Knowing When to Sell

Every startup begins with aspirations of being “the next” Google or Facebook or Amazon. This unbridled optimism is what drives an entrepreneur. Each new technology market has new success stories, and drives future entrepreneurs to chase after their dreams. However, the reality is that not every startup can “win” their market. With each new technology market, billions of potential entrepreneurs exist around the world as potential competitors.

As an entrepreneur, there is no reason to be ashamed if your startup doesn’t win the market. Every successful entrepreneur will admit that luck and good fortune play a significant role in deciding the winner. In fact, many successful entrepreneurs in a technology market are the startups that got out early, and avoided a devastating market crash or a market that never materialized.

To preserve their hard work and to protect employees and investors, entrepreneurs need to know when to turn the unbridled optimism into sober realism. They need to know when it is time to sell. At different points in a startup’s lifecycle, the management team needs assess the market and to acknowledge that the best strategy is to sell the company. Selling at the right time is the best way to preserve value.

Conversely, missing the right exit window will destroy a company’s valuation. In each new technology market lifecycle, numerous exit windows exist. A startup’s relative success and competitive positioning may dictate selling early. The competition may have clear (and potentially insurmountable) advantages early in the race, such as funding, key partnerships, technology advantageous or other related advantages. If you miss your right exit window, your valuation will suffer.

To illustrate the different exit windows in a market lifecycle, Gartner’s hype cycle is a good proxy for understanding the market dynamics.

- Most startups are created and funded during the climb toward inflated expectations. Startups can achieve increased valuations by selling near the Peak of Inflated Expectations where established companies pay increased valuation to ensure that they don’t miss the next big thing. In this phase, valuations usually aren’t based on financial metrics, but some other metric is used to justify the valuation. For example, Twitch valuation discussion centered around having 55 million unique visitors, and AlchemyAPI’s valuation discussion centered around having 40 thousand developers.
- Many startups crash in the Trough of Disillusionment as they run out of cash. The forced exit during this time period hurts valuation; however, if the company has some interesting technology or other assets, the startup can obtain a reasonable exit for the employees and investors. The investors may lose some value, but angel investors will appreciate receiving some of their money back, and the founders usually find value in having an exit on their resume.
- During the Slope of Enlightenment, valuations begin to rise again. The remaining startups survived the downturn and presumably have customers and revenue. As more conservative incumbent companies recognize the new market’s threat and opportunity, they make acquisitions based on traditional financial metrics, such as multiple of revenue or earnings.
- After entering the Plateau of Productivity, the hype is over and the clear winners begin to emerge. The winners’ growth begins matching or exceeding the overall market growth. Other startups begin to falter, although they may still be growing and profitable. The winners begin planning to go pubic. Currently, in the Hadoop

ecosystem, companies like Cloudera, Hortonworks and MapR are emerging as the clear winners, even as they jockey for position to become the overall winner of the market. The valuation for the other startups begin to falter as their optimism and promise begin to falter.

- On the other side of the Plateau of Productivity, the story doesn't end. The market dynamics will determine if there is one clear startup winner (such Cisco, Google, Microsoft in their day), if the market fractures (the ERP market in the early 2000's), or if the startups are crushed by bigger players via innovation or acquisition earlier in the cycle (Microsoft Office in its day). At this stage, unless your company is a clear winner, your valuation is based purely on performance without any premium for a promising future. Usually, private equity firms and opportunistic companies are aggressive in driving down valuations, as they execute on consolidation of the remaining industry.

On the other side of the Plateau of Productivity, one huge danger for entrepreneurs and investors is becoming a "lifestyle business". Startups can remain with limited/no growth but sufficient profitability to say alive. This lifestyle business gives the entrepreneur a comfy lifestyle; however, it destroys value for the investors and employees as the startup becomes less valuable over time. The entrepreneur fears giving up the prestigious and comfortable lifestyle (CEO of a startup always sounds good at parties). In reality, the entrepreneur fails to see that this lifestyle business is bad for the entrepreneur as they spend years not doing much except for managing a non-growing business. If an entrepreneur sits too long in a stagnant company, it is hard to find their next job commensurate with their existing position. The entrepreneur can take a huge step back in their career when the startup eventually ends. The entrepreneur needs to recognize the situation, and to avoid the trap of a lifestyle business.

For an entrepreneur, there are numerous decision points for deciding if it is the right time to sell. The CEO and management team need to continually assess the market cycle, the likely market structure, the likely market outcome, their position in the market, their competitors position in the market, and numerous other factors. Most entrepreneurs lack the structural knowledge, experience and objectivity to make this ongoing assessment. More importantly, entrepreneurs can’t spend their days thinking about their exit strategy; instead, they need to focus on execution and becoming one of the winners. However, if they don’t have someone monitoring the optimal exit time, they will miss the optimal time to sell.