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Buyers and Investors In Pre - Revenue Companies are an Endangered Species

By Dave Kauppi, President, MidMarket Capital, Inc.

Before you dismiss my premise and label me as one who is out of step with the highly publicized social media mega deals, I am excluding them from my population. I am excluding them because they have a very important characteristic of value and that is broad customer acceptance. That acceptance was generally accomplished virally and very inexpensively. The owner of that technology will, the wisdom goes, eventually figure out a way to monetize all of those valuable users.

For purposes of this article I am limiting my population to technology based products and businesses that are aimed at the B2B marketplace. A good example might be application software. I may need a little help from Charles Darwin here with his theory of natural selection or may borrow from the saying that there are old pilots and there are bold pilots but very few old bold pilots.

Technology companies that buy other companies or professional investors that buy technology based companies generally have a first gate that all acquisitions have to pass in order to be considered as an acquisition candidate. Those targets must have real paying customers producing revenues, not necessarily profits, but that also is an often used helpful gate.

Another gate is the level of revenues. We have small software companies approach us and say that Microsoft or Google or Apple should buy them. They have \$5 million in revenue. Unless they are in the massive user base category or have a quantum leap technology, there is no chance. The corporate development people in those organizations are under instructions to only consider move the needle opportunities. It takes as much resource to complete a \$300 million acquisition as it does a \$5 million acquisition. Where do you think these giants are focusing their resources?

In working with entrepreneurs we see several recurring themes. They are wonderfully optimistic. With the odds of succeeding in a start-up business not in their favor they must employ emotional blinders in order to press on. They believe their product compares very favorably on a feature/functionality basis with the leading competitive solutions on the market. Their estimate of both the TAM (total addressable market) and their eventual share of that market are highly aggressive. They under estimate the difficulty of reaching a critical mass of paying customers. And most importantly, they believe in their mission and deliver their message with the passion and commitment of a Billy Graham sermon.

We know from first-hand experience having represented several of these promising companies over the years. With this arsenal of optimism, these entrepreneurs have been

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pitching the corporate development departments, angel investors, venture capital funds, individual investors, friends and family, etc. You know what the buyers and investors all found out (even the super stars from Silicon Valley fail on 8 out of 10) was that they were not particularly good at picking the winners pre-revenue or pre- critical mass revenue.

Getting back to my Charles Darwin reference, the survivors evolved. They developed a characteristic that has enabled them to prosper. They no longer try to predict the winners pre-revenue. They let the market do it for them. No guru, no survey, no analytics is ever going to match the predictive power of the wisdom of crowds casting their economic vote to identify the winner.

The second gate, the size of revenue also performs a very important function especially when it comes to information technology or emerging technology. A large company will often expend as much internal resource in integrating a new product into their organization and rolling it out to their sales channel as they originally spent for the company acquisition. Given that backdrop, they want to eliminate or reduce as much as possible, the technology risk. In other words, does the stuff work and will it stand up to the rigors of thousands of users. A product that has achieved a critical mass of users has been subjected to the quality control of paying and renewing customers with other choices. The major bugs have been worked out and the product has gone through a continual feedback loop of improvement.

The company buyers/investors survivors recognized that it was too difficult to predict the winners pre-revenue, even with the smartest guys in the room, without a natural market vetting process. The economic vote of a critical mass of customers has proven to be the best of all predictors of success. When a technology entrepreneur hits this gate with his targeted buyer and gets quickly dismissed, it doesn't mean that he has a bad product, it means that he has one more step to take before the money starts to flow. Focus your resources on generating sales.

Dave Kauppi is the editor of The Exit Strategist Newsletter and a Merger and Acquisition Advisor and President with MidMarket Capital, Inc. MMC is a private investment banking, merger & acquisition firm specializing in providing corporate finance and intermediary services to entrepreneurs and middle market corporate clients in information technology, software, high tech, and a variety of industries. Dave began his Merger and Acquisition practice after a twenty-year career within the information technology industry. His varied background includes positions in hardware sales, IT Services (IBM's Service Bureau Corp. and Comdisco Disaster Recovery), Software Sales, computer leasing, datacom, and Internet. The firm counsels clients in the areas of merger and acquisition and divestitures, achieving strategic value, deal structure and terms, competitive negotiations, and "smart equity" capital raises. Dave is a Certified Business Intermediary (CBI), is a registered financial services advisor representative and securities agent with a Series 63 license. Dave graduated with a degree in finance from the Wharton School of Business, University of Pennsylvania. For more information

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