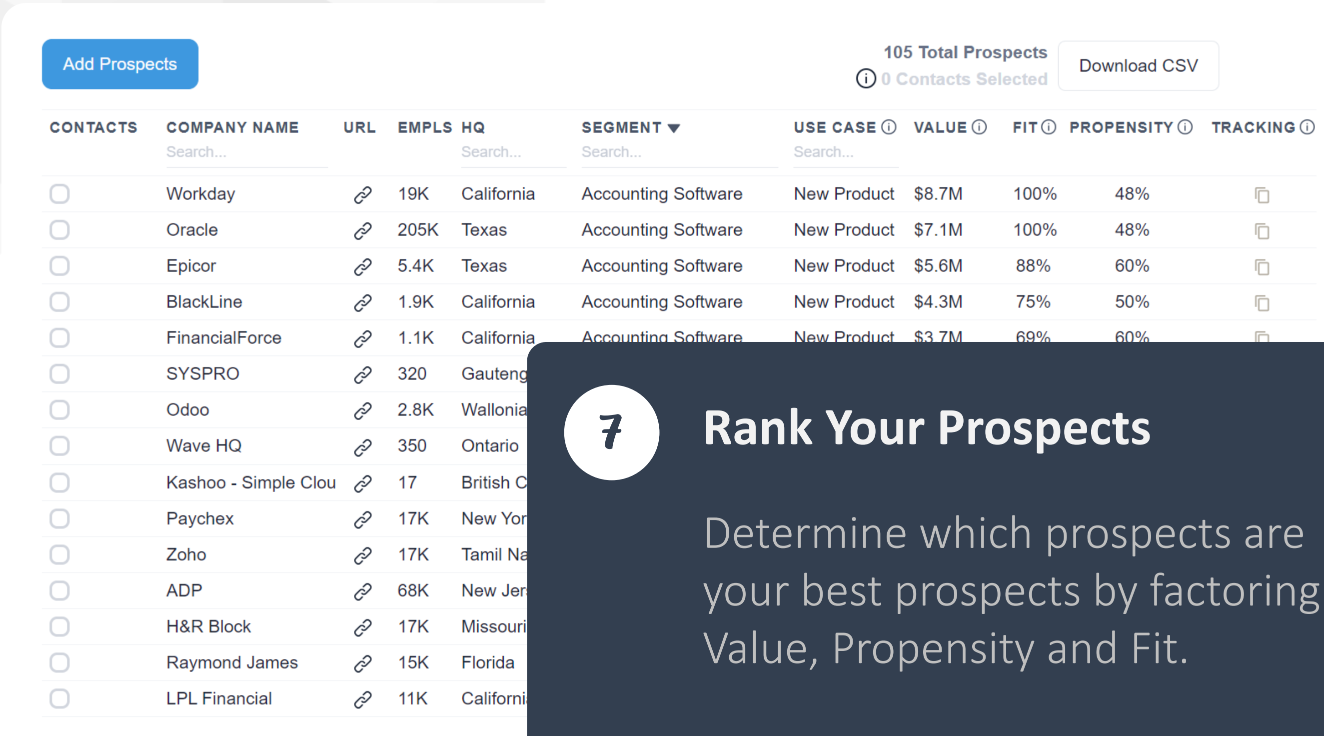
The industry standard revenue multiple for a SaaS company is 3-8x. If you have a company that raised a $2M Seed round, built a sophisticated solution, took it out to market and ran out of money at $10K ARR does that mean the company is worth $30K-$80K? Probably not. But be prepared to answer objections when you float a number that is not inline with industry standard multiples.

Capital Raised

Acquirers know that investors in a company that isn't going to hit milestones for the next round are happy to get their investment back. So oftentimes, that is where they will start the negotiation.

Cost to Replicate

It's not uncommon to hear, "My CTO said this would cost us like $200K to build." Don't bother digging into that number. What's important is that the number is missing the opportunity cost during the time spent building. That's your counter argument.



7 Rank Your Prospects

Determine which prospects are your best prospects by factoring Value, Propensity and Fit.

At Inorganic we have three calculations that we run to rank prospects.

Value is the formula presented earlier.

Propensity is the likelihood of the prospect to use acquisition to fill gaps in capabilities. It is driven by firmographics and acquisition history.

WHY RANK?

By sequencing your outreach from highest to lowest rank, you ensure that if you get an offer with an ask for exclusivity, it will be from one of your better prospects.

- Prospects that have recently had big financing events are very likely to make acquisitions.
- Prospects that often make acquisitions are likely to make more in the future.
- Propensity goes up with company size until a certain point, then it goes down. Extremely large companies are less likely to make small acquisitions.

Fit is how aligned the is prospect with your company. It is driven by their market alignment and capability gap. Acquirers with the highest fit will have your same market but be missing your capability.

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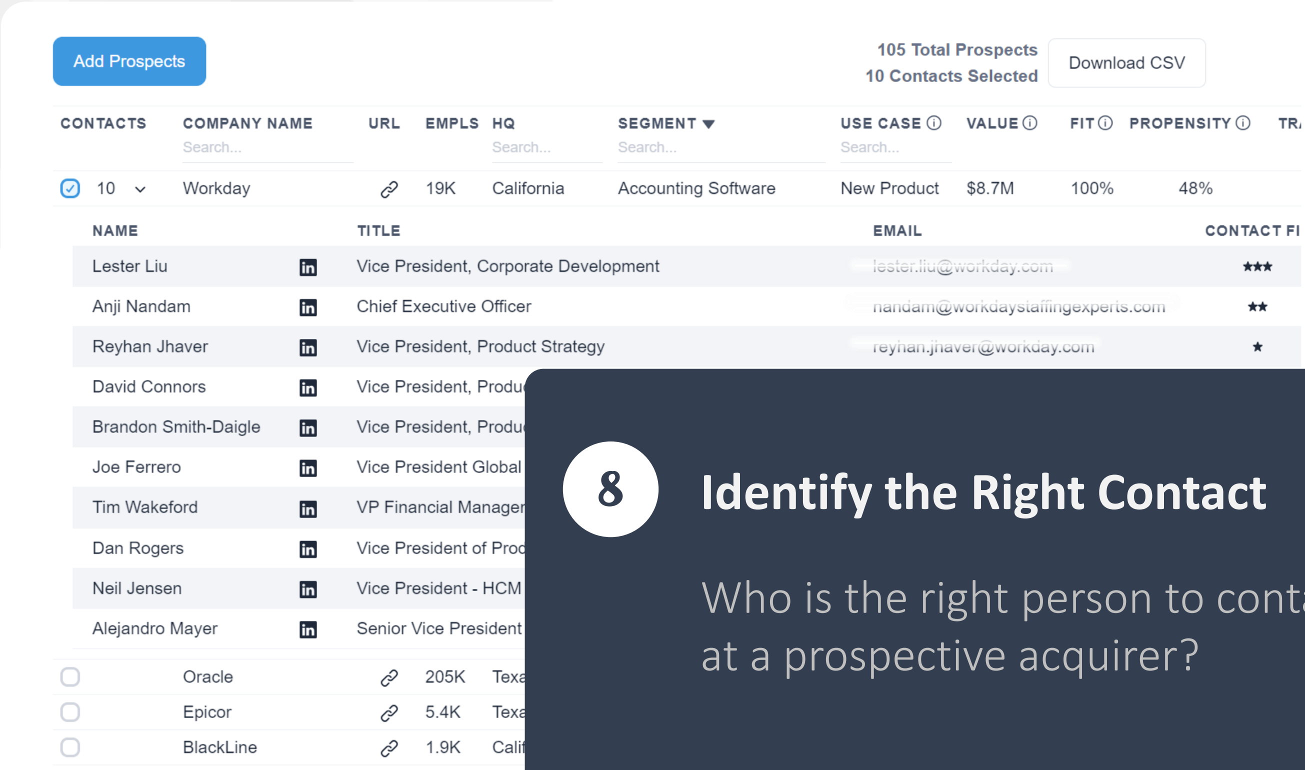

8 Identify the Right Contact

Who is the right person to contact at a prospective acquirer?

There is a simple rule for the right contact at an acquirer. If the acquirer has a Corporate Development function, the right contact is the leader for this function.

If the acquirer does not have this function, the right contact is the CEO (or the President or GM of a specific operating division).

Some of the likely titles for the head of Corporate Development:

- SVP Corporate Development
- VP Corporate Development
- Chief Strategy Officer
- SVP Strategic Development

CONTRARIAN THOUGHT

A strategy in sales is to start at a “hands-on” level to find your champion, then have them help you through higher levels of approval. This doesn’t work as well with strategic acquisitions. Here is why:

- The hands-on levels of a business, such as product management, can have a bias towards the build side of the build-versus-buy question when it comes to new capabilities
- Corporate Development is in the business of acquisitions; your best odds of getting some consideration are with this team

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Craft the Right Message

The right message makes it easy for your prospect to engage.

Strategic acquisitions are risky and time-consuming projects for acquirers. The path of least resistance is just to move on to other endeavors if there’s too much friction at the outset.

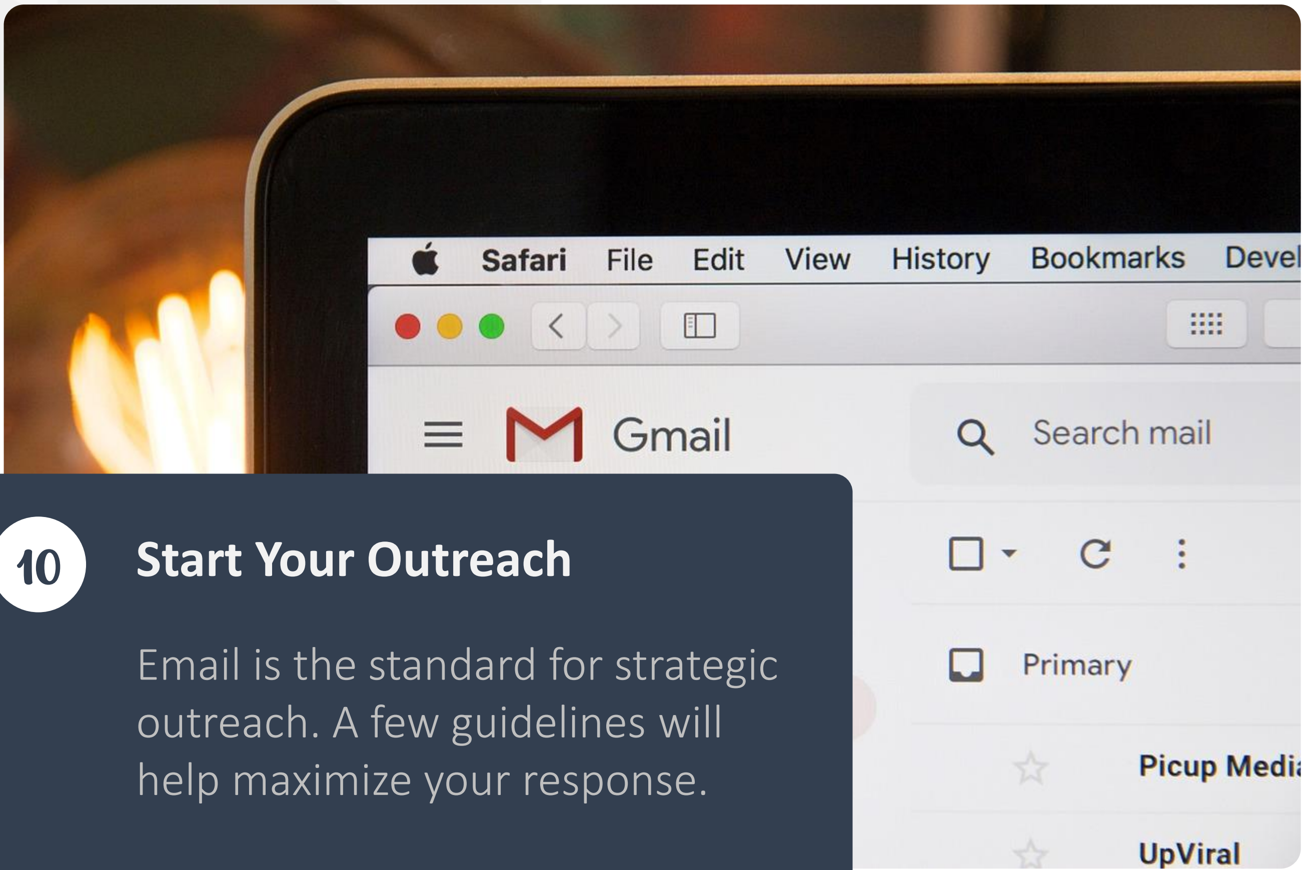
Be brief. In our countless tests of email copy, brevity almost always won. Keep copy to the most critical pieces of information.

- A sentence on the company and what it does
- A sentence on the potential use case with the acquirer
- A couple sentences with critical background info: revenue, team size, website URL, desired price.

Be specific. Proposing your thought on a potential use case prompts a response, even if you’re wrong. Being vague encourages inaction/deliberation.

Be transparent. If it feels like it’s going to be a grind to dig out the details needed for consideration, the most likely response is that your buyer will opt out. To even begin consideration, your prospect needs your revenue, team size, URL and desired price.

No hyperbole. Startups that are on the cusp of world domination aren’t actively seeking exits. If you are seeking an exit, overstating your strength looks disingenuous.



10 Start Your Outreach

Email is the standard for strategic outreach. A few guidelines will help maximize your response.

Sequence your outreach in order of highest ranked prospect to lowest ranked. If you get a hot offer that requires a "no-shop" period, you want it to be from your best prospect.

If you do not get a response, **follow-up** after two weeks and state that this is your last follow-up. It's very common for opportunities to be circulated internally. If your contact is waiting for feedback from the rest of the team, the follow-up can prompt a response.

No is no. Strategic acquisitions are huge, time-consuming investments. They are not the type of sale where a compelling pitch or fancy objection handling will overcome resistance. Take your no's gracefully and move on.

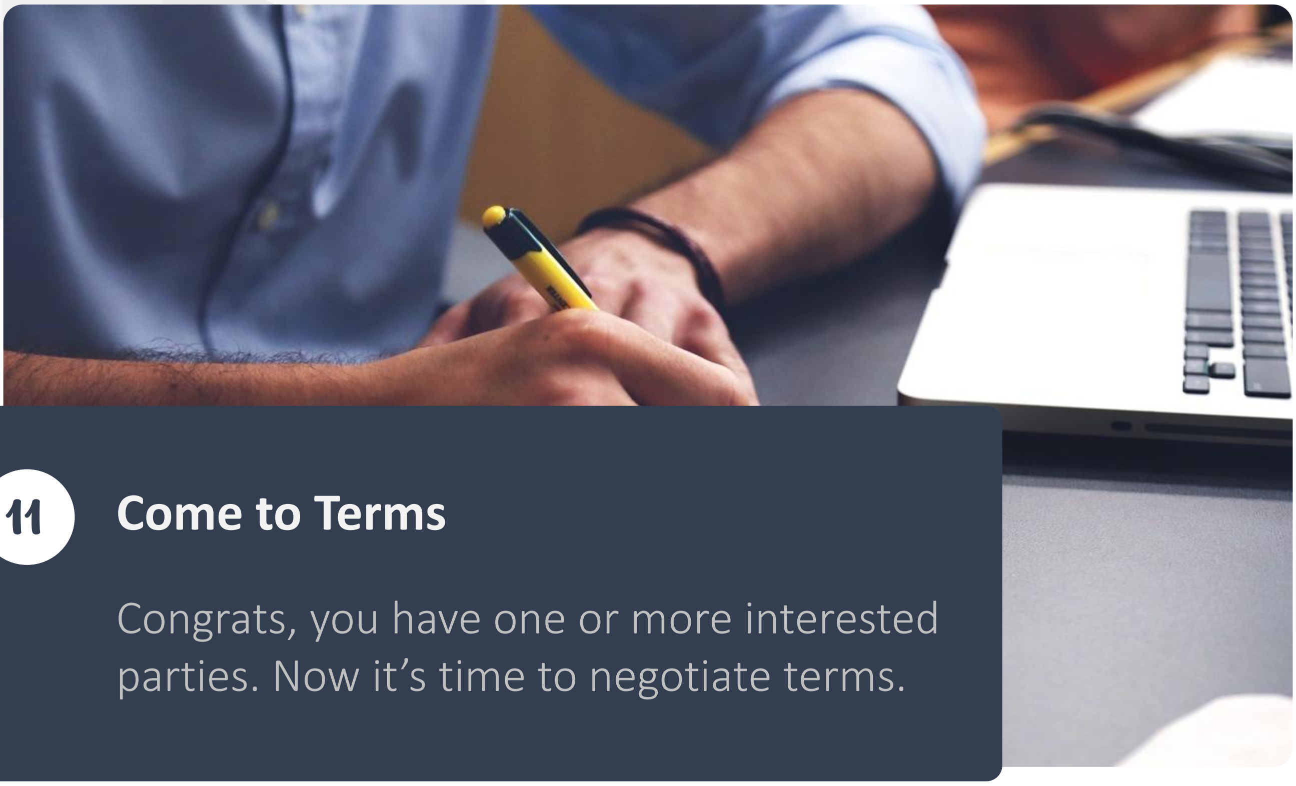
SHARING INFO

Your prospect will need sensitive information to make a decision. It is fair for you to ask for non-disclosure (NDA) protections when you are beyond casual consideration. A guide to expected information at each stage follows.

Before the NDA:
Revenue, company name/URL

After the NDA:
Detailed P&L, architecture, anonymized customer information (to gauge revenue concentration)

After the LOI / during diligence:
Code walk-through, de-anonymized customer information (for verification if required)



11 Come to Terms

Congrats, you have one or more interested parties. Now it's time to negotiate terms.

This could be a book to itself, but here are some tips to optimize your deal.

1. Avoid involving 3rd parties in your early discussions. Investors, attorneys, advisors and others may want to get involved, but I find that this sort of formality puts a buyer in a defensive position at a stage when the conversation needs to be fluid. Get the rough terms settled in one-to-one conversations.

2. Your buyer will want equity to be the bulk of consideration. You will want 100% cash. This is a common point of negotiation, and usually, parties settle somewhere in-between (majority cash, some equity).

3. Earnouts are usually where the most time is spent negotiating. It is fair for the buyer to want incentives for a smooth transition. It is also fair for the seller to not want too much consideration at risk after the sale. Here are a couple sticking points to watch:

- Beware product performance incentives. Since the buyer will control your resources after the acquisition, they can also control product performance.
- Earnouts that are contingent on key personnel tenure are fair, within reason. The norm is 1-2 years.

4. Once you have your rough terms, protocol is that they be documented in a Letter of Intent (LOI). The LOI will specify a closing date, and you will enter a period during which you are prohibited from soliciting competing offers while the buyer completes due diligence.

12 Due Diligence

Diligence is typically a 1-2 month period during which the buyer can review company materials to verify claims.

During this period, you will be asked to upload documentation to a “data room” that your buyer can access.

Before your diligence period, you should already have your deal team assembled.

The team should comprise the following:

> **CAUTION**
>
> Some unscrupulous buyers might try to use this period for renegotiation. Let your attorney counsel you here, but generally, I draw a hard line on this. Unless there is a legit surprise or change in the business, the negotiation period ended at the LOI.

Mandatory

- The startup CEO. You absolutely cannot outsource this process (sorry).
- An attorney. Preferably one with lots of acquisition experience. M&A specialists use a shorthand that makes this process move much faster.
- An accountant. The tax implications of these transactions are important.

Optional

- An M&A advisor. They can be very helpful with complex transactions involving personnel. For most small transactions, however, an attorney is sufficient.

CONGRATULATIONS!

You made it through diligence. Now it's time to close the transaction by signing docs and receiving your wired funds.

For a strategic process platform, check out https://inorganic.io
Or join our free Slack community at https://exittalk.inorganic.io

