



# **Center for Private Equity and Entrepreneurship**

**Tuck School of Business at Dartmouth**

**Entrepreneurial Exit Strategies Program**

**Results of Survey of Private Equity Funds**

**April 2005**

# Center for Private Equity and Entrepreneurship

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## Survey Regarding Exit Strategies

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# Executive summary

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## The Study

- The exit strategies survey is the second phase of the Entrepreneurial Exit Strategies Program funded by a generous grant from the NASDAQ Stock Market Educational Foundation. The exit study addresses the decision-making processes and strategies of entrepreneurs and private equity fund managers with successful companies exploring exit opportunities and liquidity events. The survey builds on the results found through a review of academic and business literature as well as interviews with over 20 general partners, management teams, investment bankers, and legal and accounting professionals.
- 116 private equity funds, from both the venture and buyout perspective, completed the survey (24% response rate).

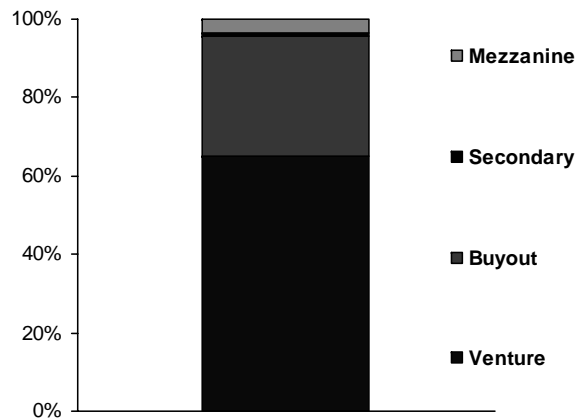
## Key Findings

- 32% of all respondents said that they would consider a Dutch auction for one of their portfolio companies.
- 35% of buyout respondents believe it is likely that income trust securities will become a valid exit vehicle.
- 66% of venture capitalist respondents will stay on boards of directors post-IPO.
- 41% of all respondents said average Sarbanes-Oxley expenses are at least \$1M per company in the first year of implementation, and 20% of respondents agreed that it will cost at least \$1M per company on an ongoing basis.
- 36% of all respondents have seen a jump in compensation for outside directors of 25% or more as a result of SOx.
- Directors and Officers (D&O) insurance has at least doubled for 46% of respondents.
- Most respondents said that they most frequently target an exit to a strategic buyer, but 90% said they also use dual tracking (IPO filing and trade sale negotiation) at least some of the time.

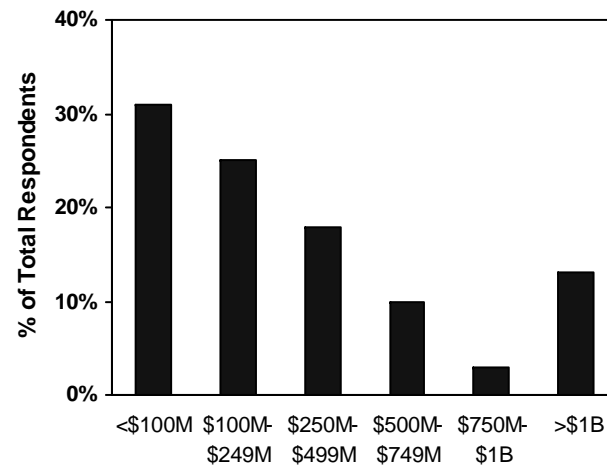
# Characteristics of exit survey respondents

- 65% of respondents characterize themselves as VCs, 31% as buyout investors, and the remaining 4% are involved in other areas of private equity.
- While the majority of funds are below \$500 M in total committed capital, larger funds (over \$1 billion) are also well represented.
- The pool of respondents has significant experience with exits, as evidenced by the number of funds under management.

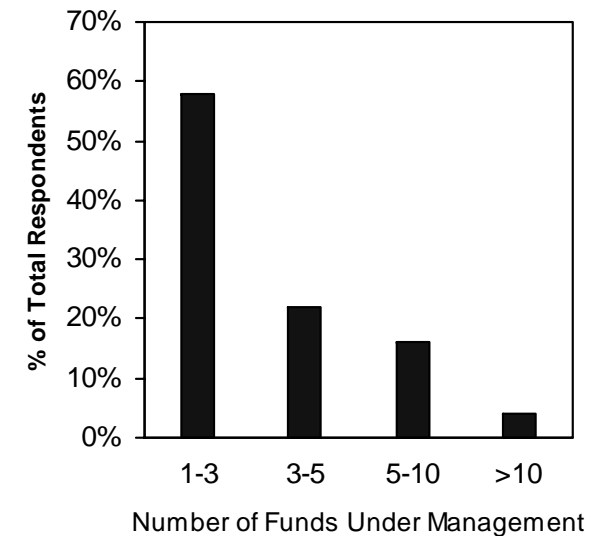
*"How would you characterize the majority of your funds under investment?" (n=114)*



*"What is the committed capital of your most recent fund?" (n=115)*



*"How many funds has your firm or partnership raised?" (n=114)*

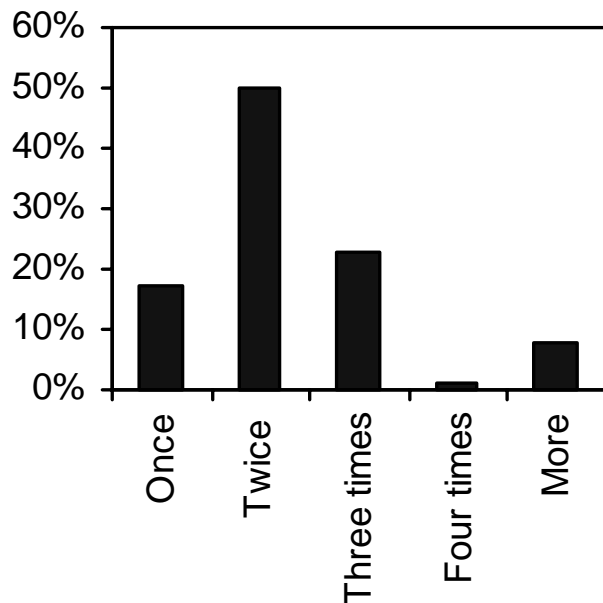


# Exit strategy decisions

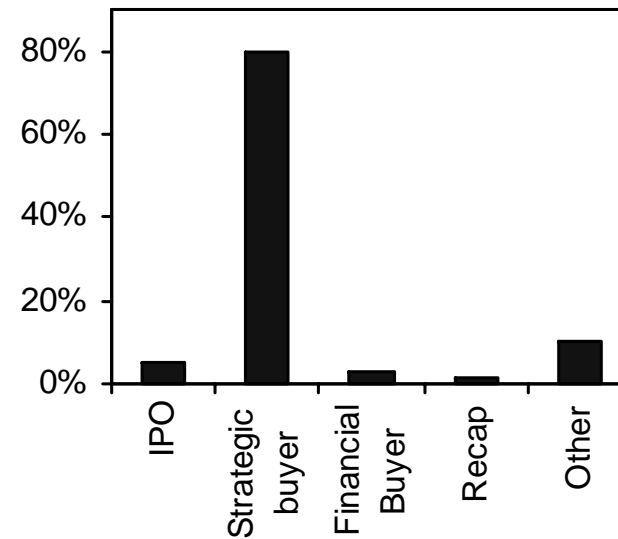
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- Over 80% of respondents said that the exit strategy changes at least twice over the life of the investment.
- An overwhelming majority of respondents said they most frequently target a sale to a strategic buyer early in the life of the investment.

*"On average, how often does the exit strategy change over the life of the investment?" (n=109)*



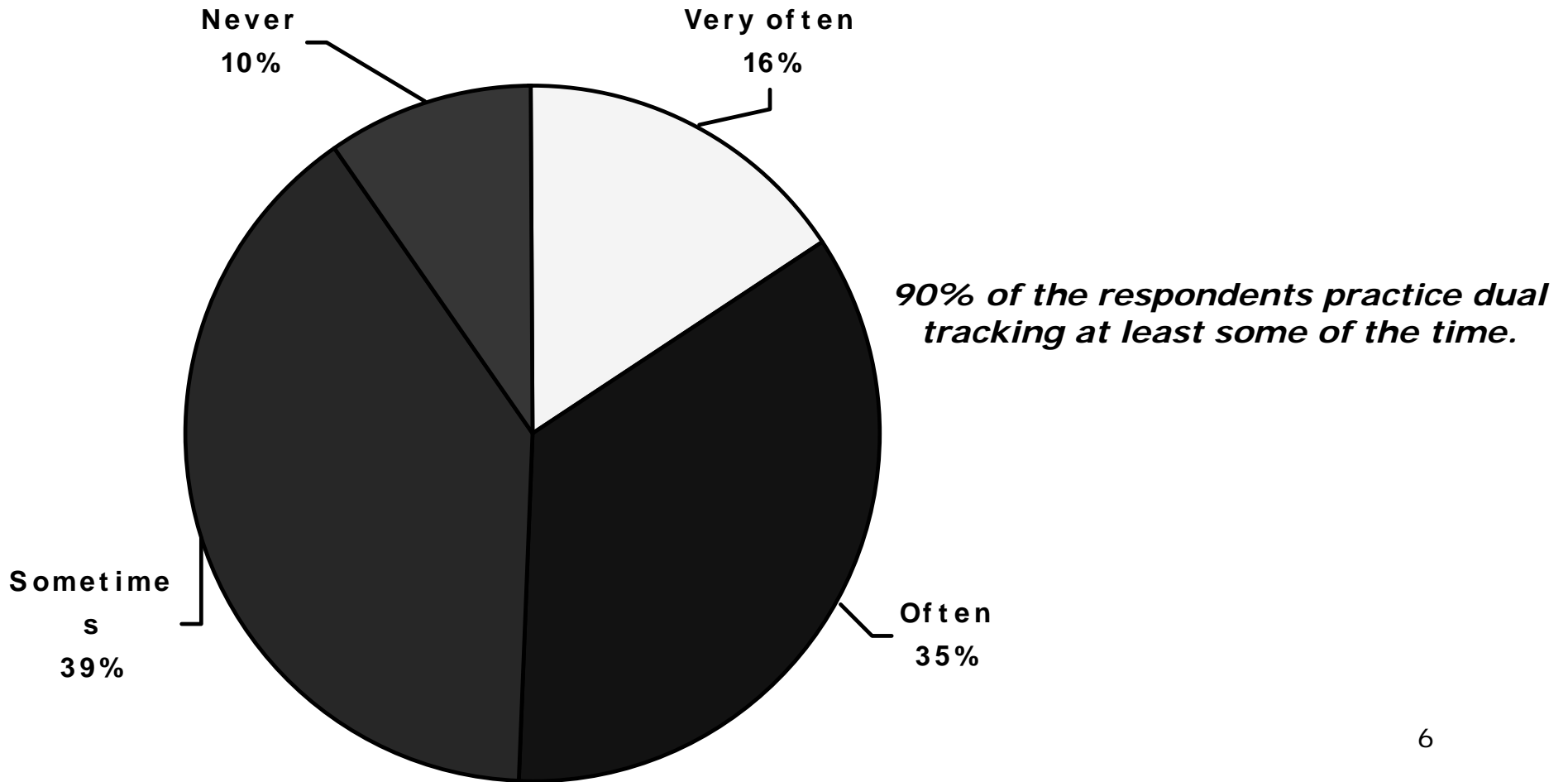
*"Which of the following exit strategies do you most frequently target early in the life of the investment?" (n=114)*



# Many GPs are dual tracking

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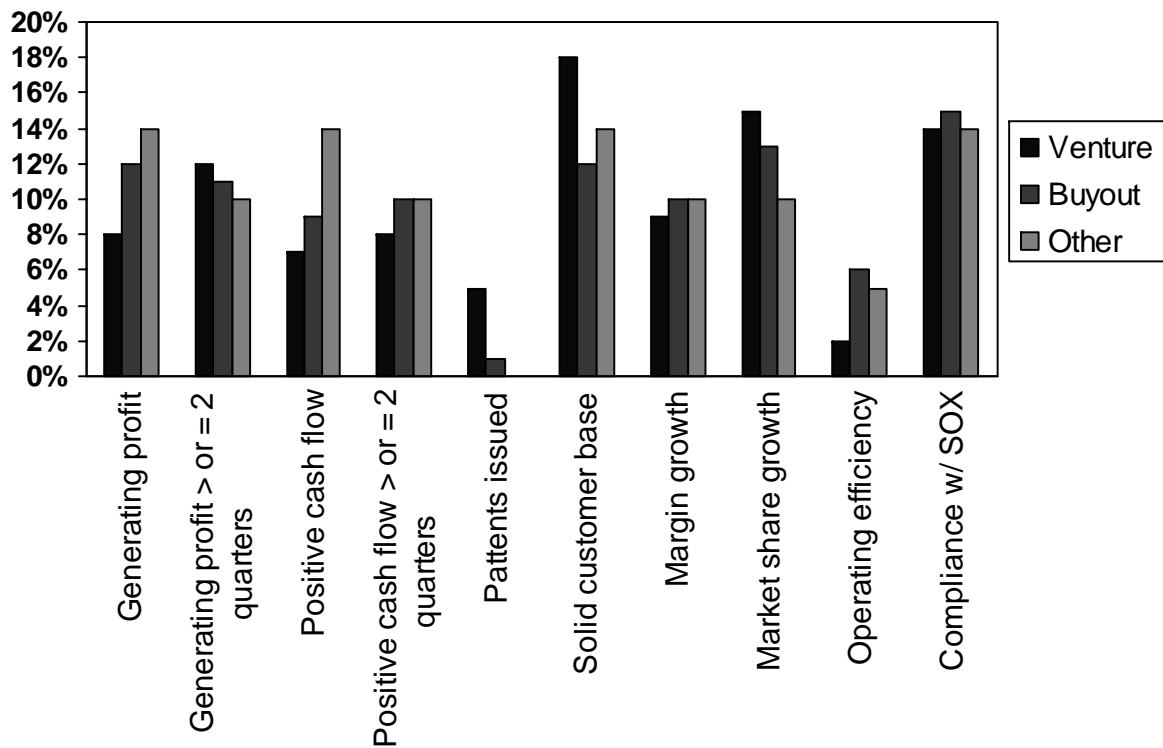
*"How often do you pursue an IPO registration and M&A negotiations in parallel (dual tracking)?" (n=113)*



# Milestones to IPO

- Respondents agreed that there are many milestones that need to be reached before opting for an IPO exit in today's environment.

*"What are the milestones that a company needs to reach to conduct an IPO in today's environment?" (respondents could answer more than once)*



The top "fill in" responses also included:

- *Predictability and stability*
- *Justify a \$50 M - \$200 M market cap*
- *Proof of human efficacy*
- *Strong revenue that continues to grow*
- *Complete management team*
- *Substantial backlog*
- *Satisfied accountants*

# Major pitfalls in M&A and IPO negotiations

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*"What are some of the major pitfalls that occur during M&A negotiations?" (n=85)*

*"What are some of the major pitfalls that occur during the drafting of an S-1 for an IPO?" (n=77)*

- 1) Pricing issues
- 2) Unfocused management
- 3) Difficulties with acquirer (buyer is shopping around, trying to change the terms, or trying to get out of the deal)
- 4) Surprises during due diligence
  - Market conditions
  - Intellectual property issues
- 5) Sarbanes-Oxley compliance
  - Unaligned interests
  - Exclusivity

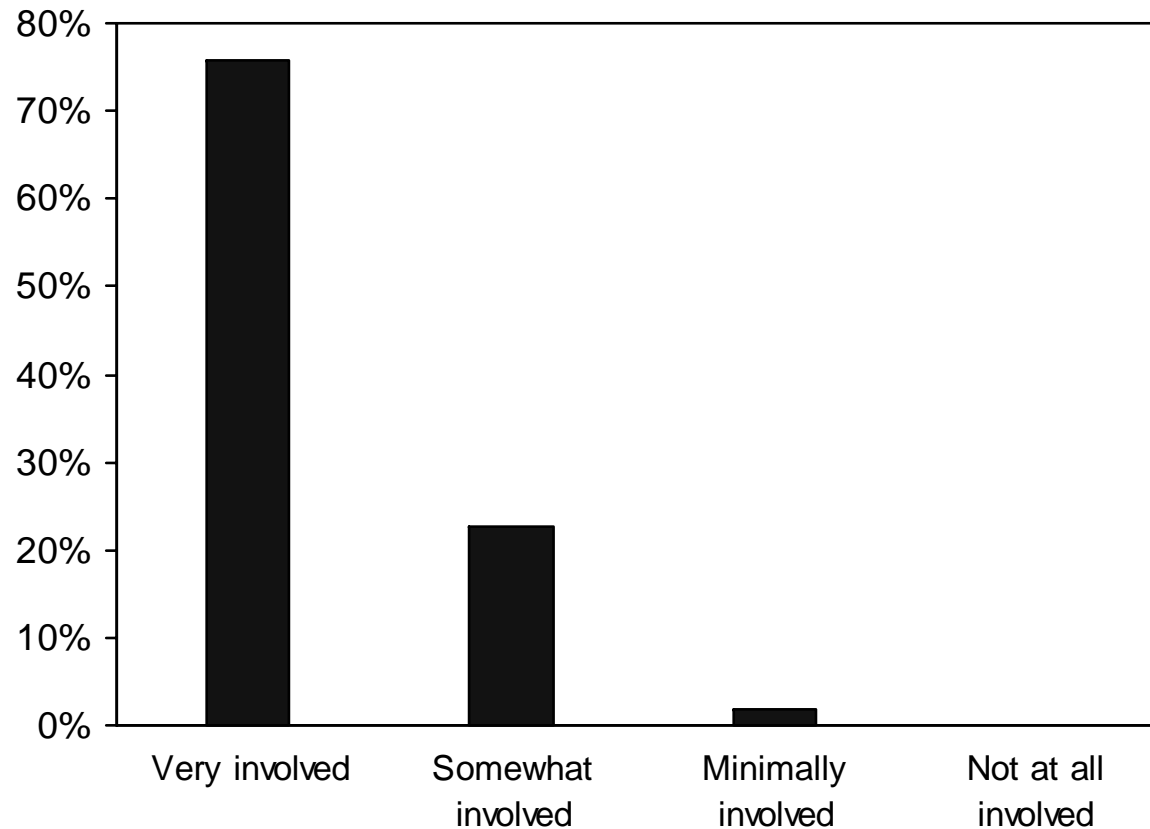
- 1) Sarbanes-Oxley compliance
- 2) Market conditions
- 3) Unfocused management
- 4) The time it takes to take a company public
- 5) Pricing issues
  - Underwriting issues
  - The cost of taking a company public
  - The company is not ready

# Management involvement in the exit process

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- Nearly 25% of GPs believe that management should only be somewhat or minimally involved in the exit process.

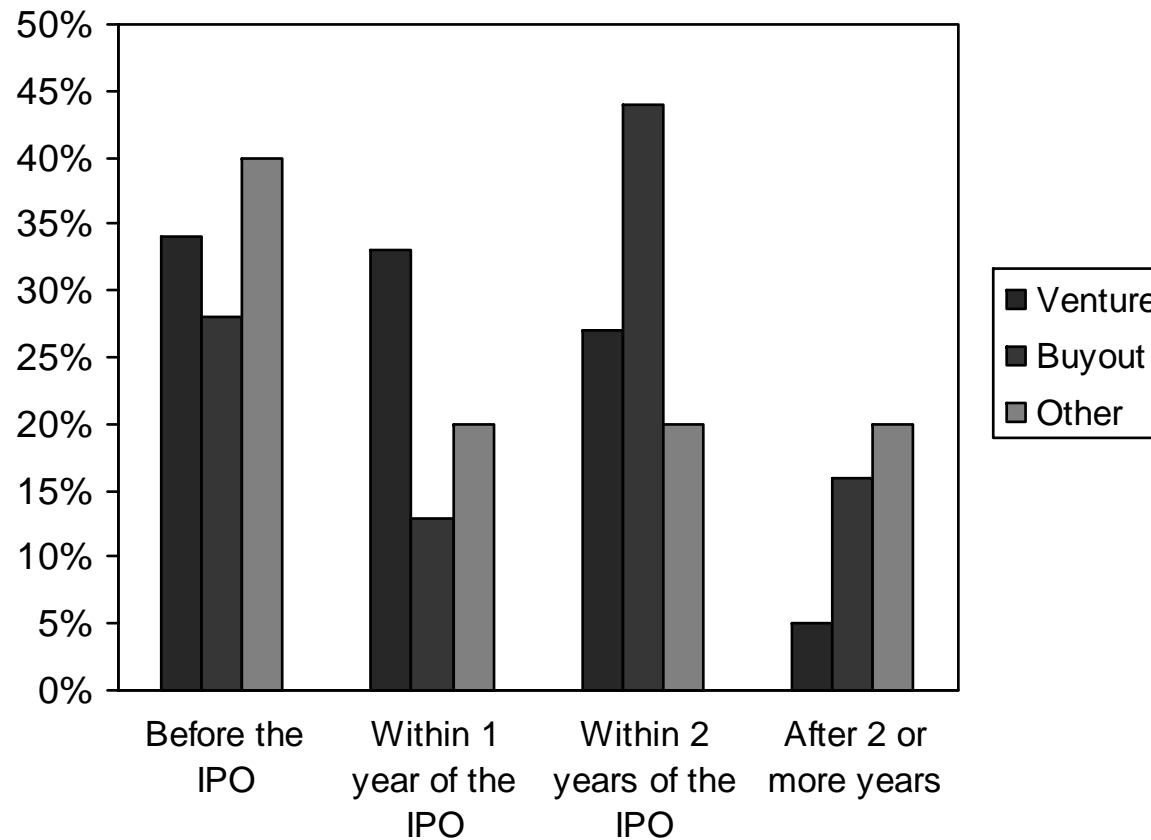
*"How involved should management of a particular portfolio company be in pursuing the exit process?" (n=115)*



# GP representation on the Board of Directors

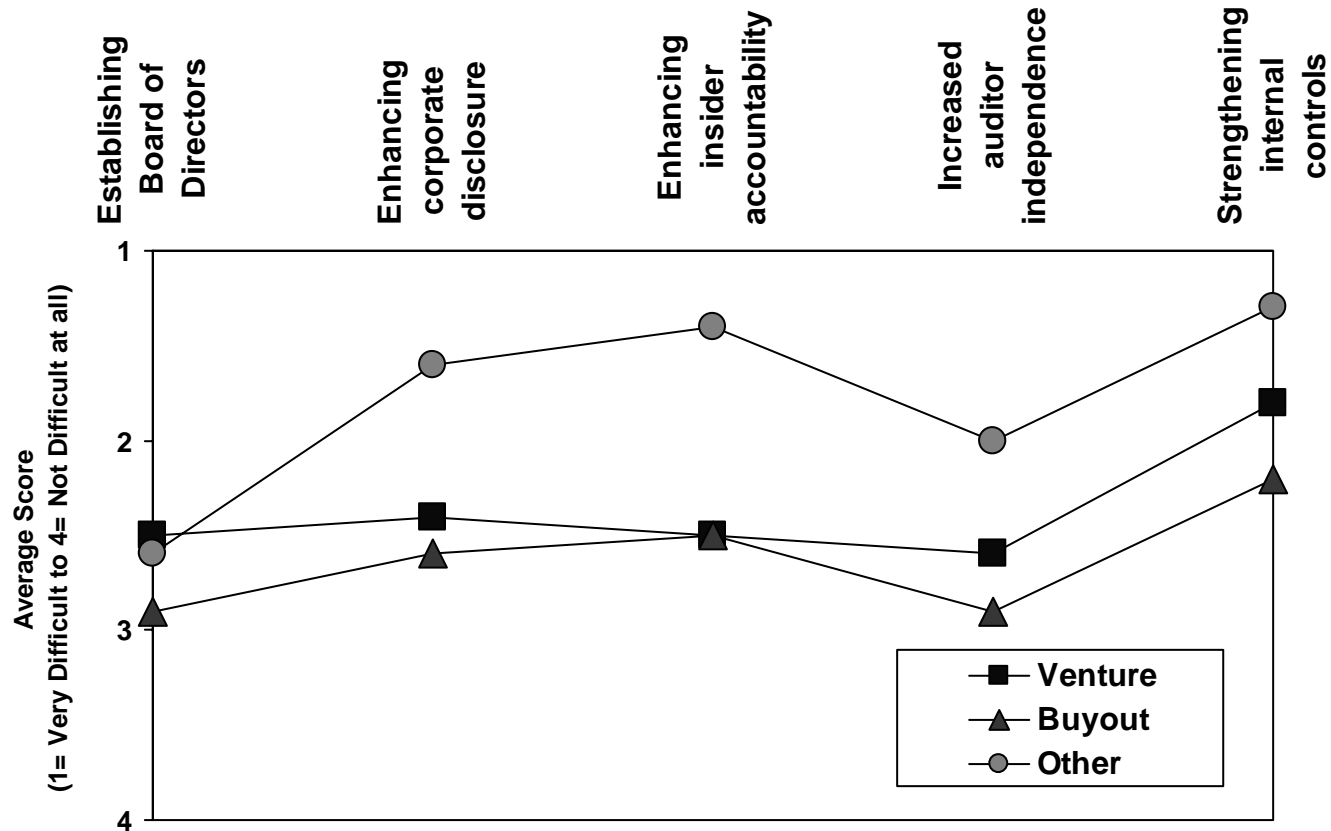
- 66% of venture capitalists choose to stay on the Board of Directors of a portfolio company post IPO.
- 16% of buyout respondents stay on the Board of Directors for two or more years.

*“When, in relation to conducting an IPO, do you generally plan to resign from the Board of a portfolio company?” (n=110)*



# Challenges of Sarbanes-Oxley

*"Please rate, in the order of difficulty, the most difficult aspects of Sarbanes-Oxley to implement in your portfolio companies."*

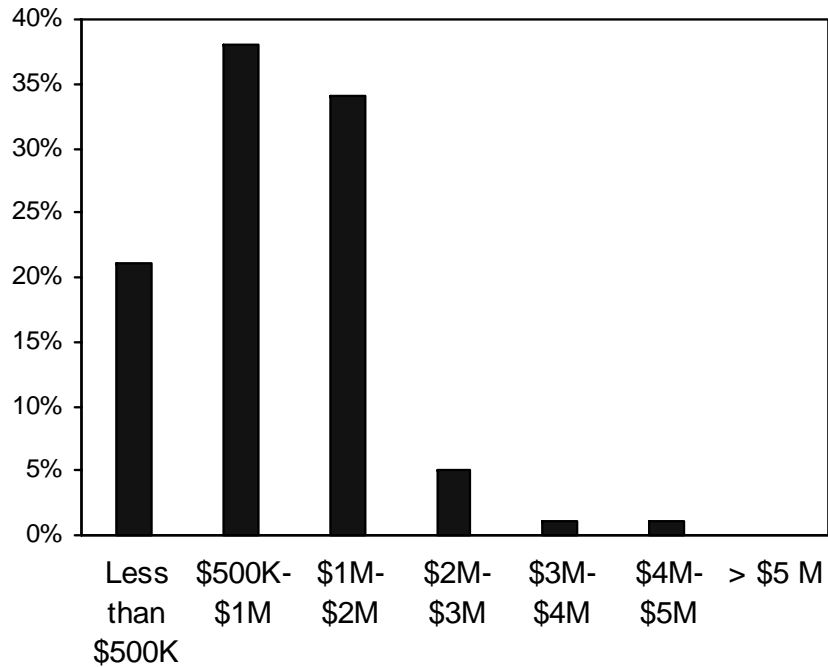


Venture, buyout, and other private equity respondents agree that strengthening internal controls is the most difficult aspect of Sarbanes Oxley to implement.

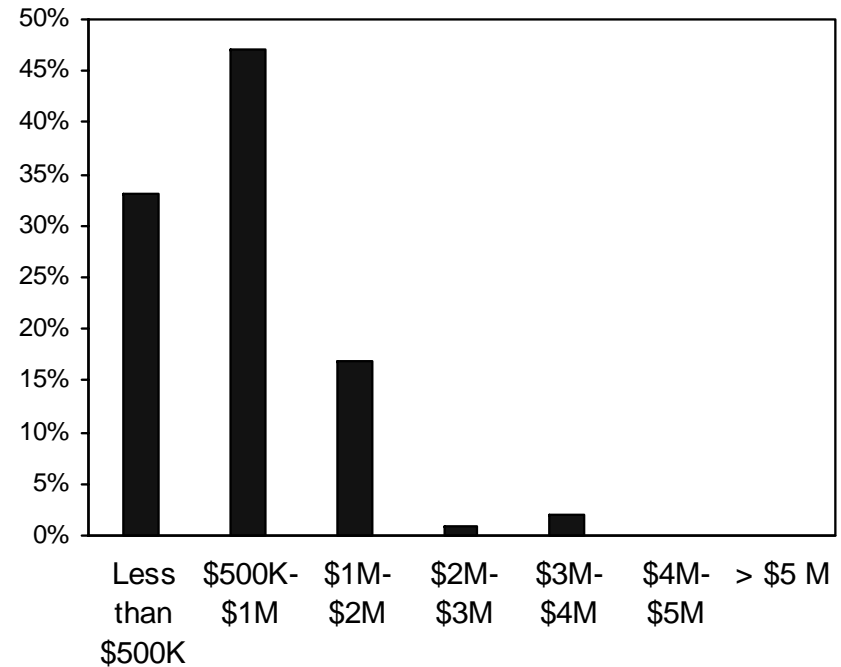
# Sarbanes-Oxley is expensive...

- Sarbanes-Oxley is costly for portfolio companies both within the first year of implementation and on an ongoing basis. 41% of respondents said SOX costs at least \$1M within the first year, and 20% of respondents replied that it costs at least \$1M on an ongoing basis.

*"What is the average cost of instituting Sarbanes-Oxley measures for a typical company during the first year of implementation?" (n=105)*



*"What is the average ongoing annual cost of Sarbanes-Oxley for a typical portfolio company?" (n=102)*

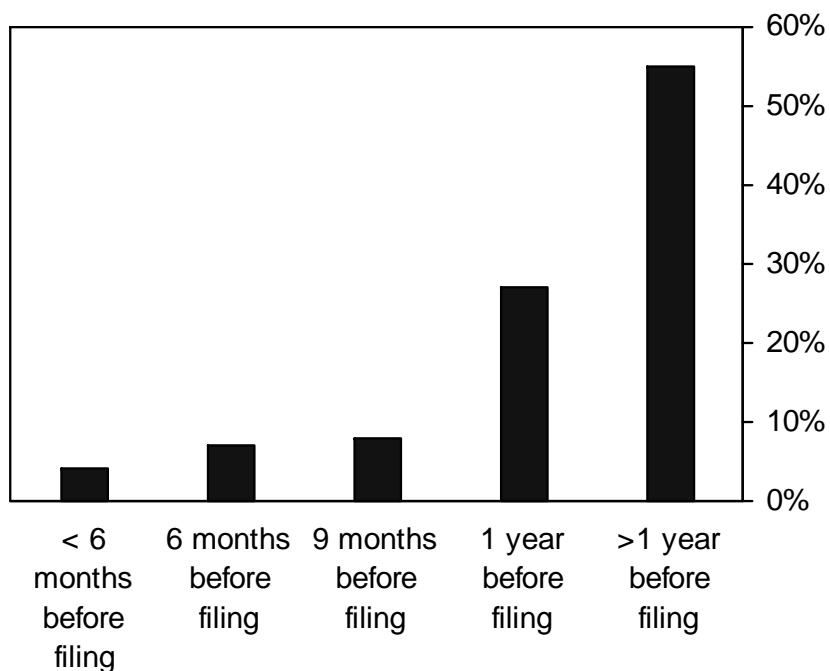


## And time consuming

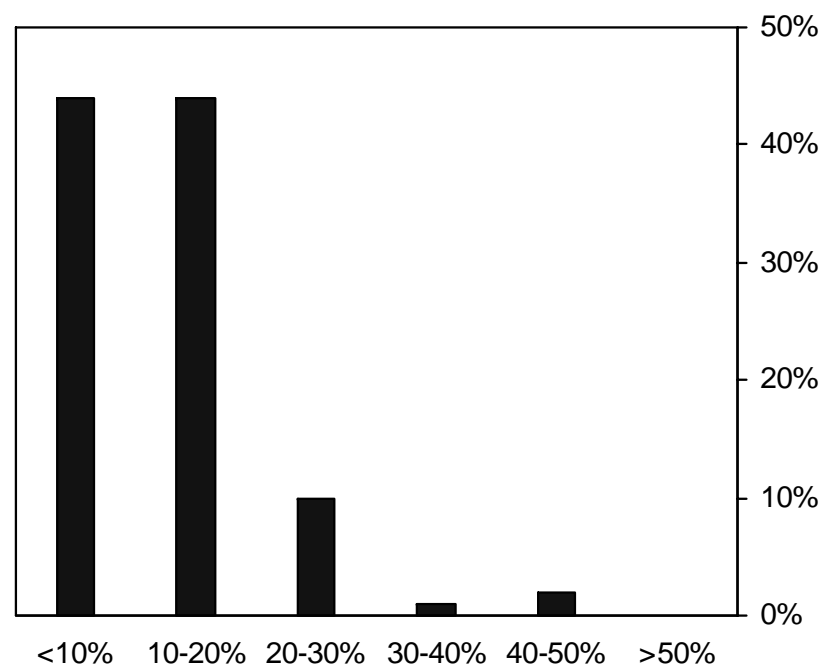
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- Over 80% of GPs agreed that they start to implement Sarbanes-Oxley requirements at least 1 year before filing for an IPO.
- Complying with Sarbanes-Oxley takes up a significant portion of a portfolio company's CEO's time. 44% of respondents said that it takes up 10-20% of the CEO's time, while 13% of respondents said that compliance takes up 20% or more of his/her time.

*"How long before conducting an IPO do you start to implement the Sarbanes-Oxley requirements in a typical portfolio company?" (n=106)*



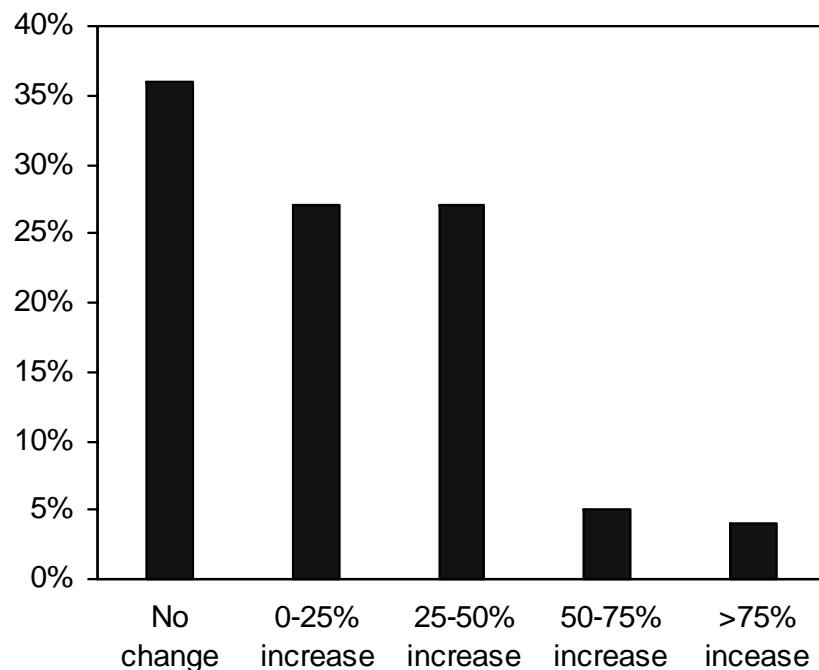
*"What percentage of your portfolio companies' CEO's time is spent on Sarbanes-Oxley?" (n=103)*



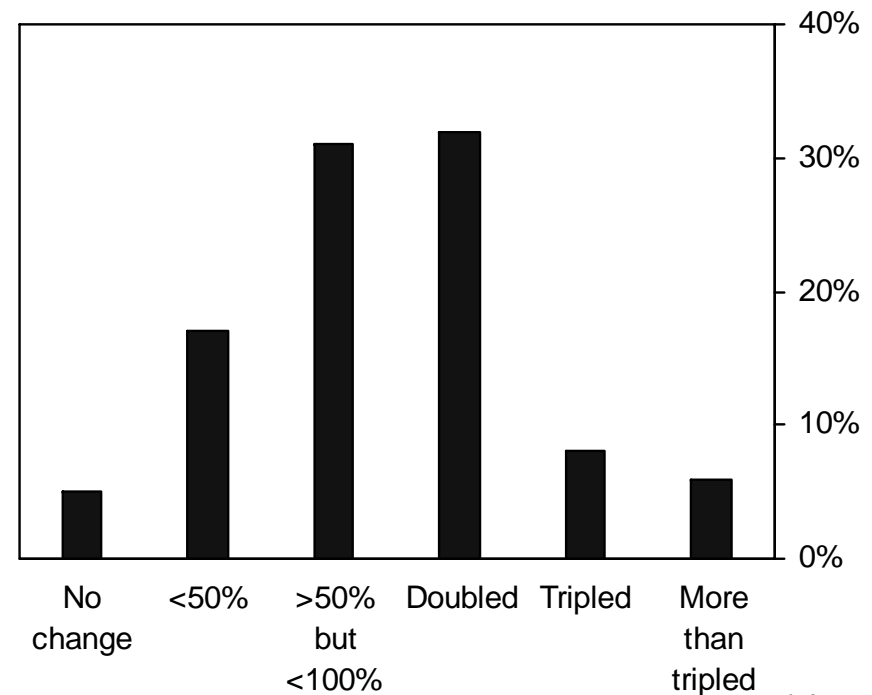
# D&O compensation and insurance is also on the rise

- 36% of respondents have seen at least a 25% jump in compensation for outside directors as a result of Sarbanes-Oxley.
- D&O insurance has at least doubled for 46% of respondents as a result of Sarbanes-Oxley.

*"How much, if at all, has compensation for outside directors increased since SOX was instituted?" (n=99)*



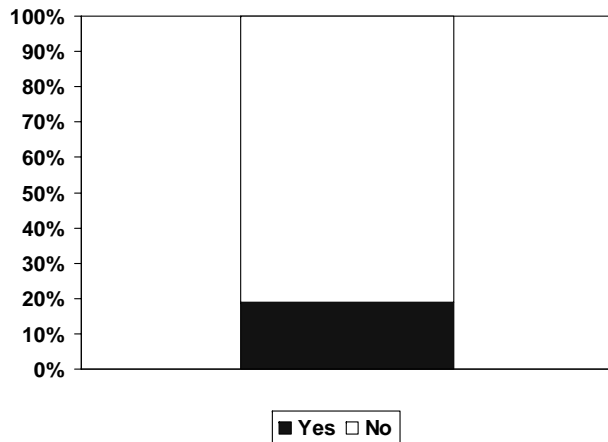
*"How much, if at all, has D&O (directors and officers) insurance increased since SOX was instituted?" (n=93)*



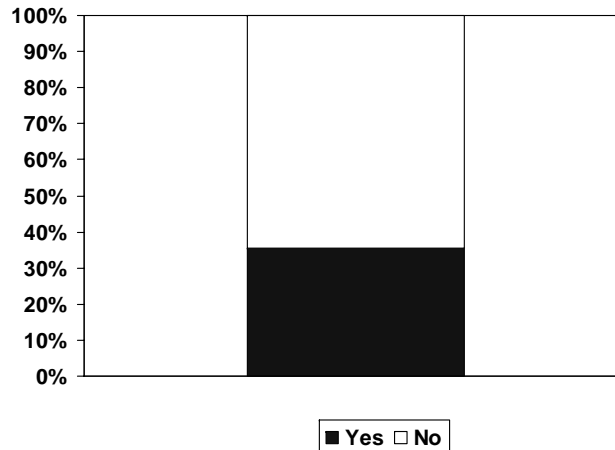
# Does Sarbanes-Oxley limit exit opportunities?

- Sarbanes-Oxley compliance has prohibited a portfolio company exit for 19% of respondents.
- A larger percentage of respondents, 36%, said that the time and cost of Sarbanes-Oxley has kept at least one of their portfolio companies from choosing to file for an IPO.
- 18% of respondents said that they have considered taking a portfolio company private because of Sarbanes-Oxley.

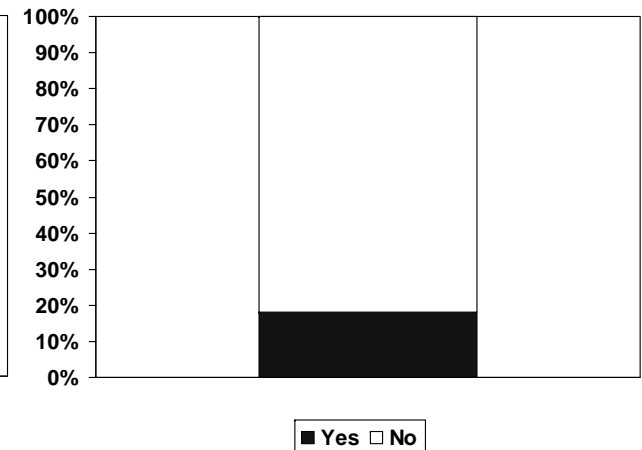
*"Has a lack of Sarbanes-Oxley compliance in any of your portfolio companies affected your ability to exit the investment?" (n=110)*



*"Has the time and cost involved in implementing Sarbanes-Oxley measures kept at least one of your portfolio companies from choosing to file for an IPO?" (n=107)*



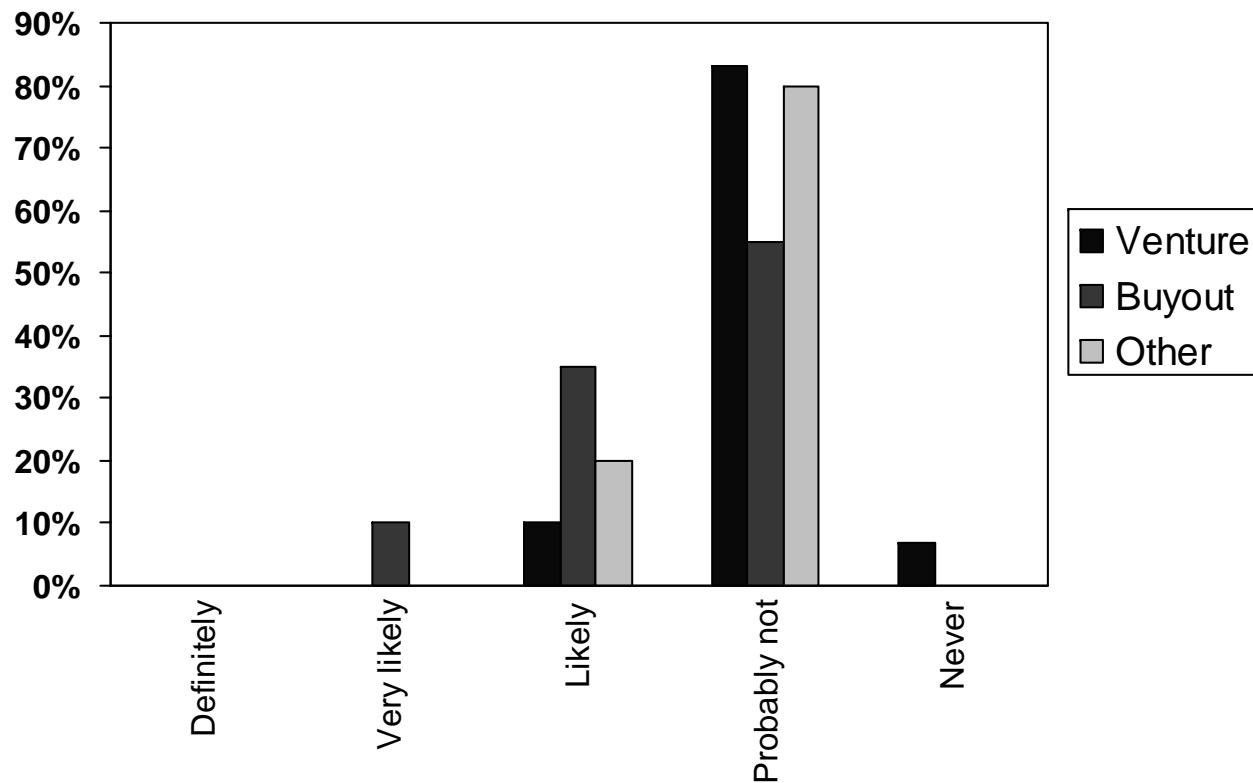
*"As a result of Sarbanes-Oxley, have you considered taking private any of your public portfolio companies?" (n=105)*



# Income trusts (income deposit securities)

- Buyout respondents are more confident than venture respondents that IDSs will become a valid exit vehicle.

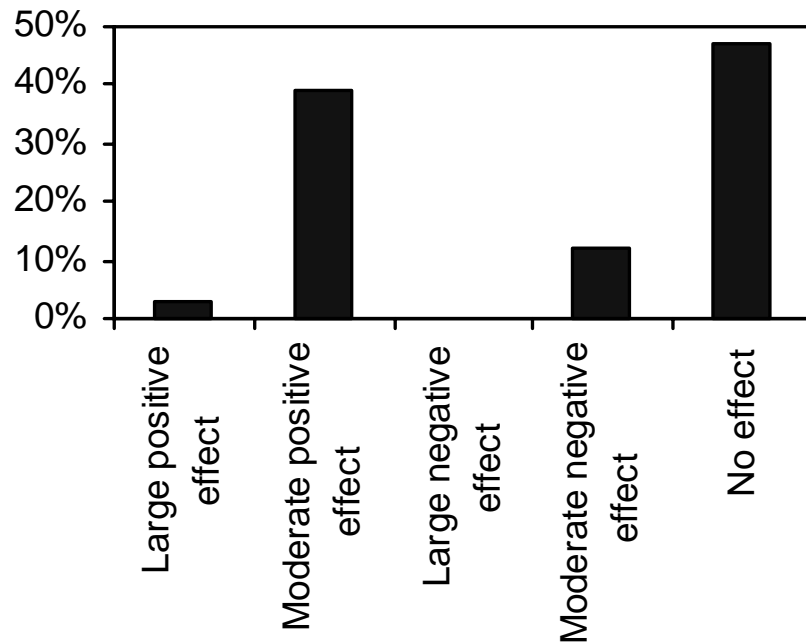
*"What is the probability that income trusts will become an alternative exit strategy to IPOs?" (n=95)*



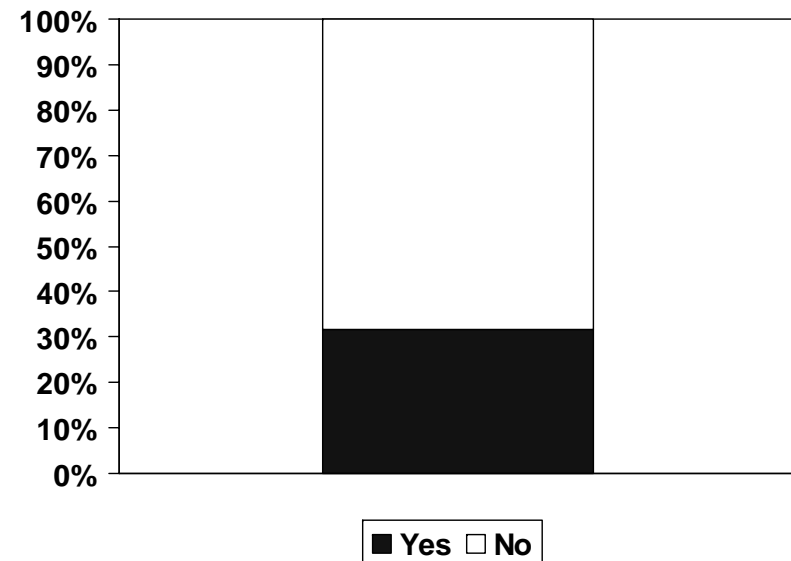
# Dutch auctions

- 39% of respondents believed that the Google IPO had a moderately positive effect on the acceptance of Dutch auctions as a viable IPO process.
- 32% of respondents said they would consider a Dutch auction for one of their portfolio companies, evidence of increasing market acceptance for this strategy.

*"Describe the effect of the Google IPO on the market's acceptance of Dutch auctions?" (n=109)*



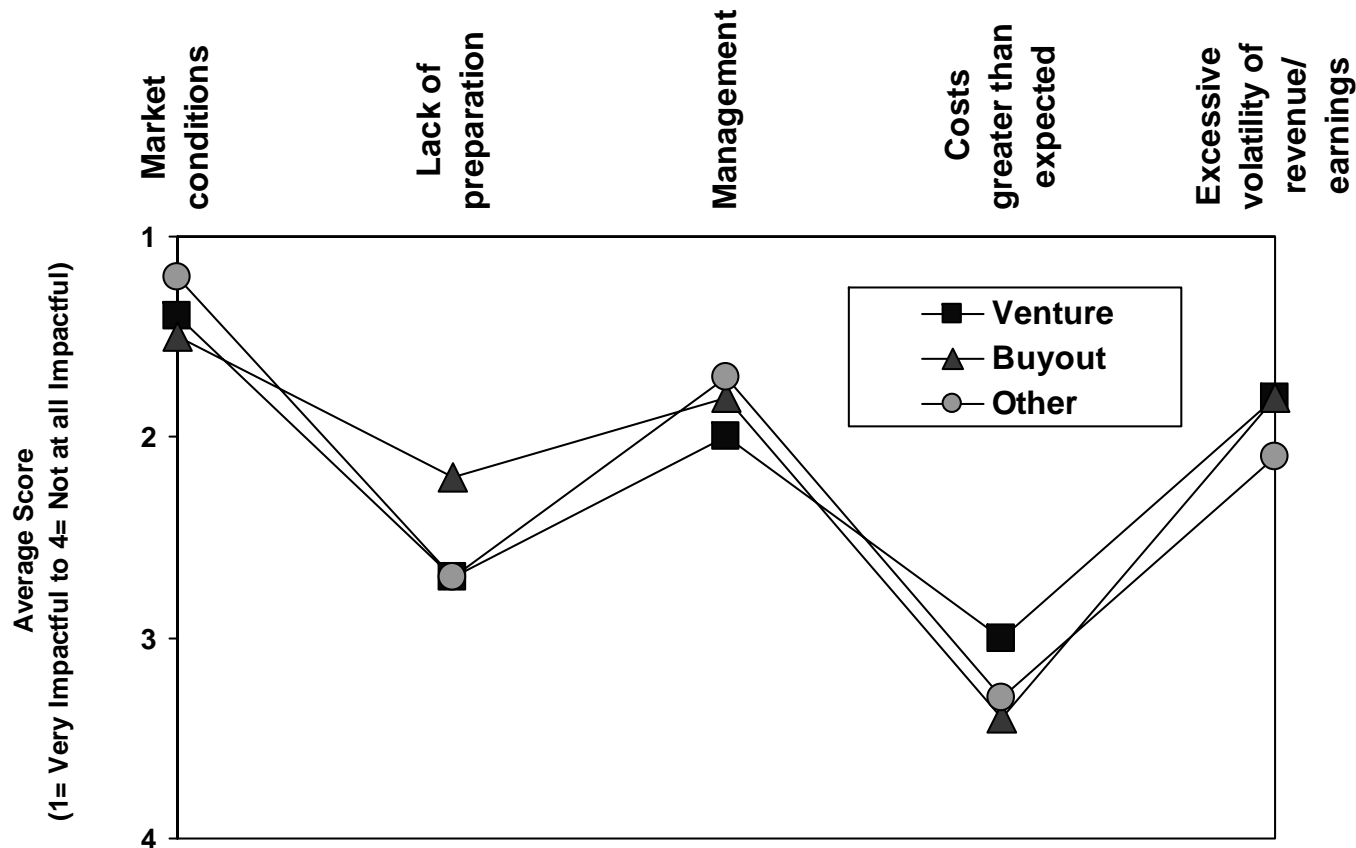
*"Would you consider a Dutch auction IPO for one of your portfolio companies?" (n=111)*



# Unsuccessful exit strategies

- Market conditions have the most impact on hindering the success of an exit strategy, followed closely by management behavior and excessive volatility in revenues/earnings.

*“What are the top reasons a company fails to complete a successful exit strategy? Please rank the impact of each item.”*



# Incentive compensation alternatives

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- Given recent accounting guidelines requiring the expensing of stock options, respondents listed some of the methods they are using to incentivize their portfolio company executives.
  - 1) *Cash bonuses*
  - 2) *Restricted stock*
  - 3) *No change – options still granted*
  - 4) *Stock grants*
  - 5) *Stock Appreciation Rights (SARs)*
  - 6) *Performance vesting*
  - 7) *Loans*
  - 8) *Narrow the pool of eligible employees for stock options*

# About the Center for Private Equity and Entrepreneurship

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The Center for Private Equity and Entrepreneurship aims to produce practical and insightful global private equity and entrepreneurship research and education. The Center is a trusted independent source of information on best practices and trends in private equity and entrepreneurship. It covers both macro and micro issues relating to private equity in areas such as capital markets, financing structures, governance and entrepreneurship. The Center is actively involved in the practitioner communities of private equity and entrepreneurship, both to gain information about current trends and challenges and to share insights and solutions. The Center interacts with institutional investors, venture capitalists, buy-out investors, corporate venturers, angel investors, entrepreneurs, portfolio companies, industry lawyers and accountants, industry associations, and the media.

A thought leader in the field of private equity, the Center's work is represented in prestigious publications and industry conferences. The Center is a regular contributor to the *Venture Capital Journal*, the leading industry magazine, and its directors are sought out as authorities by top business publications, such as *The Wall Street Journal* and leading television media such as *CNBC*. The Center seeks to educate Tuck students in private equity investing and entrepreneurial management through such courses as Private Equity Finance, Advanced Entrepreneurship, Field Studies in Private Equity and through supporting internships, fellowships and independent studies.

For additional information on the Center for Private Equity and Entrepreneurship please visit: <http://mba.tuck.dartmouth.edu/pecenter/>

# Acknowledgements

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