Selling Your Information Technology Company

Is Not A Do It Yourself Job

By Dave Kauppi, President, MidMarket Capital, Inc.

People who start software and information technology companies are generally very smart people. When it comes to representing yourself in the sale of your business, the key issue is not smarts, but experience. The purpose of this article is to highlight the intelligence versus experience issue and give examples where experience trumps intelligence. Some very well-known examples were the experiences of the great author, George Plimpton as he stepped into the boxing ring against Joe Louis, put on the goalie pads for the Boston Bruins or barked out signals as the quarterback for the Detroit Lions in a pre-season football game.

These experiences resulted in some great reading. The competitive outcome for the inexperienced combatant, however, was not a happy ending. Curious George was totally outmatched. Admittedly, I had earlier written self-serving articles and Blog posts on the benefits of business seller representation by a Merger and Acquisition Advisor or Business Broker. There are hundreds of similar articles out there from our competitors. The message is pretty much the same:

1. They know the market and the valuations.
2. They have an active database of identified buyers.
3. By representing yourself, you alert the market, your customers, your competitors, and your employees that you are for sale.
4. Running a business is a full-time job. Selling a business is also a full-time job.
5. A business owner normally conducts a serial process (one buyer at a time) which dramatically reduces his market feedback and negotiating position.
6. It is complex, you may only sell one business in your lifetime and the buyers are much more experienced than the sellers.

I really want to dissect point number 6 because I don't believe most business owners fully embrace either the complexity or the consequences of the disparity in experience. First of all, as a generalization, successful business owners are really smart people and have solved myriad complex problems over the years to make their businesses prosper. To many of them, selling their business is just another of those complex problems that they have routinely solved to their advantage. Well, I am a pretty smart guy (my kids might differ), but if my doctor presented me with my lab test results from my physical and asked me to prescribe my treatment, I would refer him to a mental health professional. The point here is not my intelligence, but my level of experience.

Joe Louis spent 10,000 hours perfecting his craft under extreme conditions of competition and pressure. George Plimpton worked in a gym for a couple of weeks with a boxing trainer. If you asked Joe Louis to write a Pulitzer Prize winning novel, you might have to duck a right cross. Both Joe Louis and George Plimpton were geniuses at their craft. They were inexperienced in other areas and were at a distinct disadvantage when trying to compete in another field against the experts in that field.

As I retrieve my third golf ball from the water hazard, I rationalize to myself, "Well at least Tiger Woods can't run an HP 12C present value calculator like I can. Knowing Tiger Woods, he actually probably can.

Let me try another example of the value of experience to illustrate my point. Have you ever tried mounting a new door? The first time I did it, it took me several hours – getting the special hole drill for the knob and internal mechanism, measuring for hinges, chiseling the slots for the hinges, propping the door and securing it for mounting, etc. Each one of these steps was something new to me and I wasn't very good at any of them. By my third door mounting, I was starting to become pretty competent. For a business owner, your business sale is your first door. By the way, that is one very important door.

Now let's look at the buyers. The first category is the Private Equity Investor. They buy businesses for a living. Ask an average PEG (Private Equity Group) how many deals they look at for every one they actually acquire. They will tell you it is well over 200 different companies. Most of these 200 are dismissed at the start of the process with the teaser or blind profile. They can judge whether the target meets their broad criteria of revenue, EBITDA, profit margins, industry segment, and others.

Many businesses pass their initial screen and they enter the excruciating process of conference calls, detailed data requests on customers, vendors, gross profit by product/customer/vendor, sales by product/customer, top ten customers, top 10 suppliers, percentage of business in the top ten, and on-and on. Many more companies are eliminated in this process. We then proceed to the indication of interest letter (broad statement of the economics of their proposed deal) followed by corporate visits. Once through that process, the surviving targets get additional data requests and follow-up questions. This is not always a one-way elimination. Sometimes the PEG IOI letter is not high enough to make the seller's cut and they will be eliminated from the process.

The home stretch is submitting a Letter of Intent with a much tighter presentation of the final deal value and structure. This is a competitive process and the seller winnows the suitors down to 1 finalist through back and forth negotiations. Once the highest and best LOI is countersigned by the seller, there is an exclusive period for due diligence. Often the deal blows up in due diligence when a material issue is uncovered and the buyer attempts to alter their original offer in response to this new data. Often times the seller will simply blow up the deal. So the process starts all over.

The point here is that these Private Equity Groups have vast experience, not only in closing deals, but vast experience with every stage of the deal process. So for every deal completed they originally look at 200 teasers that result in the execution of 50 confidentiality agreements and the review of 50 memoranda. 20 of those deals warrant a conference call with the owners and follow up questions. 8 companies survive that process and result in 8 indications of interest letters and 5 corporate visits. 3 companies survive to due diligence and 1 makes it to the finish line. This is a continual moving pipeline of deep deal experience.

As a business owner, by the time you connect with a PEG, they have pretty much seen every twist and turn a deal can take. Their approach resembles an apartment owner's rental agreement – tremendously one-sided in their favor. For a PEG, a deal that blows up in the eleventh hour becomes an expensive lesson learned and war story. For a business owner, it can dramatically negatively impact their future business performance.

Wait, you say. I am a software company with the next big thing. My buyer is not a private equity group, but one of the strategic buyers – IBM, Google, Facebook, Adobe, and Microsoft (pick your giant). Let me give you a humbling dose of reality. We have represented some world class technology companies and just getting one of these blue chippers to take a look at them is a monumental task. The primary objective of the M&A department of the giants is to protect the mother ship. They want to prevent entrepreneurs from getting into any potential legal claim on the Blue Chip's intellectual property.

Therefore they institute a screening process designed to surround the company with a corporate moat around the castle. That moat has different names at each company. At one it is called the "Opportunity Management System". At another it is the "Partnership Management Department".

Here is how it works. The individuals in this department are very hard to find and very seldom answer their phone. You are directed to a Website and are required to fill out an exhaustive 16 page submission form. You are then issued a submission number. You then go into the black hole and may be reviewed by a junior level screener that does not have the breadth of experience to judge a Twitter versus a Pets.com.

It gets worse. Every day 100 more "Opportunities" get submitted and piled on top of your number. The only way to get attention is from the Division Manager who owns the functional area where your product fits. Convince him to go rescue your number and to get your form to a senior opportunity manager to process and vet the idea.

Just like with the PEGs, this is a relentless process of deal flow for these company buyers. Sellers in this environment are on their heels right from the start and struggle to garner any negotiating leverage. If your technology is strong enough to be rescued for a more comprehensive look, the guys on the other side of the table are the heavyweight champions of M&A deals. They have seen it all.

Not to minimize the first 5 benefits identified earlier in this article, but balancing the experience of the buyer's team with the experience of the seller's team is critical to enhance, protect and preserve the value of your transaction.

In its purest form, a letter of intent is a document designed to define the economic parameters of a transaction that, pending completion of due diligence, will be memorialized in a definitive purchase agreement and a deal closing. In its practical use, a letter of intent is like an apartment renter's agreement with every subtle advantage benefitting the author of the document. An inexperienced seller will agree to a seemingly innocuous clause about working capital adjusted at closing according to GAAP accounting rules. If you are the seller of a software company with annual software licenses or prepaid maintenance contracts, that could be a $ million mistake. It is a rare attorney that would ever catch that. Well, not actually. They are all representing the experienced buyers.

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 or a free consultation please contact Dave Kauppi at (630) 325-0123, email davekauppi@midmarkcap.com or visit our Web page http://www.midmarkcap.com

MidMarketCapital, Inc.
102 S Quincy Street Hinsdale, IL 60521
PH: 630-325-0123 • FAX: 630-230-3052 • Mobile: 630-215-3994
davekauppi@midmarkcap.com www.midmarkcap.com