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Entrepreneurship: how to design growth and exit strategy

Abstract: This paper is based on a case study of an entrepreneurial start-up firm designing its growth and exit strategy. The paper discusses the wealth creation challenge a company faces once it has successfully opened shop. Specifically, the paper describes an entrepreneur's analysis of advantages and disadvantages of different growth models: organic, franchise, acquisition; it also discusses how to prioritize growth opportunities. Additionally, the paper analyses the application of financial modelling and valuation methods to entrepreneurial businesses. Finally, the authors explore issues and options the entrepreneur could consider when designing an exit strategy.

Keywords: entrepreneurship, valuation, growth strategy, exit strategy, wealth creation and capture, financial modelling, multiples.

JEL codes: L21, L25, M10, M13.

1. Introduction

There were approximately 24.1 million businesses in the US in 2003. (Donahue, 2003). About 95.5% of them are small "mom and pop" type businesses (defined as companies with revenues under \$1 million). These entrepreneurs' objective is to achieve a middle class income and lifestyle. A small minority of entrepreneurs is involved in high-growth businesses. These entrepreneurs' objective is significant wealth creation. There are 313 billionaires and about 8.2 million millionaires in the US (Sahadi, 2004). It is estimated that 80% of both groups originated as either entrepreneurs or were associated with entrepreneurial activity (Armstrong, Newcomb, 2004).

These figures may be misleading at first sight: is entrepreneurship such an easy way to make money? Yet, only one out of ten entrepreneurial start-ups is profitable three to five years down the road and the average entrepreneur will fail about three times before achieving success. (Rogers, 2005).

Such statistics on entrepreneurship in the United States inevitably pose questions. How can an entrepreneurial start-up grow to a multi-million-dollar turnover firm? What distinguishes high-growth, high-aspiration entrepreneurs from the average mom-and-pop shop? Is there a proven way against entrepreneurship failure?

We attempt to address these questions through the study of an entrepreneurial firm that designs its growth and exit strategy. The idea for the paper was born out of our consulting work for an entrepreneur, a fresh US business school graduate. He started up his firm while still in university, in the basement of his apartment building. Within a year, he expanded his business to multiple locations in the US and was about to raise funds from external investors exceeding \$1 million. Thus, the paper could be helpful as a “road map” for entrepreneurs who have just opened shop and think about growing the business and soliciting financing.

The paper has the following structure. We first discuss how an entrepreneur could think about growth. Is organic or acquisition expansion the best way ahead? How should an entrepreneur select opportunities for growth? Second, we provide a framework for financial valuation of the company. The question to address is: “How much is the company worth?” Valuation of the business “as is” and projecting future valuation, once growth prospects are included, play a role here. Finally, we discuss the exit options for the entrepreneur to reap the benefits of successful company growth.

2. Growth model

When designing a strategy for growth, the entrepreneur will typically face two types of critical issues – how to expand the business to new customers, geographies or product segments (the “growth” question)¹ and how to finance the growth of the company (the “funding” question).

2.1. Appropriate growth model

The entrepreneur who wants to grow the business into new geographies, new products or serve new customers will need to select an appropriate growth model. Based on our case study we believe there are three broad options: organic growth, franchising and acquisition. Each has its advantages and disadvantages. An entrepreneur needs to weigh the growth models depending on the industry, the availability of funds, and the state of the competition, among others (Figure 1).

¹ To design an effective growth strategy, an entrepreneur needs to leverage and understand own business assets. The assets cover own value proposition, understanding of the competitive landscape and company strengths and weaknesses.

The **organic** growth model is the most “fluent” transition from the start-up phase to a multiple-location / multiple-product firm. The entrepreneur will typically invest in new assets (e.g. open a new office in another town) “from scratch”, will establish their own management teams, and will instil own business practices, reporting and monitoring of activities. Provided external funding is available, the entrepreneur’s independence will be intact – the owner will ensure that new markets / clients are served in a manner that reflects the core competencies of the firm. This model will be suitable for businesses that require intensive customer service and provide value by knowing and thoroughly meeting specialized customer needs; or for businesses that serve highly-specialized niche markets (e.g. some service sectors, such as consulting, real estate, private equity). On the downside, the organic growth model will rarely allow super-fast growth – expansion will be limited by the capacity of the firm to raise funds, open up new locations, instil processes and management practice, and monitor performance.

The **franchising** model provides another growth option. The entrepreneur may funnel existing firms (independent of the entrepreneur’s business) that will operate as franchisees². Thus, the entrepreneur will share the risk of business expansion with another entity and will minimize both potential losses and capital needs. On the other hand, however, the entrepreneur (the franchisor) gives up a portion of the profit pie to an external company; and will be unable to keep track of the business in the same fashion as with organic growth. Furthermore, the franchising model may be unattractive to the franchisee – especially if the entrepreneur is a small firm with a brand that has no recognition among customers. In that case, the entrepreneur will need to give up even more of the company value to attract franchisees. This model may be suitable for firms in industries that offer a standardized product, where customer service processes are straightforward and monitoring is easy to perform.

The **acquisition** model allows rapid expansion. The entrepreneur may be able to capture significant market share by acquiring another company already on the market. The acquired company may possess valuable assets, such as customers, know-how, or presence in strategic locations. Yet, as shown in Figure 1, such an acquisition will likely require capital that the entrepreneur will find difficult to raise. Furthermore, the acquired company may not match fully the core competencies of the acquirer’s business. The entrepreneur will be dependent on the business culture and skills of the staff in the acquired company, and will need to ensure that management understands the company objectives and follows the strategic plan set ahead.

² The franchisee will run as an independent entity with its own balance sheet and profit and loss statement (P&L), using the entrepreneur’s brand and paying a franchising fee (plus some profit sharing) to the entrepreneur’s company; the latter will usually have strict requirements as to how the business should be run and customers served.

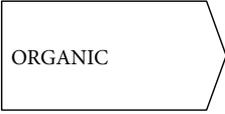
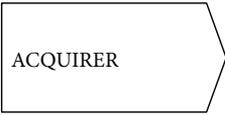
Model	Pros	Cons
 ORGANIC	<ul style="list-style-type: none"> • Medium capital requirements • High independence • Core competence 	<ul style="list-style-type: none"> • Slower growth
 FRANCHISOR	<ul style="list-style-type: none"> • Low capital requirements • Lower risk of expansion 	<ul style="list-style-type: none"> • Low value proposition for the franchisee (maybe higher with a more established brand) • Upside growth potential shared with another party • Lack of full control on business
 ACQUIRER	<ul style="list-style-type: none"> • Rapid expansion • Business consolidation 	<ul style="list-style-type: none"> • High capital requirements • Absence of similar players in the market • Low independence • Different skill set

Figure 1. Growth models

2.2. Growth phases

Independent of which growth model is chosen, the entrepreneur needs to formulate an overall strategic plan for several years, with intermediate goals against which performance can be measured. Oftentimes, as in our case study, it is helpful to view the growth of the company in stages, and set up objectives and benchmarks for every stage. For example, a company may wish to get established on the market in a single location / for a single product offering (Phase 1) before expanding to other geographies, products or customers (Figure 2). Clearly, such a plan will depend on the entrepreneur’s view of where to steer the company to; it will also depend on the selected growth model, financial resources and, most importantly, the changing needs of the customers and the value proposition of the firm. Yet, the phases of growth shown in Figure 2 will help to anchor the entrepreneur’s aspirations for the business and will serve as a measurable reality check of how the company performs.

2.3. Prioritization of opportunities

For any growing business there may be endless opportunities on the horizon. Wise entrepreneurs will choose only a limited number of opportunities to focus on. Prioritization of opportunities is a very important exercise: it will tell the entrepre-

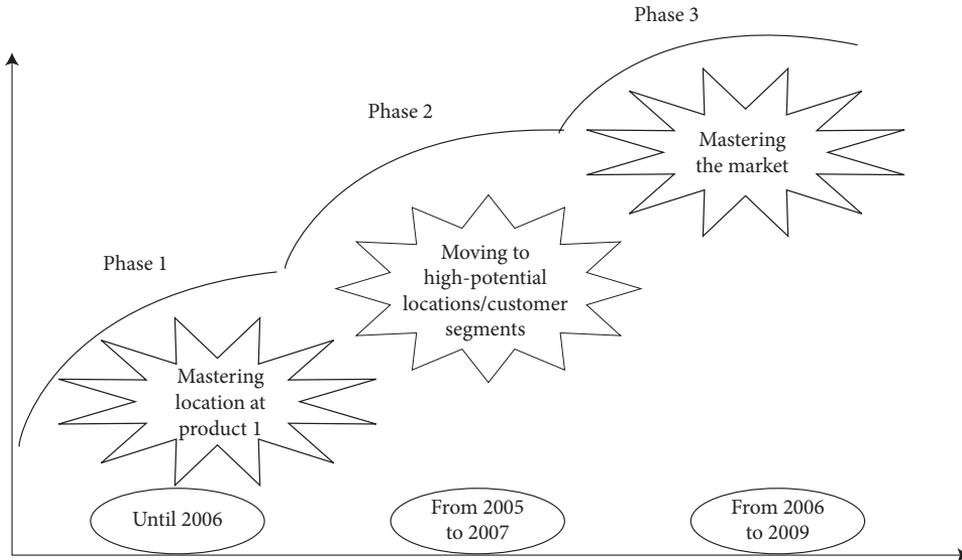


Figure 2. Strategic organic expansion plan

neur where to employ his limited resources (management skills, time, and funds). The opportunity analysis can be conducted in a very sophisticated manner. However, given the size of the enterprise to start with, we chose a simple size vs. ease analysis. The analysis puts all identified opportunities on a map where the size of the opportunity is placed on the x-axis and the ease of implementation or entry is on the y-axis. The “size” of the opportunity would typically be defined as the dollars of profit available in a given market. If the business has fairly constant gross margins potential revenue could be used instead (Figure 3). A bottom-up analysis cross-checked against a top-down view of market revenues or profits is the most appropriate way of calculating the opportunity potential. All opportunity size drivers need to be identified and modelled to see how they affect market potential.

As shown in Figure 3, basic research and experiential guesses can be used to calculate potential opportunity size “bottom-up”. The acquired result needs to be confronted with top-down comparables of how competitors or firms in related markets perform. The estimation goal of opportunity sizing is to group opportunities into high, medium and low potential buckets (Cesar *et al*, 2005).

The ease of implementation or the entry dimension is defined by identifying characteristics vital for a given industry (Figure 4). For example, these can include regulatory or cultural features, proximity or managerial hurdles to entering or capturing the opportunity. Once relevant criteria are identified a qualitative analysis is needed to classify entry or implementation as easy, medium or difficult. Ease of

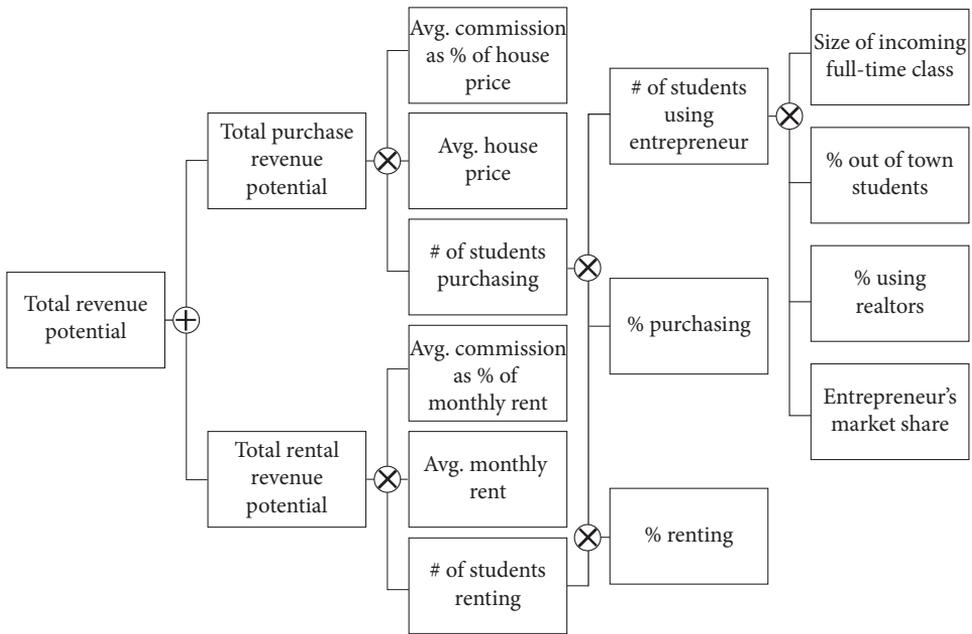


Figure 3. Opportunity size bottom-up calculation – real estate industry example

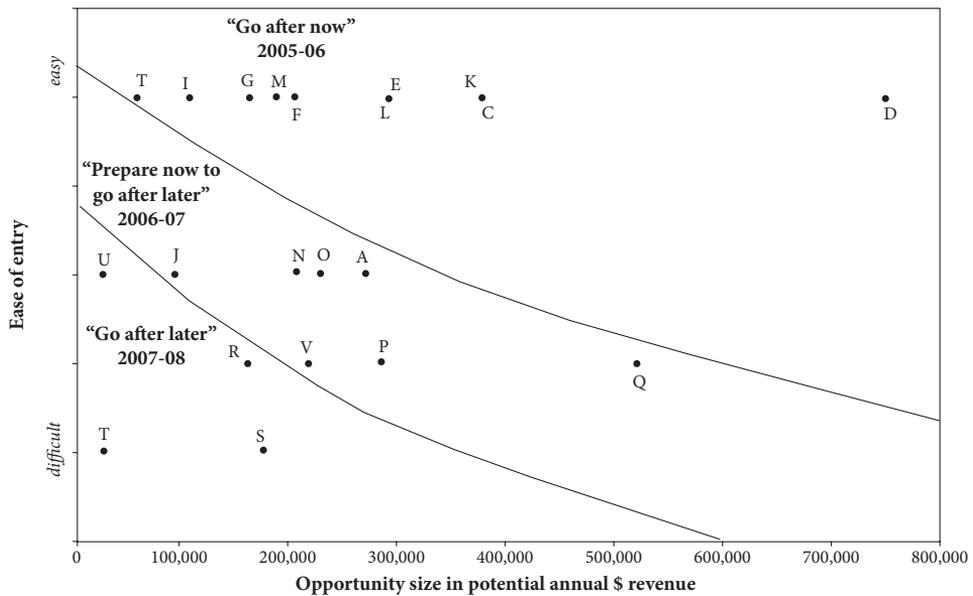


Figure 4. Opportunity prioritization – size/ease map example

entry has a flip side as well. Markets more difficult to enter may provide a competitive advantage and be more profitable in the long term. As presented on Figure 4, once all opportunities are mapped opportunities of the largest size and easiest implementation are typically chosen as the first to go after.

2.4. Funding question

A start-up company may launch operations with limited funds, typically out of the owners' pockets or from family members and / or personal contacts. In our case study, following an initial success using own funds, the entrepreneur faced a question of how to fund the growth beyond what personal or family funds can provide for.

Equity or debt financing (or hybrids of the two) could be the principal sources of capital once personal funds become insufficient. The company needs funds for both operations (working capital) and investment (fixed assets) needs. Some industries are characterized by strong seasonal fluctuations in their operating capital needs³. The rate of company growth further depends on the availability of investment funds – the entrepreneur will need to adjust asset acquisition plans given the amount of funds generated internally or attracted from external investors. Finally, the funding decision is tightly linked to the independence of the company. While the entrepreneur might prefer debt financing in the early growth stage⁴, bank loans will be difficult to procure⁵. Instead equity holders will get a share in the company, and will thus be entitled to a portion of future profits – the entrepreneur gives up some of the upside growth potential. Thus, the entrepreneur needs to weigh the pros and cons of different sources of funds – accounting not only for the cost of capital but also for the involvement of external investors in the activities of the firm.

3. Financial analysis

3.1. Principles of financial modelling

Financial analysis of the business is an on-going task in any enterprise. Yet, such analysis becomes a must when the entrepreneur explores his / her exit options. To

³ For example, there may be a gap between the amount of accounts receivable and accounts payable throughout the year (e.g. when a company pays its suppliers in the summer but only receives payments from its customers in the fall).

⁴ Bank lending will typically be cheaper than private equity funding; and bank officers will rarely be engaged in the day – to – day activities of the firm.

⁵ A young entrepreneurial firm, with no track record, may need to settle for private equity funding.

know how much they can cash in from selling the whole or a portion of their business, entrepreneurs should know how much the business is worth. Also, whenever an entrepreneur seeks any type of intermediate financing of the business, valuation of the company is important. This is the objective of financial modelling. Based on the current performance and financials of the company, and the prospects for the future, the entrepreneur can make assumptions on how revenues, expenses, assets and investments will grow. Based on these assumptions, future profits and growth can be estimated. These estimates then become inputs to the company valuation – setting the price for the entrepreneur’s business.

Several principles should be observed in financial modelling so that financial forecasts and company valuation are consistent and yield reasonable results. First of all, the entrepreneur should model all three “pillar” statements of the company’s finances – the balance sheet, the profit-and-loss statement (P&L) and the cash flow statement. Modelling the three simultaneously is indeed important. For example, the balance sheet will not “balance” out (that is, assets will not equal liabilities) if the profit line is not consistent with the projected profit in the P&L; and future investments will appear in the cash flow statement, but will also determine net assets in the balance sheet.

Secondly, financial modelling can follow a “bottom-up” or a “top-down” approach. Bottom-up, the entrepreneur should forecast all key drivers of revenues, costs, investments, depreciation, as well as their growth rates, at a great level of detail; and the pro-forma balance sheet, P&L and cash-flow statement will be the aggregated result of these drivers’ projections. Alternatively, the entrepreneur could forecast only the major lines of the business (e.g. a top-down statement of future revenues would read: “my revenues will grow by 7% over the next 5 years”); and base the company valuation on his / her general understanding of how revenues, costs and investments will grow. Ideally, a thorough corporate valuation should employ both approaches. While the bottom-up method ensures that the entrepreneur has thought through the details of what drives the business forward, he may tend to lose the “big picture” of how top-line revenues or costs have grown, and even more importantly, how they may grow in the future. This is what the top-down method does – it gives a safety check that the big picture of the business makes sense, without exploring the details behind the key business drivers.

Third, any sensible financial forecast should include a horizon that is long enough to capture future growth, and short enough to avoid the excessive uncertainty of long-term planning. Usually, financial projections extend over five years.

Fourth, solid financial analysis always employs scenario-based forecasts. As a minimum, three different scenarios (e.g. base-case, worst-case and best-case) need to be included. Different scenarios not only add credibility to the company valuation (when examined by external parties); they also show that the entrepreneur knows the business and can think of what can go wrong (or for that matter, right) with the company (Rogers, 2003).

Fifth, financial projections can be real or nominal. Real forecasts exclude the impact of inflation and only look at the “real” growth of the business (i.e. by how much revenues have grown, excluding the impact of inflation in the prices of the goods or services that the company sells). Nominal forecasts, on the contrary, do not exclude inflation from revenue / expense growth. An important caveat is the consistency of financial forecasts – the entrepreneur needs to follow the same method throughout all models in order to end up with consistent projections.

Finally, any attempt at financial modelling relies on making assumptions. Assumptions are needed for several reasons. For one, the entrepreneur may lack data that can only be found through private sources of information (e.g. market shares of key non-public competitors, or customer segment penetration figures). For another, the entrepreneur has to project future revenues, costs and investments; and any projection for the future is somewhat arbitrary and subject to assumptions. Yet, making assumptions is not random number generation. Solid assumptions rely as much as possible on factual information – information from public sources or research companies, historical data (especially if one believes that the future growth of an industry would not be radically different from the past), or data from other industries (e.g. if the developments in the sector under analysis will likely resemble other industries that one can observe). Also, good assumptions tend to build consensus. In other words, they will unlikely be discarded by different industry experts as unreasonable or extreme; there will be general agreement that they “make sense”. That said, making assumptions is usually a chore that requires several rounds of iteration and a thorough “think-through” process with numerous revisits of key hypotheses.

3.2. Valuation models

Discussions of numerous valuation methods are abundant in the corporate finance literature⁶. Here we review three models that are widely used in financial valuation and especially suited to small and medium-sized firms; these are the models we employed in our case study.

3.2.1. Discounted cash flow (DCF) analysis

This method has traditionally received strong backing by the academic community and is more and more used by practitioners. While few experts question its theoretical underpinnings, it poses several challenges to its practical application.

This method has the following mechanics. First, the entrepreneur will forecast his balance sheet, P&L and cash flows over the projection horizon (e.g. 5 years). Then,

⁶ For a complete review of basic valuation methods, including their practical application, see *Valuation – Measuring and managing the Value of Companies* – 3rd edition by McKinsey & Company.

he will discount the free cash flows (the money at the disposal of shareholders) for each of the five years by an appropriate discount rate. Finally, he will come up with a terminal value of the business (e.g. the value from year 6 until infinity), discount this value back to present terms and sum it up together with the discounted values for each of the first 5 years. Certainly, this method is a solid reflection of the basic principles of finance: it is the future growth and cash flows that matter, not the present; and future cash flows need to be discounted by an appropriate discount factor. The difficulty of applying this method lies precisely in where its strengths are. In order to come up with reasonable projections of future cash flows, the entrepreneur needs to have a strong vision and solid assumptions of where the company is headed to. Even more importantly, estimating the *appropriate* discount rate will likely be a burdensome task. The discount rate will typically depend on factors such as the riskiness of the business, the nature of the company (public versus private), the liberalization of the financial markets and the availability of funds, and the diversification of the company stockholders. Finally, our case study exacerbated another weakness of the model: the entrepreneurial firm we had examined was in business for a little longer than a year. This posed several issues to DCF modelling. On the one hand, data on past performance was very “thin”, not allowing strong assumptions based on historical trends. On the other, the scope of the business was changing so fast that the structure of costs and revenues would look dramatically different in the future; and thus difficult to forecast. That said, the DCF method has its virtues and despite the challenges in its practical application will bring insights into company growth forecasts.

3.2.2. Valuation by multiples

This method implies that the price of a company can be determined as a multiple of its profit or revenues⁷ (e.g.). The multiples most widely used are price to net income (P/E), price to EBITDA⁸ (P/EBITDA) or price to sales (P/S). Yet, the range of multiples is virtually limitless – different industries may apply specific multiples pertinent to sectors or lines of business (e.g. price per square meter in real estate, or price per barrel for the valuation of oil storages). To employ this method, the entrepreneur needs to know the valuation by multiples for other *comparable* companies. For instance, if company A, a public competitor of the entrepreneur’s business, trades for \$3.2 million (e.g. each of its 1 million shares trades for \$3.2) and has net income of \$0.4 million, its price is 8 times its net income. The example above shows two of the major weaknesses of this method. First, its application is dependent on the availability of information for other firms in the industry. We can observe the price of publicly traded firms directly from the stock market and infer their multiples; the task however becomes much more difficult for industries where the ma-

⁷ One may hear that a company is worth “seven times its net income”.

⁸ Earnings before interest taxes, depreciation and amortization.

majority of firms are *not* public. Second and more important, the firms we pick up for estimating multiples need to be *comparable*. Does a firm operate in the same lines of business? Is it part of a larger industrial conglomerate? Does it serve the same markets or is much more (or less) global? Does it get its supplies at market prices or is it large enough to exercise control over its suppliers? In short, it is oftentimes difficult to find a true comparable firm to the one under analysis; and reasonable approximations do need apply⁹.

Many entrepreneurs and venture capitalists use rule-of-thumb valuations by multiples that give them a “quick and dirty” idea of how much a company may be worth, especially if data on comparable companies is absent (or no close comparables exist). For instance, price-to-sales ratios of 0.7 – 1.0 and price-to-EBITDA ratios of 3.0 to 5.0 often yield valuations close to the transaction price. While these proxies do not eliminate the need of searching for comparable companies and their valuations, they give a decent idea of the range within which the price may fall.

We spent the bulk of time in our case study identifying comparable companies that were as close as possible to the business of the entrepreneur; yet none of them was a perfect comparable. We arrived at valuations differing by a factor of three to five. Thus, valuation by multiples only served as a pad of “what-if” scenarios that we could discuss with the entrepreneur.

3.2.3. *Transaction analysis*

Transaction analysis is very similar to valuation by multiples. The entrepreneur will look into sale-and-purchase transactions of comparable companies and will infer price multiples from the price paid / received in the transaction. For instance, if company A, a competitor of the entrepreneur’s company, was sold for \$ 6.3 million three months ago and had net income of \$ 0.7 million at the time of the sale, its price was 9 times its net income. Again, it is critical that the entrepreneur looks at *comparable* companies for the purpose of transaction analysis. In addition, the more recent the transaction, the more relevant the multiple will be. Old transactions may have taken place at market or general economic conditions that have since changed. Yet, depending on the industry in question, finding *any* comparable transaction may be problematic. Thus, entrepreneurs will need to dig deep in order to employ this otherwise powerful valuation method that investors typically like; eventually, the price paid by others for similar companies is the most compelling benchmark.

We ran all three valuation methods in our case study. This is because no single valuation is the best one and each of the methods discussed above has its virtues and drawbacks. Thus, any entrepreneur who wishes to know the fair value of the business should consider running more than one valuation method. While the results

⁹ Finally the accounting can play tricks here as well. Despite a trend towards common accounting standards companies still account differently for many items resulting in making comparisons the more difficult.

may differ (sometimes even by a factor of 4 or 5), they will help the entrepreneur build a valuation range. Understanding the differences in valuation will then allow room for negotiation with potential investors in the company.

4. Exit strategy

Once a high growth business is able to create value an entrepreneur needs to capture the created value. Therefore, every fast-growing entrepreneur needs to define early on what his or her exit strategy will look like. An exit strategy is defined as a plan for the entrepreneur to capture the value created through their entrepreneurial activity. It is also reasonable to assume that the wealth creation will not be limited to the entrepreneur. In the US, the average start-up goes through seven rounds of financing before going public, making the entrepreneur's equity share relatively low (Rogers, 2003) and letting investors capture most of the value.

4.1. Issues to be addressed in an exit strategy

There are number of issues that need to be addressed in an exit strategy. The entrepreneur in our case study based the exit strategy on his own beliefs about how much value is to be captured, on the timing of the exit; on the level of managerial or ownership control he wished to retain after the exit; and last but not least, on payment options (Cesar *et al*, 2005) (Figure 5).

The value capture level issue is often the most difficult to grasp for an entrepreneur. The precise dollar value is less important, but the fact that a number or a range is set is very helpful. The value capture target should reflect an entrepreneur's aspiration. It could read something like the following: "I intend to capture a value of 10 million dollars in 5 years". This target could then be confronted with value creation expectations based on the selected growth strategy. The value to be captured is also a very important benchmark for potential investors.

The value to capture is directly linked to the issue of exit timing. An entrepreneur could expect a positive correlation between the value to be captured and the number of years of operations until exit. There are two main reasons for this relationship. Firstly, a high-growth business should generate more and more value with every year passing and thus there should be more value to capture later. Secondly, the time value of money means individuals have a preference for less money sooner rather than more money later. In our case study for the purposes of exit strategy definition the entrepreneur was asked to choose a timeframe which best suits his personal preferences; yet there is no need to worry about being overtly exact. Many

entrepreneurs work in 2-3 years (“grow and sell quickly”) or 5-6 years (“grow and sell big”) horizons (Cesar et al, 2005). A preference for a staged exit would also be considered a timing issue.

The level of managerial control is also a key issue. An entrepreneur often has managerial control of the company prior to exit. Most often, the entrepreneur is the chief executive officer of the company (CEO). In an exit strategy the entrepreneur needs to define whether or not to keep managerial control and what level of managerial control is to be retained. There are exit strategies where managerial control is passed immediately to new owners / inventors. On the other hand, depending on the type of business, new owners may be interested in retaining the entrepreneur in a managerial role for a specified time period or even indefinitely.

The level of ownership control is directly related to how final an entrepreneur’s exit is. Ownership control is defined by the share of equity retained in a company after exit. It can range anywhere from zero equity (where an entrepreneur is fully bought out and retains no shares in company) to majority control (where post – exit an entrepreneur still controls a majority of shares). In some circumstances an entrepreneur can retain ownership control even with a minority stake if there is signifi-

Issue	Questions to be discussed
Amount of money	<ul style="list-style-type: none"> • Do the entrepreneurs have an idea on the value to be captured? (also total value vs. entrepreneur’s value)
Timing	<ul style="list-style-type: none"> • When does the entrepreneur want to exit the company? • Is the entrepreneur looking to exit completely at one point in time or over a period of time?
Managerial control	<ul style="list-style-type: none"> • Is the entrepreneur prepared to retain managerial responsibilities? If yes for how long? • Does the entrepreneur want ownership control with a minority stake?
Ownership control	<ul style="list-style-type: none"> • What share of equity is the entrepreneur looking to own after an exit transaction?
Payment options	<ul style="list-style-type: none"> • Is the entrepreneur prepared to take paper (debt) and how much are they willing to take? • Is the entrepreneur looking solely for a cash payment or would other payments be acceptable?

Figure 5. Issues that need to be addressed in exit strategy

cant dispersion of shares among other shareholders (e.g. in the initial public offering scenario); a minority block of shares can retain control through other means¹⁰.

Finally, as discussed in Figure 5, payment options represent an important issue for how an exit is to be performed. In a most simple model, the payment for the company value can be made in cash, debt or equity. Entrepreneurs looking for immediate and full exit will have a preference for an all-cash or mostly-cash payment. An entrepreneur is most likely to be forced to take company debt if new owners want to tie value capture to future company cash flows. Finally, an entrepreneur may be asked to take the acquiring company equity to tie value capture to future value creation of the new combined entity.

4.2. Exit strategy options

There are a number of options for executing an exit strategy. They can be classified into four buckets. The first option for a company to become public is through an initial public offering. This is typically the rarest exit as there are only a total of about 17,000 public companies in the US (Donahue, 2003). The second option is sale to an industry player. This is by far the most common exit strategy for entrepreneurs. Every year hundreds of companies are bought by competitors¹¹. The third option is sale to a financial investor. This option is becoming more and more popular as the private equity industry is growing bigger. Finally, the fourth option is the leverage strategy. Under this strategy, lenders inject a company with cash, which is then used by the entrepreneur to conduct a share buyback. This is a popular partial exit strategy. Each of the exit options has advantages and disadvantages for an entrepreneur (Figure 6).

However distant and scary the prospect of an *IPO* for a start-up, as it was for our case study entrepreneur, one of the clearest advantages of striving for an IPO is that public companies enjoy a premium in valuation over their private counterparts. This premium stems from the fact that investments in public companies, as compared to investments in unlisted firms, are a lot more liquid and the transparency of information regarding a public company lowers the risk premium. In the United States, the average public-over-private company premium is 15 to 25% (MacDonald, 2001). The second big reason for an entrepreneur to set the IPO goal is that it is often possible to retain both management and ownership control of the company after the IPO. Typically, managerial control is retained in most cases as

¹⁰ These could include preferred shares, voting vs. non-voting shares, limits on voting rights etc.

¹¹ Li (2004) estimates, using Security Data Company Merger and Acquisition Database, there have been almost 17,000 acquisitions of privately held targets in the US in the years 1980 to 2003, which is equivalent to about 740 a year. Li excluded in the count certain types of acquisitions, such as spin-offs, recapitalizations, self-tenders, share repurchases, acquisitions of minority stakes and privatizations.

the market bases the company valuation on the ability of the current management to deliver future cash flows. Retaining ownership control is trickier. Obviously, ownership control would be retained if the entrepreneur controls more than 50% of the shares post – IPO. However, with dispersed new ownership, an entrepreneur may still be able to exercise a good deal of ownership control even with a minority stake. Finally, selling shares to the market has the advantage of multiple buyers purchasing company shares. Indeed, it is easier to convince fund managers to hold some of the company shares in their portfolios than to convince a single buyer to take over the whole company.

The benefits of an IPO are not costless. There are many costs associated with taking a firm public and then maintaining its public status. These range from observing regulatory requirements to costs of building credibility to costs of revealing information to competitors. For many small firms the costs of complying with the Securities and Exchange Commission (SEC) requirements in terms of reporting are high. Additional employees may have to be hired and positions created to assure regulatory compliance. Audit costs can also be a significant burden. In the US the costs of maintaining public status have increased substantially in the last few years; in the wake of the Enron and WorldCom scandals additional requirements were imposed by the Sarbanes-Oxley Act. Costs of building credibility may include bringing outside investors in prior to an IPO and thus having to share the IPO gain with such investors. All these costs translate into certain requirements for companies looking to carry out an IPO. In practice, companies have to reach a certain size in terms of revenues and profitability to justify the public status costs. Beyond all the pros and cons listed in Figure 6, an IPO also serves as an excellent aspiration target for an entrepreneur. It is an ambitious undertaking and even if eventually a company does not go public, having an initial IPO goal may help an entrepreneur create more value.

Sale to an industry player would have significant advantages for the entrepreneur in our case study. Specifically, if a start-up serves a niche market that is a strong complimentary business for larger competitors, the latter may be willing to pay a premium to buy out the successful entrepreneur. In many industries, consolidation makes the sale to an industry player the most obvious strategy for an entrepreneur. Typically, the buyer's goal is consolidation of the acquired business, which gives an entrepreneur the opportunity to achieve full ownership exit from the venture. This may be an advantage or disadvantage depending on the entrepreneur's preference. Typically, entrepreneurs prefer to be bought out completely if they lose ownership control. Also, industry players tend to value companies higher than financial buyers do (Gupta, 1996), thereby creating more wealth for the entrepreneur.

There are a number of disadvantages associated with a sale to an industry player. Often, an entrepreneur has to stay on in the company in a managerial position. The entrepreneur's managerial skills are typically a valuable asset for the acquirer. The

duration of the stay may range from a few months to many years. Another drawback is that an entrepreneur will typically be asked to take company debt as part of the payment. In such a way, the acquirer has to put up less cash for the purchase and assures that the entrepreneur will be interested in the company's success post-acquisition. Entrepreneurs may be asked to take as much as 25% of the purchase price in company debt. The debt often takes the form of notes payable by the acquired company to the seller (Sahlman, 1983). The notes typically mature before other financing so they are in effect similar to preferred debt. Finally, the purchase price in a sale to an industry player will typically be lower than in an IPO. The acquirer will want to pay for the current business only and then benefit from an upside from synergies and future growth.

Sale to a financial investor also has advantages for the case study entrepreneur. Financial investors, especially private equity investors, are more and more active in taking over entrepreneurial ventures. Financial investors often have less expertise in the industry so they may be relatively more passive. Therefore, the entrepreneur can sometimes retain a good deal of ownership control after the sale. Possible disadvantages of the sale to a financial investor are very similar to the ones in the sale to an industry player. An entrepreneur has to almost always stay on in the company in a managerial position. The entrepreneur's managerial skills are a very valuable asset for the acquirer. Also, the entrepreneur will typically be asked to take company debt as part of the payment. Finally, the purchase price will also be lower than the

Option	Advantages	Disadvantages
Initial public offering	<ul style="list-style-type: none"> • Opportunity to capture the premium for public companies (15-25%) • Possible to retain control with a small stake • Does not require finding a single large buyer 	<ul style="list-style-type: none"> • Costly to take a firm public and maintain public status • Requires minimum size • Sector may not be well suited for the public market
Sale to industry player	<ul style="list-style-type: none"> • May provide full ownership exit from the firm 	<ul style="list-style-type: none"> • May require staying on at a firm for a while in management position • May require having to take company debt as part of payment • Sale price may be lower than in IPO
Sale to financial investor	<ul style="list-style-type: none"> • Possible to retain ownership control with a small stake 	<ul style="list-style-type: none"> • May require staying on at a firm for a while in management position • May require having to take company debt as part of payment • Sale price may be lower than in sale to industry player
Leverage	<ul style="list-style-type: none"> • Possible to retain full ownership control 	<ul style="list-style-type: none"> • Requires staying on at a firm permanently in management position • Funds transferred to owner may be relatively low (lower than in full exit options)

Figure 6. Exit strategy options

purchase price in an IPO and may even lower than the price when selling to an industry player. The financial acquirer, just like the industry player, will want to pay for the current business only; yet financial investors are typically tougher bargainers than corporate players. The investor's upside will be in future growth.

If an entrepreneur is unable or unwilling to sell the business to new equity holders there is always the option to *leverage* or effectively sell part of the business to new debt holders. Debt is raised by the company with the sole purpose of paying off the entrepreneur (e.g. through share buy-back). The advantages of this approach include the possibility of retaining full ownership control and the relative ease of implementation, especially when compared to an outright sale. The key drawbacks of this strategy are centred on the fact that it is a partial exit only. Therefore, management stays on indefinitely. Another drawback is the fact that funds raised by the entrepreneur may be relatively low. For instance, banks are likely to provide much lower levels of debt financing to a company¹² than the expected purchase price in a company sale (Rogers, 2003).

4.3. What does it take to IPO?

Only very few entrepreneurs end up taking their companies public. Still designing an exit strategy through an IPO is a useful exercise. The IPO goal serves as an aspiration and as a pitch for investors. Determining company's IPO requirements requires an analysis of comparable companies. In our case study we identified and analyzed IPO success stories in the entrepreneur's industry. Such data in the US is easily available due to the public status of comparable companies. Given the minimum size requirement, we needed to identify what are typical revenues, profits and growth rates of companies from this industry that have successfully done an IPO¹³. Finally, we also looked at the age of the companies going public (i.e. how many years it takes to reach the "IPO-ready" size) to determine a realistic time horizon. Successful IPO stories give the entrepreneur, as well as the entrepreneur's consultant, a feel of how much money could be raised and what are the typical post-IPO valuations. For longer-term public market valuations an analysis of key multiples such as price to earnings (P/E), price to EBITDA (P/EBITDA) and price to sales (P/S) is required. P/E and P/S multiples are used as a proxy for determining the enterprise value. P/EBITDA multiple is used to determine the equity value of the company¹⁴ (Figure 7).

¹² In the US banks will often lend up to 3 times EBITDA as compared to 5-6 times EBITDA paid by investors in a sale (Rogers, 2005).

¹³ Sometimes, the exercise is more difficult as finding comparable companies may present a challenge in industries that have few representatives on the public market (e.g. real estate brokerage, consulting).

¹⁴ Since EBITDA excludes debt service, equity value does not include the value going to debt holders.

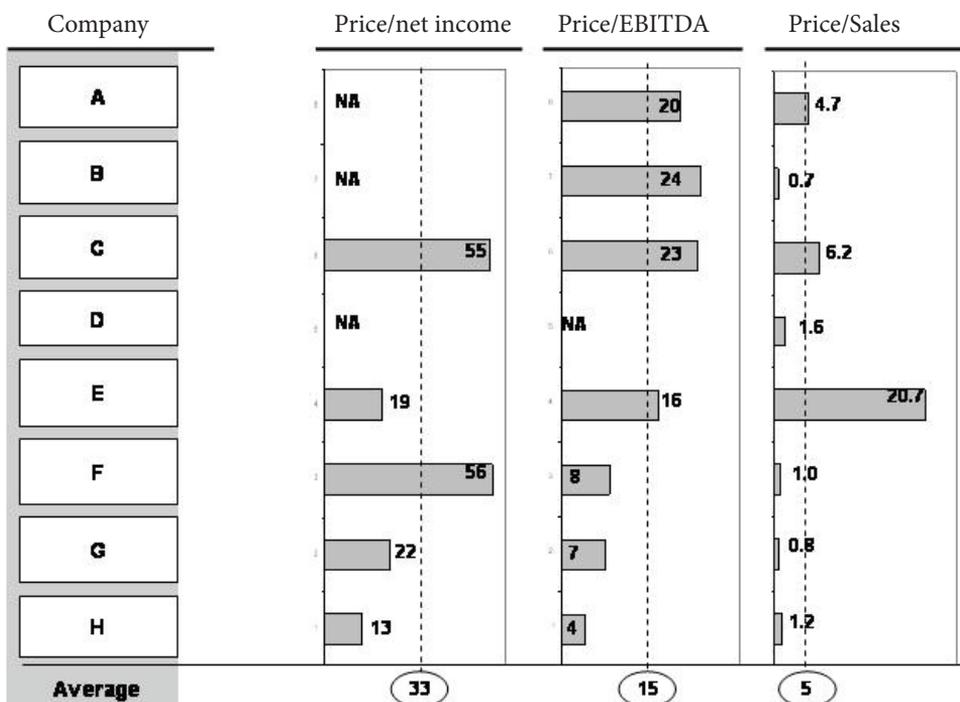


Figure 7. Current industry multiples disguised example

4.4. What does it take to sell to an industry player?

Many entrepreneurs end up exiting by selling to industry players. Again, in our case study we used comparables as the preferred method of assessing such a sale prospect. Specifically, as shown in Figure 7, we looked at previous transaction comparables in terms of sale price relative to key financials at the time of sale. Data on previous transactions may be difficult to obtain especially if purchases are conducted by non-public companies. Such was the situation in our case study. If data on previous transactions is limited one can use as a proxy public market multiples described in the above section. In this case obtained valuations should be discounted by the public market premium. Presumably, listed industry buyers would only pay private market prices and treat the public market premium as part of their upside potential.

5. Conclusion

Every day millions of entrepreneurs around the world create and capture value through their entrepreneurial activities. This paper uses the authors' case study ex-

perience to look at how those successful entrepreneurs could think about further growing and then exiting their business. This discussion could serve as a roadmap for those who are “mom and pop” size now, but have an aspiration to create and capture significant wealth in the future. Additionally, a growth and exit strategy could work well as a fund soliciting presentation to investors, as well as an aspiration setter for the entrepreneur.

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