Priming a New Venture for a Successful Exit

Jeffrey A. Bridge Hyde Park Capital Partners

A number of motivating factors ultimately drive entrepreneurs to exit a business: a desire to monetize equity or paper wealth associated with the venture, a wish to pursue other personal or business interests, retirement, or a desire to pass the business along to a next generation of managers (management buyout). Due to the rigorous demands of building a business from the ground up, the idea of planning for an exit in early-stage companies is often daunting and overlooked by many entrepreneurs. The planning process entails a number of short-term decisions including timing, valuation, and picking an advisor. However, optimizing a business for potential sale requires a long-term view and the earlier an owner begins priming the company for an exit, the more value he or she is likely to create. To that end, the following steps provide a general framework for strategies which help build long-term value for an enterprise and reduce the risk for potential buyers.

Quality and experience of management team – It is often believed within the venture capital community that a strong management team carries as much or more value than the actual business idea. The ability of a management team to execute on the business plan is one of the most important factors investors take into consideration when evaluating an opportunity. Building a senior management team of experienced, qualified people provides the wherewithal to reach company milestones. An ideal management team consists of personnel that cover each of the following areas: finance and accounting (CFO), sales and marketing (CMO), technology (CIO) and operations (COO). Each member of management plays a role in telling the story of the company during the due diligence phase of an exit strategy; therefore a strong management team that can articulate the company's vision can add tremendous value during the transaction process. In addition, depending on the exit strategy, members of the management team are often asked to stay on post-transaction to continue to oversee the day-to-day operations of the company and many times have the opportunity to capture two "bites of the apple" through a second sale process.

Financial reporting systems – Effective financial reporting involves creating a broad range of reports that will provide the information necessary to make informed decisions in a timely manner, as well as the ability to establish and monitor performance metrics. These reports should track everything that affects the company's bottom line, including nonfinancial performance measures such as employee retention, customer satisfaction and market share. Many early stage companies can benefit significantly from hiring a quality accounting firm to assist with financial record keeping. By engaging a certified public accountant, a company can focus its efforts on growing its business while the accounting firm implements internal financial controls and generates external financial reports. Additionally, in today's lending environment companies in need of capital are more likely to secure financing with lower interest rates if they have audited financial statements, which help provide a sense of security to lenders.

Organizational systems – In an early stage company, owners are often responsible for overseeing the day-to-day operations of the business. However, as a company continues to grow and new members of management are added to the team, it becomes important to lay out the reporting relationships that govern the workflow of the company. A formal organizational chart makes it easy to visualize the workflow, and identify new areas where positions might need to be filled. Similarly, organizational manuals are a big positive as they can serve to codify standard operating procedures and service offerings. This allows the owner to focus attention on growing the business rather than ensure service delivery is uniformly delivered across employees. This organization is invaluable during a sale process as it can help relieve a potential buyer's anxiety about possible departures of key personnel.

Formalizing agreements – Before any decisions are made regarding the future of a business it is imperative that formal control arrangements are made between the company's founders. At a very minimum, these formal arrangements should include a shareholders' agreement, which regulates the ownership and voting rights of the shares of the company, details how the company will be controlled and managed and makes provisions for any future disputes between shareholders. A vesting schedule and a right of first refusal should be enacted should any of the company's founding members decide to prematurely exit the business. Along the same lines, it is important to assess the corporate structure of the company early on, as there are important tax consequences associated with selling C-Corp and S-Corp businesses which should be considered when determining the ideal corporate form.

Recurring revenue streams – Creating a recurring revenue stream provides a company with a reliable and stable source of revenue that is highly likely to continue in the future. The more predictable the flow of funds from customers are, the more valuable the recurring revenue dollars become because there is less risk of experiencing a decline in revenue. High percentages of recurring revenue will generally lead to increased valuations by both buyers and investors.

Customer mix – Having a high customer concentration (one customer accounting for 20%-30% or more of total revenue) often leads to a decrease in valuation due to the substantial risk associated with the possibility of losing that one customer. More often than not the owners are responsible for bringing in key clients during the early stages of a venture. The personal relationships owners build with these clients heightens the risk of customer churn when the owner exits the business because the customer's allegiance is often tied to the owner. Therefore, instead of relying on a single customer it is important for startups to focus on diversifying their customer base. Potential buyers and investors seek a customer base that spreads across multiple customers or industry sectors and provides opportunities for incremental revenue growth.

The aforementioned principles help drive considerable value in a company and carry significant weight among investors and buyers when evaluating potential investment opportunities. By incorporating these tenets into an organization from its earliest stages, owners not only benefit from the implementation of good business practices but are also able to create a track record of performance which increases enterprise value and minimizes risk during the sale process. It is never too early for an entrepreneur building towards a successful exit to define a clear strategy and start implementing business practices that will demand a premium down the road.