TECHNOLOGY ACQUISITION UPDATE

Optimum Price vs. Market Stage

Recognizing the pre-tipping point of a market space is critical if a company wants to sell for the optimum price. Why is this important? Because market timing is the primary driver of price when selling a company. Whether it is a high price, medium price or low price, the market timing has more influence than any other factor.

The market may be on a different time schedule than your company's growth curve. If a company waits to sell until its revenues have peaked, there may be little growth left in the company. The company has maxed out. Buyers will realize this and will not pay top dollar. Paying attention to the reality of the market is not only a good survival skill, it is the primary requisite for realizing the optimum price.

The best time to sell is when the big companies decide to move into a market. That is when they are willing to pay top dollar. Large companies need to acquire technology, market knowledge and expertise in a hurry. They want to acquire the technology, rather than develop their own technology in order to make a speedy market entry. They also need to acquire a company that has a team of people that understands the market, the customers and the customers' issues.

Large companies are rarely early movers into a new market. Big companies want to go into big markets, not small markets. New markets are almost always small markets. So, until a market has clearly demonstrated that it will be big, the large companies sit on the sidelines and wait until they are sure that the market will be significant. Once these larger companies do decide to move, the pre-tipping point is at hand. Now the clock begins to tick and the tipping point is not far behind.

Why the pre-tipping point? Because if you wait for the tipping point, it will be too late. The biggest exit mistake that technology companies make is that they decide to sell too late in the game. They want to sell when the company has peaked. The problem is that this is usually unrelated to market timing. This is an internal focus and an internal focus rarely leads to the highest price. Many technology executives ignore market timing. The highest value is achieved by looking externally and capitalizing on the optimal market situation.

Market Stages

The life cycle of a market consists of several stages that are typically illustrated by a graph showing industry revenues over time. These stages are introduction, growth, maturity and decline. A similar graph can illustrate the best time to sell. However, instead of the vertical axis representing total revenues, it represents the relative selling price of acquisitions. It is critical for a selling company to view the market stages from this viewpoint—from the perspective of how much a buyer is likely to pay. The stages break out like this:

- Early Development
- Growing Nicely
- The Light Bulb Goes On
- The Slide
- Consolidation

Early Development

In the Early Development stage a number of smaller companies are developing technology and scrambling to get customers. The market is new, so there are not any medium-sized companies yet. The large acquirers don't yet know if this market will be a significant market. If a buyer is willing to make an acquisition at all, it will be for a moderate price at best. Medium-sized buyers are the only buyers at this stage because small acquisitions of less than $20 million are meaningful to them. These buyers are situated on the edge of the market or in an adjacent market, not in the core market.

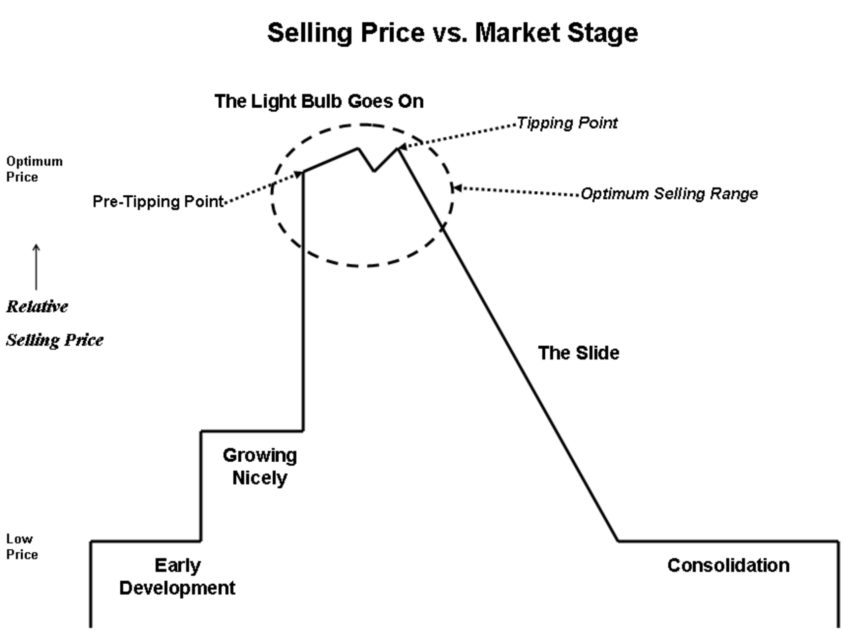

Figure 1

Growing Nicely

Small companies are expanding from $5 million in revenue to $20 million in revenue. At this stage an intelligent buyer will pay a good price for technology and people who have a familiarity with the market. However, most large buyers will not make acquisitions at this stage. They will wait until it is proven that the market is large before moving in.

One of the problems with the Growing Nicely stage is that most smaller companies prefer to continue building on their own rather than be acquired. They think the timing is premature. Most entrepreneurs are quite independent and the idea of selling early is anathema.

Discrepancies can arise between the goals of the entrepreneur and the objectives of the shareholders. The company must be clear what its goals are—to build a business and stay independent (sometimes at all costs) or to build a business and sell at the optimal time.

If a company is growing nicely, it usually wants to continue down this path. The entrepreneur and his team are doing well and having fun. They have overcome hurdles and obstacles. It feels good to be growing nicely. They want to continue enjoying the ride. The last thing they want to do is to sell. They view selling as "game over." If they were to consider selling, it would be after just one more good quarter of revenue, one more new product release, one more industry trade show, etc. There is always something.

An ironic situation can occur at this point. A second tier company may not be growing quite as nicely as the company described above. It may be having difficulty making headway in the market so it decides to sell to a larger company on the periphery of the market. Now the second tier player has access to the financial strength and the sales and distribution capabilities to make major inroads. Their technology may not be the best, but with strong sales and marketing power they can be a potent force in the market.

The Light Bulb Goes On

At the Light Bulb stage the big companies finally get it. They recognize that the market will be substantial in size. They make acquisitions and are willing to pay top dollar.

Acquisitions are the best way to grab a foothold in a short time period. Competitive pressures dictate that they participate in this market, so they follow each other into the market. They do not want to be left out. Even a company on the edge of the market who is not a major player may make an acquisition in order to procure software or technology that can be part of their overall product solution.

The apex of the graph represents the point in time when the first large company makes an acquisition to enter the core market. This is the pre-tipping point. A second company will soon follow with another acquisition. Companies are realizing that this will be an emerging and vital market. Sometimes a third company joins the fray. Rarely, however, will there be more than three big players making acquisitions at this stage. Sometimes a major player will make several acquisitions. The first small or medium-sized company to sell often obtains the best price, a kind of "first seller advantage."

The Slide

The Slide begins after the tipping point, after the large players have moved in. The only reason an acquisition would be made during the Slide phase is if a large company chose to acquire a medium-sized company in order to add mass and shore up some of its product offerings. In this phase the big companies are firming up U.S. operations and possibly moving into a few foreign markets. The acquisition of an overseas company is about the only good possibility in this stage. The large companies have already made their acquisitions and any remaining smaller players must settle for a smaller piece of pie.

Consolidation

In the Consolidation phase buyers will make acquisitions primarily to add customers. The price will not be a high one. Buyers do not need to acquire technology or engineering teams because they already have their own teams and technology. Even if a smaller company has truly better software or technology, the costs of switching are too high to make an acquisition attractive. A buyer may seek to acquire a company in a new geographic location. Almost all acquisitions made in the Consolidation phase are motivated by a desire to add to the customer base.

Mapping the Market

Market maps are an excellent way to visually represent the state of the market and the movement of that market. There are three states: the present state, the movement and the future state. What can we learn from looking at these diagrams?

Market Map – The Present

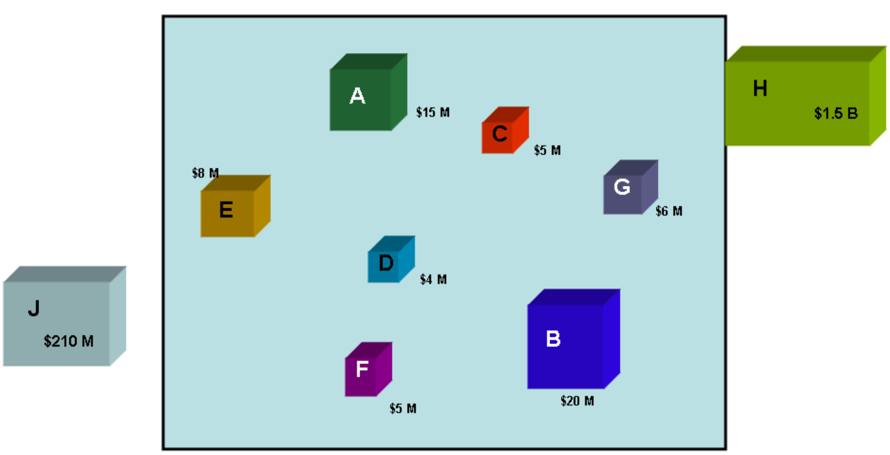

Figure 2 **Dollars are company revenues.** **Total Market Size: $63 million**

The Present

This market map depicts the present market situation, typically consisting of a handful of small players. The technology is not cast in concrete; no standards have been set. There are no big companies because the market is too new and too small for them. However, there are a few big companies in adjacent markets who are keeping an eye on the pace of growth in this new market.

Many CEOs have a myopic viewpoint, focusing only on their core market. Their viewpoint is black and white—a buyer is regarded as either in their market or not in their market. However, the gray edges of the market and the adjacent markets can be fertile areas for good acquirers.

Movement

The Market Movement Map is a dynamic map illustrating the movement of companies into the market, making acquisitions, as well as companies moving away from the core. This is where the market begins to morph. Some companies are moving in, some are making acquisitions, and some are doing both. A big company in an adjacent market is making an acquisition. A smaller firm is moving toward the edge of the market, deciding to focus on a particular vertical niche rather than cater to the market as a whole.

Many companies do not see this picture very clearly. The management teams are busy running their companies and have their heads down, focused on developing technology and selling product. Their focus is operational, trying to "peddle faster," rather than thinking about the broader strategic picture.

Medium sized companies rarely make acquisitions during this morphing phase. The likely target companies are their competitors and they may not particularly like them. They think their own technology is superior so why would they acquire another company?

Market bitterness may also play a role. They may have lost sales to a competitor or heard remarks at a trade show that the competitor was badmouthing them. These reasons may seem petty but they inhibit a growing company from seeking an acquisition. So, they choose to grow only organically. The downside is that a bigger company in an adjacent market can acquire a small player and very rapidly gain a strong market position, sometimes eclipsing the medium-sized company that was doing fairly well in the market originally. The lesson here is—when the market begins to morph, when the big players begin to move, a medium-sized firm needs to take action and make an acquisition in order to grab a bigger piece of the market. A smaller company should seek to acquire or to be acquired or it will be left to languish.

The Future

The Future Market Map looks almost exactly the same for most market sectors. There will be one or two

Market Map – The Future

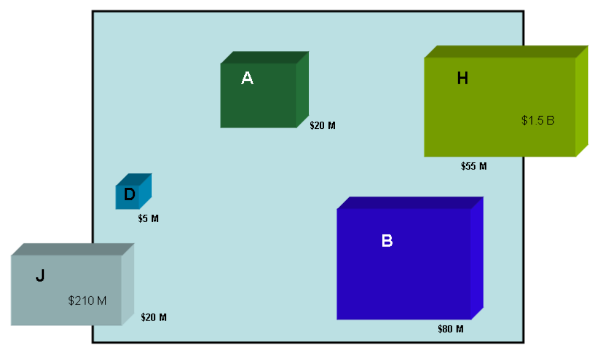

Figure 4

Total Market Size: $180 million

market leaders and one third-place company. If a fourth or a fifth company exists, it will be small and will not be particularly profitable.

There are a few other observations to make from the market maps. Notice that Company A does not make an acquisition. It grows from $15 million to $20 million, which is respectable, but now it is a third place player. Company H and Company B have grown through acquisitions and have eclipsed Company A. Notice that this market has tripled in size from $60 million to $180 million in total revenues and is still growing. What started out as an

Market Map – Movement

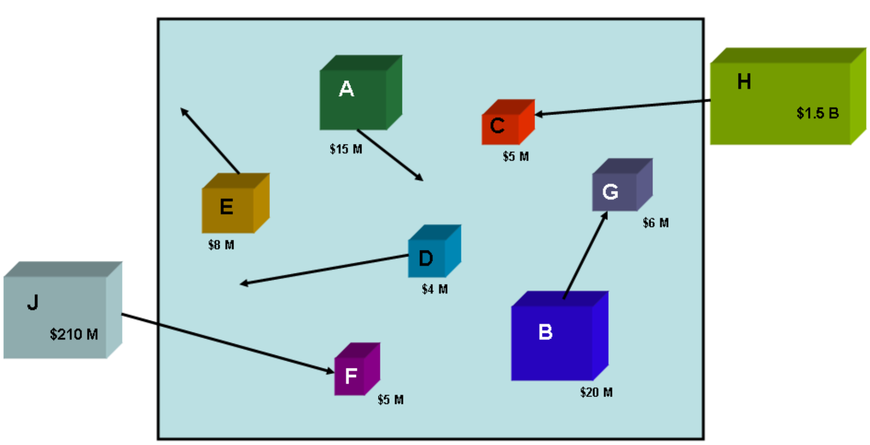

Figure 3

insignificant market is now a very respectable market.

Recognizing the Pre-tipping Point

The first major sign that the pre-tipping point has been reached is when one of the large companies makes an acquisition in the core market space. Large is a relative term—it could be a $1 billion revenue company or it could be a $200 million revenue company. It depends on the market, the size of the market and the relative size of the companies in that market.

When a second large company makes an acquisition in the space, it is time to get moving. The tipping point is near at hand. The time period between the first acquisition and the second acquisition could be short, within six months or maybe a little longer, up to 18 months. But rarely is the second acquisition any farther down the road than that.

A good example of the pre-tipping point is the online advertising industry. Google recently bought Double Click for $3.2 billion. A month later Microsoft acquired aQuantive inc. (which owns Avenue A and Razorfish) for $6 billion. This deal was disclosed less than 24 hours after WPP Group's $649 million acquisition of 24/7 Real Media. In the time span of less than two months the three major players have made three acquisitions. The tipping point is now at hand.

Another clue is when a large company develops technology internally in order to enter a new market space. If this is the case, articles and news releases will report about the company's move into the market sector. For example, Microsoft developed its own software for its music player, Zune.

A large company may contact you out of the blue about acquiring your company. Do not dismiss the idea too readily. It may be the right market time. If a big company has acquired, or is acquiring, one of your competitors, it may be wise to be proactive and explore a sale to another large competitor.

Summary

If a company wants to sell for the optimum price, the best thing it can do is pay attention to the stage of the market. This goes against the instincts of may tech people who are overly focused on their own technology. The stage of the market is the primary driver for realizing the optimum price for the sale of a company.

This article is a chapter of Mr. Metz's book entitled *Selling the Intangible Company*, published by John Wiley & Sons in 2008.