

TECHNOLOGY ACQUISITION UPDATE

Why Companies Don't Sell

by Thomas V. Metz, Jr.

Why don't companies sell? Over the last two decades working in the technology M&A space, we have worked on several assignments that did not result in a closed transaction. What common themes emerge from these experiences?

We are discussing the sale of technology companies -- software, hardware and intellectual property. These types of companies are acquired for their technology, not for their revenues or profits. The best buyer is the one to whom the technology is the most strategic. So, these are strategic sales.

These firms are seeking to be acquired generally because they lack the significant capital to effectively penetrate their market. They may have experienced a minor setback: taken longer to develop the technology, shifted market focus, or had a management issue. The best way for the company get to the next level of growth may be to team up with a larger player with greater resources rather than raising additional capital and attempting to crack the market on its own.

Four themes emerge: (1) the problem has been solved, (2) the market space is polarized or fragmented, (3) price expectations are unrealistic, and (4) the president gets in the way.

1. PROBLEM SOLVED

The most common reason that a technology company doesn't sell is because the potential buyers have already solved that particular technology problem. Buyers have either

developed their own solutions in house, licensed similar technology, or acquired a competitor.

The selling company may have excellent, even superior technology, but unless it is remarkably better, an acquisition is unlikely to occur. Most technology companies are sprinting as fast as they can and can't bother with replacing or upgrading technology if their current solution is good enough.

First Seller Advantage

Timing is critical. The first company in a market space to pursue being acquired has a real advantage because the potential buyers have not yet developed solutions. For a company that goes out too late, most of the likely buyers have already developed, licensed or purchased a solution. If a company decides to sell too late, the greater the probability that potential buyers have developed an alternative.

The lesson: Keep a watchful eye on competitive solutions in your market. If other solutions exist and your company isn't getting its products to market on time, start thinking about strategic alternatives.

2. POLARIZED AND FRAGMENTED MARKETS

Be aware of the dynamics of fragmented markets. If a market is polarized or fragmented, finding an acquirer may prove difficult. In polarized markets you find two sets of companies: big fish and little fish. The big fish are so big that an acquisition under \$30 million is simply not substantial enough to put a dent in their revenues (say, over \$1 billion). The little fish are often in the same situation as the seller – trying to get to the next level of growth, but they are just treading water. (Can fish tread water?) Smaller companies rarely have the wherewithal to make an acquisition. What about the mid-sized companies? Generally, there are very few mid-sized companies in polarized markets.

In one market we explored, the space was totally fragmented with more than 600 companies and only five big players. The big companies had good technology and did not care about a few additional customers. A roll-up opportunity, you say? I doubt it. The history of roll-ups is dismal. Not enough value is created.

The lesson: Unfortunately, there is no lesson here, at least, not one you can do anything about. The market is the way the market is. Be aware of the dynamics of fragmented markets.

3. UNREALISTIC EXPECTATIONS

When the asking price is too high, buyers balk at spending the significant time and effort required to evaluate a potential acquisition. Time is at a premium in the technology arena, and companies have plenty to do without exploring overpriced acquisitions. Unrealistic expectations result from two primary factors -- bogus comparables and shareholder problems.

A. Bogus Comparables

Bogus comparables are insidious because management can convince themselves that they are legitimate. I cannot tell you how many times I have heard this story: "Acme Corp. sold two years ago for 3.5 times revenues and our technology is better than theirs, so we ought to sell for at least 3.5 times revenues." First of all, two years ago is an eternity in the technology world; the

market has changed significantly since then. Secondly, the valuation was the result of a strategic sale. Acme's technology was a very good strategic fit for the buyer. It had little to do with revenues.

Value is strategic in the technology markets. The price of an acquisition depends on how strategically important the technology is to the buyer. Acquirers are buying technological capability, not revenues -- so multiples of revenues simply are not relevant. Quoting revenue multiples is kind of like a capitalist version of "Post hoc ergo propter hoc."

How do you know what price to ask? This is not easy because value depends on the market, not on the intrinsic value of the technology. In fact, technology rarely has any intrinsic value. It is worth something only in the context of the marketplace. If no one wants it, it is worth zero. Valuation in the technology markets is more art than science.

B. Those Pesky Shareholders

Dormant issues come to a head when money is on the line. Founders and venture capitalists can be at odds about who gets how much. In one deal we were involved in, we had an excellent buyer in hand. As negotiations progressed, a problem surfaced between the founder and the venture capital firms. After several rounds of financing, the founder had been diluted to less than 10% ownership. He still viewed his role as critical and wanted the VCs to give him and a few managers a bigger piece of the pie. He wasn't being that greedy; he actually had a good point. However, it was the VC's money; they had taken the financial risk, and the idea of reducing their share was not palatable. Both sides had valid arguments. The parties could not resolve their differences and no transaction ensued.

In another situation, the venture capital backers were seeking liquidity because their fund was at the end of its term. After nine years of lackluster growth, it was time to sell the company and move on. The president, however, wanted to continue building the company. He wanted to stay in the game and if he was going to sell, it was going to be for a very good price. The venture capitalists liked the idea of a very good price as well. In discussions with potential buyers, the shareholders were firm at the high valuation.

The market said no dice.

If the president thinks he can still grow the company, his valuation belief is often based on what the company could be worth rather than what is actually worth today. And, of course, there is the classic case in which each of the three founders wants to net \$1 million (or some other even multiple of millions) regardless of what the market says.

The lesson: If you have decided to sell the company, our advice is to go get as many offers as you can and take the highest one.

4. PRESIDENT GETS IN THE WAY

The president of a company may have objectives that differ from the shareholders or venture capital backers. The venture capitalist has the portfolio effect working in his favor; the president does not.

Frequently the president does not want to sell, but has been directed to by the board. Ego can be a problem. The president doesn't want to admit failure. He or she believes that with just a little more money, success is right around the corner.

A situation we are seeing more frequently is when the president's options are not yet in the money; the CEO will profit only if the company is sold at a very high valuation. This situation can be subtle because it may not surface until late in the negotiations. A president may be better off financially by running the show and earning an attractive salary. His equity stake may be too small to truly act like a

shareholder. (By the way, CEOs should stay out of the negotiations. They may love to wheel and deal, but more often than not they are part of the problem.)

The lesson: Make sure the president's interests are truly aligned with those of the shareholders.

There are many reasons that companies don't sell. The message to glean is that when you are having problems or are slow getting to market, don't put off examining your strategic alternatives.

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