BETTER EXITS

Written by John Wall and Julian Smith,
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Results of a survey of the Venture Capital exit market
and guidance on how Venture Capitalists
can improve exit performance

INTRODUCTION

This special paper, written by John Wall and Julian Smith of Price Waterhouse Corporate Finance, was commissioned and edited by the Exits Committee of the European Venture Capital Association (EVCA). The role of this committee was to stimulate exit opportunities for venture backed companies. With the successful launch of Easdaq, the committee has now fulfilled its role.

The Committee requested Price Waterhouse Corporate Finance to carry out a survey of the practical experience of major European venture capital funds in exiting their investments with a view to establishing what steps can be taken to improve exit performance. 30 venture capitalists were interviewed representing 14 countries in Europe. This paper presents the findings of the survey and gives advice to venture capitalists on how the problems identified in the survey might be resolved or reduced in order for them to achieve a significant improvement in exit performance and therefore investor returns.

THE AUTHORS

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I EXECUTIVE SUMMARY

European VCs are better at investing than exiting. Consequently there is a significant overhang of investee companies waiting to exit.

The Price Waterhouse Corporate Finance survey found that:

- European VCs regard IPOs as the ideal exit, and consequently do not devote enough attention to trade sales
- Financial buyers are not taken seriously by most VCs
- Many exits are by buy back, though this is often not anticipated at the outset of the deal
- Many VCs do not plan for exit from the date of investment
- Most VCs do not market their investments widely enough, and many do not make full use of intermediaries to help them, and
- Management are often an obstacle to a profitable exit.

This paper therefore discusses how exit performance could be improved by:

- Focusing more attention on alternatives to IPO
- Planning exit from the beginning of the investment
- Preparing adequately for trade and financial sales
- Making effective use of the buy back option
- Wider marketing of businesses for sale
- Using intermediaries when needed, and
- Getting the support of management for the VC's exit intentions.

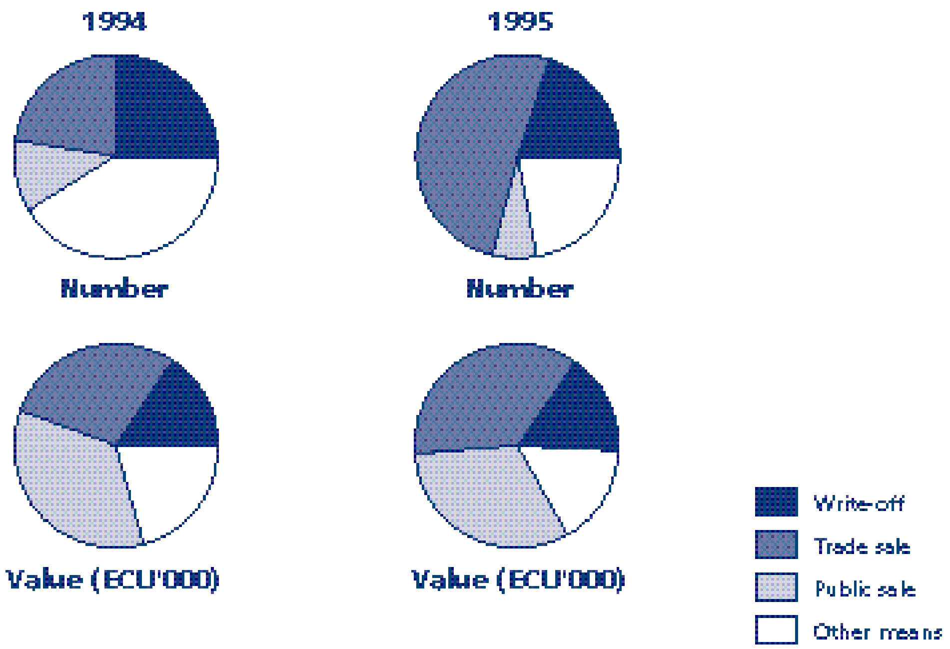
II THE INVESTMENT OVERHANG

A comparison of the level of exits with the level of new investments for venture backed companies in Europe indicates that there is a significant overhang of investee companies waiting to exit. In other words, venture capitalists (hereafter referred to as VCs) appear to be better at **investing** than they are at **exiting!** The current European venture capital portfolio, totalling ECU 25.1 billion at the end of 1995, equates to 8 years of divestment activity whereas the venture capitalists we interviewed had a normal target life for their investments of between 3 and 6 years. More importantly, given that the majority of large investments (greater than ECU 50 million) exit relatively early, the position must be significantly worse for smaller deals.

There clearly is a problem in achieving exit within an acceptable timescale and for that reason this survey was undertaken.

The annual survey of EVCA members indicates that by far the largest number of exits takes place by trade sale. The only exception was in 1994, when IPOs had a particularly strong year and overtook trade sales in terms of value, though not number.

EUROPEAN VENTURE CAPITAL EXITS BY ROUTE



Source: EVCA

III THE SURVEY

Coverage

Thirty venture capitalists were interviewed representing venture capital funds in 14 countries throughout Western and Central Europe. The funds chosen had investment portfolios of at least ECU 100m and were judged by EVCA to be a representative sample of the venture industry in Europe.

The survey covered the following issues:

- The record of VCs in achieving exits
- The significance of price compared to other factors in deciding on exit
- The advantages and disadvantages of different exit routes
- How pro-active are VCs in planning exits?
- The steps taken by VCs to prepare their investments for exit
- Marketing to trade buyers
- The use of intermediaries or advisers
- The role of management

This was a survey of attitudes, not outcomes, and it covered a heterogeneous industry. Statistics would not be meaningful or representative; the results are therefore reported using the words of the interviewees and, whilst the answers are inevitably subjective, they have been edited to give a representative overview of the European exit market.

Exit record

The exit experience of venture capitalists varies greatly from country to country and from one institution to another; the most significant factor in this variation is the degree of maturity of the venture capital market in each country. During the survey two types of venture capital investor were clearly distinguishable, although the majority of VCs combine some of the features of each type.

The pro-active investor

The pro-active venture capitalist prefers to buy a business as a principal and then incentivise management by stock options or otherwise. He generally plans the exit from day one and is motivated exclusively by cash returns or internal rate of return in determining the exit route.

The passive investor

An alternative approach is to act as a passive investor, generally with a minority stake. The passive VC often invests on a longer term basis with no specific exit route in mind, relying on an annual dividend to provide his return. Very often his only exit route is by means of a redemption or buy back of his investment by the management or co-shareholder. He operates in a younger venture capital market, often with few other players, and is concerned about the reputation of both his institution and the venture capital 'industry' in general and may therefore not choose to maximise returns if this would require an exit route, such as a trade sale, which would not be welcomed by management.

Reasons for failing to exit

70% of the venture capitalists interviewed said that they had at some time experienced difficulties in exiting their investments. The following reasons were identified as the causes of their problems:

- Stock market sentiment
- Lack of institutional buyers for IPOs
- Lack of trade buyers for a particular investment
- Uncooperative management or co-investors
- Due diligence results
- Poor performance by the business

Many of these problems could be avoided or their effects reduced by proper planning of the exit from an early stage in the life of an investment. For example, the problem of market sentiment or a lack of institutional buyers of stock could be dealt with by having a contingency plan for a trade exit as an alternative. A lack of trade buyers does not arise overnight, and therefore a company with a properly planned exit route would identify such a problem and enable the venture capitalist to search for alternative buyers outside the sector or market concerned or to consider the possibility of financial buyers.

It is true that management often have a vested interest in keeping their jobs and may therefore obstruct a trade sale. However, the venture capitalists with a successful exit record have been able to motivate and incentivise management or their co-shareholders to work with them for common goals.

If new information at the due diligence stage causes a buyer to withdraw this often indicates that the process could have been better managed. Such information should certainly not come as a surprise to the vendor if the business has been properly prepared for exit and therefore there is no reason to surprise the purchaser - unless it is a deliberate tactical reason! Generally however, a smooth exit process should avoid the purchaser being derailed by surprises which put a successful outcome at risk.

Poor business performance is perhaps the one issue which cannot easily be addressed by exit planning; however, the effects can be minimised by correct timing of the exit - and this does depend on planning.

Despite widespread problems, many of the "pro-active" VCs claimed a high rate of success, while most of the "passive" investors did not.

Exit consideration - Is price the only issue?

Most VCs view price, or their IRR, as the overriding factor determining their approach to exit:

> "Price is the only issue"
> "No other factors - IRR only"

Where other factors were mentioned, it was often because of their impact on the IRR;

> "Relative certainty of it happening; nature and style of consideration"
> "Timescale. No warranties"
> "Liquidity, tax considerations"

In contrast some of the passive VCs have other factors to consider, often driven by their own status or ownership:

> "We don't invest only to make money. We are generally the principal banker so the price on exit is only one part of the discussion. The final goal is customer loyalty for the branch, as long as we make money."

> "The future of the company is important; we want it to prosper after our sale."

> "We are the only active VC house. We would not like to leave behind a dissatisfied entrepreneur."

Exit routes

Trade sales and IPOs

The two most common exit routes for VCs are sale to a trade purchaser and IPO. VCs have strong views on the advantages and disadvantages of each.

IPO - The Holy Grail?

Advantages

- Higher price?
- Favoured by management
- Can be a dual track approach - may provoke a trade bid
- Share in future growth of the business from retained shares

Disadvantages

- Higher cost than other routes
- Is it really an exit? The lock up agreement prevents an initial 100% exit
- Continued shareholding carries a risk that gains may not be realised and VCs lose the special rights they have in a private company
- Many European markets are illiquid
- The message has to be simple and attractive to a large number of investors
- Not an option for many small companies

The VC world's view of IPOs is summed up by:

> "You get the best price if the market is strong - it also flushes out the trade buyers."

IPOs are the VC's "Holy Grail"; they are seen by many as the ultimate exit, to which all aspire, because of the super returns they have sometimes produced and because they allow management to stay in charge. However, the reality is that many more investments exit by trade sale.

The disadvantages of IPOs, particularly in Continental Europe, are summed up by the statement:

> "You can only sell 10-20% (of the company's shares) and then you have to wait two years - fewer and fewer companies are going to the market."

The lock up agreement which requires a VC to retain a significant investment, if not its whole stake, in order to inspire confidence in institutional investors, means that an IPO is not always an exit.

Since the survey was carried out, the French market has improved, as the following examples indicate, however public markets are inherently cyclical, and most other countries in Europe have not experienced the same improvement.

CASE STUDY - Aigle

Apax Partenaires held an 85% stake in this manufacturer of outdoor clothing. It was floated in October 1994 with a capitalisation of FF450m but due to general sentiment in the market, only 20% was passed onto new shareholders, with the vendors retaining a majority.

CASE STUDY - Europeenne d'Extincteurs

Europeenne d'Extincteurs was a publicly quoted manufacturer of fire extinguishers, with a capitalisation of around FF400m, in which Credit Lyonnais has a 65.1% shareholding. It was being prepared for sale to a strategic purchaser but the public market strengthened and CL therefore sold their entire shareholding in 10% parcels to institutions in June and July 1996.

Where only a small share is sold, a good exit price may mean nothing if the price in the market falls before the VC is able to sell the remainder; some investors therefore prefer the certainty of the trade sale process.

The strongest argument for IPOs is the idea that the preparation required, particularly in marketing, often leads to a pre-emptive trade bid, thus enabling the VC to achieve the best of both worlds. However, the other side of this coin is that proper investigation of the opportunities for a trade sale, and proper planning of the process, might well have revealed the same purchaser and saved some of the legal and professional costs associated with a flotation.

Trade Sale - the second best route?

Advantages

- Buyers may pay a premium for synergy, market share or market entry
- 100% cash exit and therefore certainty, subject to warranties, indemnities, escrows and deferred consideration
- Cheaper than IPO
- Faster and simpler than an IPO
- Only option for some small companies
- Need to convince only one buyer - rather than the whole market

Disadvantages

- Often opposed by management, who lose their independence
- There are few trade buyers in some countries
- Most VCs will not give warranties to purchasers

The most commonly identified disadvantage of trade sales, particularly in smaller European countries, was:

> "More difficult to do trade sales than flotations - there are not a lot of obvious buyers."

But it was also noticeable that many VCs do not attempt to identify overseas, non-sector or financial buyers - thereby somewhat limiting their chances of success.

There was a majority view that trade sales are quicker and easier than IPOs, with dissent only from those who experienced difficulty finding buyers.

The real debate was on prices achieved:

> "(Trade sales are) the best value - the buyer knows what he is buying and there is only one buyer to negotiate with."

However, the negative quotes about trade sale prices need to be seen in the context of the number of VCs who do not market their investments fully when they come to sell!

Sales to Financial buyers

The overwhelming majority view on exit by sale to other venture capitalists, or by secondary buyout, was:

> "Not attractive. If I can't make money, how can they?"

Sales to other venture capitalists - VCs' concerns

- Third best option on price (due to purchaser's high IRR requirement)
- Management would have divided loyalties during the sale process, and therefore the buyer would have better information than the vendor
- The price impact of the buyer's concern that the vendor may have managed the business for short term cash gain

However, there was some recognition that certain situations present opportunities for financial buyers:

> "We were approached by a venture capital house and we were surprised to see anyone had an interest in taking (our investment) on."

but these sometimes arise from emotional, not economic, reasons.

> "(A financial sale) would mean we were less successful than envisaged but you can get tired of an investment."

Opportunities for financial purchasers

- Transition from early to later stages of development "provides an independent valuation when a capital increase is required"
- Re-financing at the end of a closed end fund
- Need by the owning VC to realise a gain (for tax or reporting reasons)
- "A way for management to stay in when an IPO is not an option"
- VCs may attribute a higher value to a high cash/low growth business than a trade buyer would
- Enables a business to re-leverage
- Breakdown in relationship between management and investor - "The buyer may be a better owner for the company"

The low number of sales to financial buyers seems to be more a result of mutual suspicion than business logic. Given the increasing number of businesses now being bought from corporates by financial buyers, one would expect to see the same trend in venture capital disposals. The trend in corporate disposals is partly driven by VCs' willingness to accept lower IRRs than was formerly the case. Given the high leverage applied to VC purchases, which reduces the average cost of finance, there is no reason why a VC buyer should not match a trade bidder when there are no synergies or other special factors to be considered.

One VC said:

> "There are some businesses which should be in a permanently leveraged state."

An example is United Texon which was a £75m MBO from Emhart of the USA in 1987. Flotation in London was planned for 1994 but cancelled in favour of a sale to Apax for £131 million, which included the refinancing of £90 million of debt.

In this case some of the original investing funds were nearing the ends of their lives. The refinancing led by a new investor provided an independent valuation and this facilitated a transfer from one fund to another within the same house without any risk of favouring one fund over another. By the same token, an ongoing participation by the vendor can help to inspire confidence in a financial buyer and it seems that a large number of sales to financial buyers involve some retained stake.

A few other positive examples came to light through the survey:

> "We got a good price on X, a retailer - it was an unpopular business - an MBO was the best option and management wanted to stay in."

> "It allows you to turn over your investments. Our most recent exit was the

> second MBO for the business (and we helped finance it) - it gave management the majority stake they wanted and crystallised a 22% IRR for us (which we could only recognise on a disposal)."

Share buy backs

Buy back or redemption by co-investors or management has historically been a common exit route for passive investors, and for all venture capitalists when other routes fail.

This is often a result of poor performance leading to a lack of interested buyers, or else a consequence of the management or majority owners of smaller businesses refusing to accept a sale to a third party. It is surprising that many venture capitalists have not felt able to include standard buy back terms in their investment agreements, although the survey indicated that these are becoming more and more common. The principle objection is that a pre-determined formula may mean that the exit price is effectively capped even if the business is worth more.

> "Buy backs are the second most common exit route. We have no standard clause because this would put an upper limit on the sale price - management want it both ways."

There is little doubt that a buy back is the least favoured exit route, short of insolvency, simply because the lack of competition and the buyer's strong position result in a poorer sale price for the exiting investor.

Venture capitalists are realists, however:

> "Creates an opportunity when one would not otherwise be available. We always insist on having some sort of anti-embarrassment clause where management intends to stay in. We did a deal earlier this year for which management received a bid two months after buying us out!"

> "A buy back gets the investment off our books and out of the statistics. We may get the opportunity to buy it back again at a lower price."

> "It is more difficult than a trade sale because they have to find the money. There is a lot of discussion about value."

> "For a bad investment it is the only way out. In one case management made an offer and it required a painful negotiating process to get us a 20% return - but there was no alternative acceptable to management."

The approach to exit - planning or reaction?

We asked all the interviewees whether their approach to exits was pro-active or reactive. The majority regarded themselves as pro-active and supported this assertion with comments like these:

> "We are pro-active - we decide to get rid of a company and then work on it. We have given up planning exit from Day 1 because it always turns out to be different from what we expect. Very often the technology and the market develop differently from expectations.

> "Pro-active - we look at the business and say 'Good time to sell', and start the process."

In our view this does not constitute a truly pro-active approach. However, some people are genuinely pro-active.

> "We plan before entry. After two years we plan ahead based on performance and market windows, although we are not 'market timers'."

> "We always discuss exit openly with the founder when we make the investment. Sometimes the operating plans take into account what is required for exit."

But at the other end of the scale:

> "Reactive - the co-shareholders or directors approach us. A lot of clients would not come to us if we planned exits in advance."

> "Our companies are always for sale - price dependent."

In general it seems that the commonest approach is to regularly review the portfolio, keep an eye open for potential buyers, and identify opportunities as they arise. In our view there is scope for improving exit performance by better planning of the exit process for each investment from Day 1.

The Sale

Preparation for Sale

The venture capitalists who focus on IPOs were generally agreed on what preparation is necessary, in terms of presentation, to achieve a successful exit.

> "Professional product brochures. Three years ago we started sending financials to the press. Annual reports are consistent and accessible."

Other issues included the quality of management, consistent company performance, reporting systems and legal structure.

Whilst it was noted that these things were also useful for a trade sale, and this is shown by the popularity of a "twin track" approach, the general view was:

> "With a trade sale you have what you have - but hopefully you have done the right things."

... which implies that it is only at the point of exit that the VC starts to think about the preparation he should already have done!

Given the short timescale, often less than a year, which VCs allow for planning trade exits, it is not surprising that less attention is devoted to preparation than is the case for IPOs. Nevertheless, it is self-evident that more effort devoted to preparing businesses would assist the sale process.

Perhaps contrary to public perception, the majority of venture capitalists were opposed to the idea of managing the business strategically with a view to maximising exit opportunities and proceeds. They generally believe that it is wrong to jeopardise the long term prospects of a business for short term gain, either because a buyer might realise what had happened and adjust the price accordingly, or because they are genuinely concerned for their reputation.

> "We wouldn't manage for the sake of exit."

> "We just try to make the business as presentable and successful as possible."

> "We don't normally adjust strategy - but exit is always in the back of the mind, eg when an investment decision has to be made we ask to what extent it will add value. We may not embark on major new investment because we may not recover full value."

A small minority of venture capitalists are prepared to determine strategy according to exit requirements. Most commonly this involves making acquisitions in order to be the right size for flotation. For example:

> "We have strategy discussions, and we may say (about a proposal): 'This might be attractive in profit terms but will not make the company big enough for an IPO'."

> "The public market tends to reward a growth story."

In preparing for a trade sale, other factors come into play as size is less significant:

> "Be clear about the strategy - choose one which might make the business attractive to a competitor."

> "We had a choice of a non-exclusive export licence or an exclusive one. Management tried to make it non-exclusive but we prevented this because it might have put off a trade buyer."

> "We are a small country; the cost of building overseas markets is high so we focus on one or two to show the potential to a trade buyer. This is partly aimed at exit but is also the right thing for the company."

Marketing the business to trade buyers

Practice varies between those VCs who market their exits widely, and those who rely on their contacts in the industry.

> "The market is inactive so we have to be active. We consider who would be the best buyer in the world and approach two or three."

> "The worst thing is to get into a one horse race."

> "All things being equal, yes we market widely. Sometimes values can be eroded by wide marketing so we might just talk to one or two. Depends how much of the business is proprietary and the impact this has on value."

> "We are on the board so we know who the competitors are - who would fit strategically."

> "Yes - we or the board know them. But more and more we are using professional intermediaries."

> "We know most of the companies (who would be interested). We have not looked overseas because we have not had time."

> "We know who will buy. We don't look outside our own country. In our sort of business it is traditional to sell to a regional or national buyer. We know that UK financial buyers are interested but it is important that the deal is accepted by the other owners and staff, who are often nationalistic and afraid of foreign buyers."

The majority of venture capitalists took the view that buyers would generally be found from within their investment's own sector and country. This clearly excludes any strategic purchaser who might pay a premium to establish himself in a new market, and possibly puts a cap on the price which can be achieved. Most venture capitalists seem to be put off marketing by the resources required and the risk of breaking confidentiality. Many preferred advisers to be paid by the acquiror.

It was surprising to discover that many venture capitalists appear to be "satisficers" rather than "maximisers."

"Sometimes we don't market widely if we can achieve our hurdle IRR for the particular investment - but in one case we went around the world to do that because we knew exactly which biotech companies had a good fit."

Case study: Non-sector buyer - Elddis Caravans

Elddis Caravans was the UK market leader in the manufacture of touring caravans. It was a management buyout backed by Northern Venture Managers and Price Waterhouse advised on the sale. We analysed the UK, European and North American markets for caravans and found that they were mainly supplied by domestic manufacturers. We saw an opportunity to sell the business either in Continental Europe or in North America and targeted all the main producers, making presentations in France, Germany, Canada, New York and California. The obvious buyer was Fleetwood, a billion dollar turnover manufacturer of recreational vehicles based in California, who had European expansion plans. Thor in New York and Firan in Montreal, were in similar positions.

In addition to a strategic search with Elddis for buyers in the caravan business we searched for contacts through the Price Waterhouse Corporate Finance network. Our London office identified a company called Constantine, who were previously in shipping-related activities and then property development and had substantial cash on their balance sheet but lacked a core trade. They had no existing interest in caravan manufacturing but were interested in any transport-related companies. It was Constantine who bought the business at a premium price.

The use of intermediaries to advise on exit

Venture capitalists seem to be divided in their views on advisers. We observed five different approaches:

5 approaches to using intermediaries

- "We always use an external adviser."
- "We use intermediaries 25% of the time - if you have an interesting asset it sells itself."
- "We have our own in-house M&A section - not sure they are specialist but they say they can do it and it is difficult to go outside unless other investors request it or we have to market internationally."
- "We talk to some of the larger M&A houses - they act for the buyer."
- "We do the work ourselves. We are thinking of using intermediaries more and more, especially for companies which have been in the portfolio too long."

Regardless of individual approach it seems that there is an increasing tendency to use advisers.

"More and more they earn their fees."

"Advisers focus on one job while we are often taken out of the process by another crisis."

Where external advisers are used, they may be investment banks, M&A specialists, the corporate finance departments of the major accounting firms.

Venture capitalists look for a number of different strengths when selecting advisers.

Factors to consider when appointing advisers

- Contacts - in the sector
  - in other sectors
  - across Europe
  - worldwide
- Ability to market discreetly
- Industry sector knowledge and deal experience
- Independence
- Resources
- Ability of individuals
- Enthusiasm and commitment to the job
- Nature and size of investment

Many people appoint advisers they know and trust; others prefer a beauty parade as a means to make the adviser work hard.

The role of the adviser may vary from a simple search for acquirors to including the preparation of an information memorandum and leading or hand-holding in the negotiations.

Occasionally the adviser will be invited in at an early stage to advise on strategy.

When asked how advisers add value to the exit process, venture capitalists mentioned a number of areas:

How do advisers add value?

"Confidentiality - they judge who to trust."
"Open up connections we do not have."
"Buyers people didn't think about."
"Resources and manpower."
"Geographical coverage eg Asia and North America."

"Good quality information memorandum; acquirors are busy - they will read it quickly and form a view."
"It is useful in negotiations to have a party in between that you can shout at - you can't yell at the purchaser."
"They have the time to get a better price."

The role of management

The exit decision often revolves around management. Even if they do not have voting control, their role puts them in a strong position.

> "Anyone who says management isn't critical to a float is crazy; and they can muck up a trade sale pretty badly."

> "You cannot sell if management doesn't want to."

Many of the pro-active investors make detailed arrangements with management from day one regarding decisions on exit, and some will only invest if the management team shares their exit goal.

By contrast, life for others is more difficult.

> "They (management) try to resist exit as much as possible."

> "We never get them to agree at the point of entry. Their goal is to expand - not to sell."

Conclusion

The survey confirmed that the majority of European venture capitalists have difficulty in exiting some of their investments.

Clearly, there are cases when these difficulties are due to factors beyond the VC's control, but the survey revealed that there are many aspects of the exit process where VCs have influence and can take steps to improve exit performance.

Areas for improvement

- Use of alternatives to IPO
- Planning exit from Day 1
- Adequate preparation for trade and financial sales
- Proper use of the buy back option
- Effective marketing
- Use of intermediaries when needed
- Getting the support of management

These issues, and the action VCs can take, are considered in Part IV.

IV HOW TO IMPROVE EXIT PERFORMANCE

Planning exit from the point of entry

Exits need to be planned. Even those VCs who take a long term view need to consider what will happen when the business is no longer performing as originally expected, when they get tired of management, or when their funds are no longer needed for the development of the business.

Before making an investment the VC should consider, as part of their due diligence process:

- What will be the exit route?
- Who will buy the business?
- Is the business strategy the right one to bring about the desired exit?
- Is the structure of the business appropriate for a straightforward exit? (if not this should be addressed in the business plan)
- Is management keen to exit?
  - If not, can they be incentivised?
  - If not, how can the VC's interests be protected?

Focusing management on exit

If management are not keen to consider exit under any circumstances, it may not be in the VC's interests to do the deal.

One approach might be to ask them to consider:

- What would happen to the business in the event of retirement/death/illness?
- Whether it might at some point be in the interests of the business to involve a trade partner
- Whether they are ever likely to want a change of investor or to buy back the VC's share (using surplus cash)

Whatever the plans it is in management's interests to create a high quality business which gives them the option of selling it at some future point. They should therefore consider the exit options now. Often it may be found that this subject is best dealt with through management's financial or legal advisers to avoid the VC worrying management by giving the impression of being too focused on exit. This may also be the best approach at the point when the VC wants to achieve an exit.

If management are agreed that exit is the aim, they can be incentivised by means of shares, share options and bonuses to ensure that their goals coincide with those of the investor. Incentivisation will not work unless the management are agreed on the principle of exit. The effectiveness of incentivisation by equity stake can sometimes be increased by using a ratchet, although it is important that the ratchet is based on targets meaningful to the investor. For example, it would not be appropriate to agree a profit-based ratchet if the VC was most concerned about the final purchase price or IRR. IRR-ratchets are complicated but may ensure that management and VC have the same interests. It should be stated however that deals are often best kept simple especially as no ratchet mechanism can cater for all circumstances.

The survey results indicated that more and more venture capitalists were including buy back clauses as standard in their investment agreements. This gives them the ability to force an exit if the business does not perform to expectations. Some VCs still believe that their clients will not accept this, and there was a concern that any price-based formula acts as a cap on value.

Structuring the investment as a combination of fixed term loan (or preference shares) and equity shares - the traditional UK approach - can avoid or reduce this problem, subject to local tax and legal constraints, by providing for repayment of the majority of the VC's investment after a few years, without requiring the sale of equity shares. This combination also means that the VC has an incentive not to force repayment unless this is in the interests of the business because the value of his equity shares would be reduced.

Which exit route?

The VC needs to know which exit route he is aiming for at the point of investment. This is not however, an irreversible decision. Some of the most successful exit performers seem to be those who aim for an IPO and use this as a means to encourage pre-emptive trade bids.

The message from the survey, and from actual exit performance, is that trade sales should often be regarded as equal or preferable to IPOs, but that they require the same degree of planning.

In the current market financial bidders should be taken seriously. They are often prepared to go through a bidding and shortlisting process in the same way as a trade bidder, though they require more time to get to know the industry.

CASE STUDY: Betonson

Betonson is a Dutch manufacturer of prefabricated concrete products including piles, water mains, floors and concrete elements for bridges and viaducts, which was owned by a syndicate of eight venture capitalists. Price Waterhouse Corporate Finance advised the syndicate and the company on the disposal in February 1996.

Initially, the likely bidders were expected to be a number of international building materials producers not yet present or active in the Netherlands; however, some of the bidders turned out to be those with established Dutch operations. The eventual purchaser was Van Nieuwpoort Beheer BV, a major supplier of aggregates, who wished to avoid the loss of a key customer if a new owner were to switch purchases to their own group suppliers.

In the end skillful negotiations with all parties resulted in Van Nieuwpoort offering a price significantly in excess of initial expectations, clearly as a defensive move. Management welcomed the acquisition by Van Nieuwpoort because it preserved their business and avoided integration into another manufacturer.

Managing the business for exit

Many VCs are opposed to managing a business solely with a view to maximising the chances of and proceeds from exit; they prefer business decisions to be made in the long term interests of the business itself, although it is acknowledged that, at the margin, they might for example not make a large capital investment if they were about to sell their stake.

Despite these concerns there are many aspects of strategy and day to day management where the thought of exit may lead to decisions which are in the interests of the business - decision-making may for example be quicker and more focused if management is working towards a set timescale.

Some of the issues which management and investors should address during the life of their investment are set out in the table below. This approach should lead to a more straightforward exit process and an increased number of unsolicited offers.

Exit checklist - things for management to consider to enhance the business and make exit easier

Strategy	- Have one! - Try to achieve a consistent growth record - Reflect exit plans in the timing and choice of strategy options - Ensure that new opportunities are being created as old ones are realised - to ensure that growth continues - Remember that competitors may be the likely purchasers - they will pay more for a business which can be merged to provide profit improvements. If they do not buy, their interest will increase the price
PR/Marketing	- All achievements should be reported in trade and financial press - Results and new orders should always be announced - Remember that advertising and marketing does not just sell the product - it may help sell the business
Financial	- Accounts should look professional and be well presented from the first year
Statements	- They should be informative, and reflect the strategy of the business - they are not just a legal requirement - Ensure they are consistent from year to year
Reporting systems	- Management of the business and exit are both facilitated by reliable, timely and relevant management information - These requirements should be addressed from Day 1
Legal structure	- Keep it simple. If it is not, simplify it while there is time - Avoid minority stakes which do not have a strategic purpose - or try to eliminate them prior to exit. One single shareholder can hold up the whole process
Management	- Ensure the team is balanced, experienced and of a high calibre - Do not allow gaps to develop - Plan for succession - Ensure they can individually demonstrate a successful record at exit

How to get value from trade and financial sales

The disadvantages of trade sales raised by VCs were:

- Lack of trade buyers
- Lower price than an IPO
- Requirement for warranties

It is worthwhile addressing these issues because trade sales can be quicker and easier than IPOs, they may attract a premium, and the only alternative may be a low-value buy back offer.

The importance of adequate planning and preparation has already been mentioned. Combined with a proper marketing campaign and good publicity from day 1, this should enable a lack of buyers and therefore the low price expectancy to be overcome. This lack of buyers is often perceived rather than real - but it is necessary to look outside the sector and country of the investment and an intermediary may be needed to do this. It is surprising how often a marketing campaign produces buyers who were not on the original list of interested parties. Price can often be increased by ensuring adequate information is available and by providing warranties to cover areas of uncertainty. Preparation of an information memorandum is a worthwhile discipline as it exposes weaknesses in the business before they are discovered in due diligence, thereby avoiding aborted deals.

Practice on warranties varies immensely from one country and VC to another. Some VCs have a fixed policy of never giving warranties while others are more flexible.

Those that take the narrow approach need to recognise that they will sometimes lose value as a result because the price will be discounted. When they sell by IPO, they often have no choice but to retain shares in order to support the price; they should regard warranties in a similar light, except that in the latter case they are in control and have received the cash.

Conversely, it should be recognised that warranties are intended to deal with a situation where the vendor is reasonably certain of the facts (eg title, audited figures) and wishes to reassure the purchaser - he therefore does not expect to have to pay a significant claim and, by giving a warranty, realises full value for his investment. If this is not the case then it might be preferable to deal with the risk by an adjustment to price which might avoid the vendor suffering the entire cost. Warranties should always be limited in time and value with a minimum threshold to avoid small claims.

An alternative to providing warranties is deferred consideration. This can be structured to provide participation in any future upside, similar to an ongoing shareholding, in contrast to warranties which are generally given in respect of issues at the date of sale. The disadvantage of deferred consideration is that the vendor has no control over the outcome.

An indemnity should be avoided unless it relates to a matter for which the vendor accepts liability, but where the amount is unquantified, such as historic tax liabilities, and it is therefore necessary to avoid complicating the sale. Nevertheless, if there is a low risk of payment being required, it will often be appropriate to insist that the vendor takes the risk as this will not have a significant impact on value.

If the purchaser has concerns about the vendor's good faith or financial position, then an escrow deposit may be an effective means of adding credibility to the warranty. However, if it is expected that a large part of it will be utilised, then it might well have been worthwhile to make a corresponding, but smaller reduction in price.

V THE APPOINTMENT OF ADVISERS

Do I need one?

The survey identified an increasing trend towards the appointment of advisers to act for the company or VC investor on disposal.

An adviser or intermediary may not be needed if the vendor receives a world-beating unsolicited offer, and the vendor has the resources and experience to maximise the value of the offer. It is often the case however that the value of an unsolicited offer from a keen bidder can be increased by introducing competition through a formal sale process.

The VC who is deciding whether to appoint an adviser for a particular sale, should ask the following questions:

- Do I have the time and resources to do the job in-house without being distracted by more urgent tasks?
- Do I and the management know of all potential buyers, including overseas and non-sector?
- Is it acceptable for the initial approach to buyers to be open, thereby revealing which business is for sale (since they can find out which businesses I own)?
- Do I have an objective view of the value of the business?
- Will management/partners accept my advice as independent and impartial?

If the answer to one or more of these questions is 'No,' then the appointment of an adviser should be considered. Section III sets out venture capitalists' views of what is required of an adviser, and how to appoint them.

How do I pay them?

The effectiveness of an adviser is influenced by their fee structure. It is normal practice to pay a percentage of the consideration as a way of incentivising the adviser to achieve a sale and maximise the price. This approach is increasingly being modified to increase its impact.

A fixed element to the fee can help to ensure that the adviser devotes sufficient time to upfront tasks such as the preparation of an information memorandum. Without this, the time investment by the adviser may be very high in relation to the incremental consideration which a high quality memorandum might achieve. The retainer may therefore be in all parties' interests; however, there is an alternative view that the adviser will not work so hard if their pay does not depend entirely on results. Any retainer should be deductible from, rather than in addition to, the final success fee to ensure that the variable fee is high enough as a percentage of proceeds to provide sufficient incentive.

It is more and more common to pay a higher percentage success fee on a margin of proceeds over a certain level as a super-incentive to 'go the extra mile.' Since the vendor would not otherwise receive these proceeds, a high marginal percentage is easily affordable. The threshold may be set based on the values estimated by advisers when competing for the mandate. It was traditional to use the 'Lehman scale' (see Glossary) of decreasing percentages but this is less common now because with a small marginal benefit to the adviser from any increment in the sale price, it is clearly less effective as an incentive.

How to keep it confidential

One of the chief concerns expressed about M&A advisers was the risk of information leaking.

In practice, leaks arise more often due to gossip in an industry (regardless of confidentiality agreements) than from the adviser who will be acutely conscious of the need for secrecy.

Maintaining confidentiality depends on having the right attitude. The VC should emphasise its importance at the beginning of the process, use a codename in all correspondence, and if necessary request that the M&A adviser limits knowledge to those of his staff actually working on the job. Naturally confidentiality letters should be used but these are difficult to enforce and rely on the cooperation of the other party. Commercially sensitive information should not be released, even with a confidentiality letter, where it would damage the business if the deal is aborted.

GLOSSARY

Buy back	The re-purchase by management or the majority investor of the VC's stake in a business
Deferred consideration	A portion of the purchase price which is payable at some future date, often subject to certain conditions
Escrow account	A deposit held by lawyers as security for warranties
Exit	The sale of an investment
Financial purchaser	A venture capitalist or similar investor who purchases a business as principal. For the purpose of this paper the term includes a secondary management buyout
Indemnity	Agreement by the vendor to reimburse certain future outgoings relating to the business
IRR	Internal Rate of Return - that discount rate which, when applied to a series of cashflows, produces a net present value of nil. Used by VCs to measure performance
IPO	Initial Public Offer
Lehman Scale	Scale of disposal advisers' fees based on transaction size, as follows:

Sale proceeds	Incremental percentage fee
Up to £1 million	5%
£1 to 2 million	4%
£2 to 3 million	3%
£3 to 4 million	2%
Above £4 million	1%

Ratchet	A mechanism, usually contained in a shareholder agreement, which transfers shares from an investor to the management if the business achieves certain targets
Trade sale	The sale of a business to an industrial purchaser
Warranty	A guarantee by a vendor of certain facts relating to a business being sold, actionable by the purchaser in the event of breach

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With offices in 16 European countries and internationally, **Price Waterhouse Corporate Finance** assists, advises and supports its clients in the development of their businesses. Our services include:

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In addition, Price Waterhouse **Transaction Support Group**, an independent, pan-European team within the firm, working full time on investigatory work, provides a complete range of transaction-based services including due diligence and structuring, forensic analysis for bids, IPO reporting and advice on improving underperforming businesses.

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