Insights from

DAVE BERKUS

Flippers vs. Keepers: by Arthur Lipper

from http://www.berkonomics.com

Flippers vs Keepers–At times earnings don't matter

Posted on August 27, 2015 by Dave Berkus

Dave's note: *We are privileged this week to host a post by Arthur Lipper, a well-respected member of the international financial community since 1954. He has served as advisor to and member of numerous financial exchanges, and was the founder and CEO of Arthur Lipper Corporation and co-founder and Chairman of New York & Foreign Securities Corporation. Today he serves as Chairman of British Far East Holdings Ltd. He has written numerous books and articles for entrepreneurs and investors, and was the publisher and editor-in-chief of Venture Magazine. Mr. Lipper addresses the issue of exits, and whether entrepreneurs should take the long view or cash out quickly when the opportunity arises.*

By Arthur Lipper

It used to be that entrepreneurs started businesses as a life's work, a mission. Many thought that they were starting companies for their children and grandchildren to inherit and manage. They sought to recruit associates offering a sharing of the vision resulting in lifetime employment as an incentive for maximum effort and effective collaboration.

They financed their companies, to the extent possible, in a manner minimizing the cost of capital, planning for organic growth in the number of customers served and in associated revenues. As the business owners had a longer-term perspective, decisions were made with greater deliberation and with a more conservative recognition of risk. The businesses frequently were the owner-manager's only major asset.

The role model for many business founders were successful companies such as Microsoft, Cisco, Federal Express, all large companies, conservatively managed and often started and still managed by an individual entrepreneurs, even if later they became public companies.

[Email readers, continue here...] Now, when first meeting with an entrepreneur, I ask simply, *"Is the business being formed as a Keeper or a Flipper?"* Being one or the other is neither good nor bad, but the needs and investment considerations are very different. Keepers are financed differently than Flippers, which are started with a plan to be acquired in a few years, once the value of the technology or business model is demonstrable.

In the case of technology and Internet-related companies, competitive advantage will have only a relatively short lifespan and that therefore the window of opportunity is not infinite.

Flippers financed by venture capitalists are more likely to hire executives having high level profiles and previous exit experience. The Flipper's executives usually have significant equity holdings, either actually owned or reflected in stock options. Therefore, all of the decision makers understand that rapid growth of revenues or customers at the expense of profit is the primary objective in positioning for a good exit early in the game.

In today's world, especially where the Internet or technology is involved, prospective publicly-traded company acquirers sell at significant price/earnings ratios and have large amounts of capital available. They are also very competitive, and highly value the intellectual property of the Flipper. Their "make or buy" decision is heavily impacted by the time required to make and the value of the Flipper's brand. *Creating brand is or should be a major focus for companies in industries where positive and immediate customer prospect recognition results in sales.*

Betting on the traditional public stock market speculator's "greater fool theory" has been just plain wonderful for the owners of the Flippers, as aggressive acquirer's value determinations are based on future events, rather than achieved profitability and present balance sheet values.

Keepers are more likely to be in industries with slower growth rates and lower price/earnings ratios. In other words, those intending to own and manage businesses for longer periods are more conservative and risk adverse. They also tend to have invested more of their own money in their businesses.

What does all of this say about market levels and public attitudes? I believe we are witnessing a shortened attention span by most technology and Internet company managers and controlling shareholders, who tend to be younger, as do those financing and trading in the shares of early stage companies.

When, or perhaps if, there is a downward adjustment in public company valuations, many of the younger players are going to learn some of the lessons the older game players learned in previous downturns – that valuations can revert to the mean or lower as companies mature, or as economies suffer challenges. However, in the meantime the highly publicized transactions of very young companies being acquired for enormous amounts of money will be sirens prompting entrepreneurs to be Flippers, which is fine if they have a chair when the music stops, and if they can find their acquirer before heavy dilution from financing rounds takes its toll on equity value for those early investors.

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Nothing commands a higher multiple than hope!

Posted on August 20, 2015 by Dave Berkus

Dave's note: Guest author, David Steakley returns to explain his theory of exit valuations. It's a short but excellent read…

By David Steakley

You may recall that earlier in this series, I explained the definition of an inciting incident, using the movie industry and its story telling as the model. The inciting incident in a movie is the event at the beginning of the story that causes the hero's life to be completely transformed and irrevocably changed, and makes the whole story unfold.

I thought of this in a recent liquidity event in one of my portfolio companies. The company provides identity theft protection, and took a large round from a private equity firm, which returned about eight times investment in cash to the early angels, and still left them with all their stock in the deal, an outstanding result. The CEO did an

absolutely masterful job in this transaction. The key to this was: *Nothing commands a higher multiple than hope.* The company had done very well, growing revenue rapidly, and demonstrating excellent results in several diverse sales channels. It had refined its offerings to the point where its service was the clear market leader. So with that tail wind behind, let's quickly bring in the freshly minted MBA to calculate the present value of the discounted future cash flows, and cash in!

[Email readers, continue here…] Not so fast. The company had a number of potentially huge, blockbuster deals in progress. No one could say what these deals could be worth, or even whether they would ever be consummated. But, they were clearly mouthwatering. This prospect was what enabled the company to command a multiple of revenue so high that I first thought it had to be a typo. As we often hear, "You don't sell the steak, you sell the sizzle."

When you're selling your company, you have to work hard on your story, and the story doesn't really begin until the inciting incident.

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