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The Unusual Relationship Between Revenue and Valuation Over Time
davidcummings.org

People love to think of a startup's valuation as readily determinable by a valuation expert based on agreed upon financial formulas. In reality, a startup is only worth what an acquirer is willing to pay. This is true because equity in a startup is an illiquid security that is very difficult to turn into cash, especially in a reasonable amount of time. Of course, valuations are set all the time based on things like public market comparables, multiples of profit (a typical company is worth 4-6x profit), combination of growth rate plus revenue, and other factors.

For startups, there's an even a more unusual relationship between revenue and valuation over time as there's no-to-little operating history, no-to-little revenue, and no profits. Here are a few data points over time:

- Month 1 – With a fresh idea and unlimited potential, the startup is actually worth more than when it starts to generate early revenue (e.g. valuation of $2M pre-money for an angel investor)
- $50,000 in annual recurring revenue (ARR) – With a few paying customers and some product / market fit, investors will begin digging into the start of a financial model, and since there's some revenue, will start talking about multiples of revenue or annual run rate (e.g. valuation of $1.5M pre-money even though the company is clearly further along than month one yet the valuation isn't better)
- $1,000,000 in ARR – With the magical seven figures market crossed, a whole new class of investors emerge (many VCs won't invest unless the startup has at least a million in recurring revenue), valuations are discussed as multiples of revenue (e.g. a valuation of $5M pre-money based on 5x run rate)
- $5,000,000 in ARR – With an even more substantial base of revenue, product / market fit clearly in place, and market adoption risk negated, the revenue multiple starts to expand, especially with a high growth rate (e.g. a valuation of $35M pre-money based on 7x run rate)

So, valuation stays flat or even goes down from the initial formation of the company though the first or second year. Then, as revenue starts to grow, valuation grows at an even greater rate and really expands at a few different inflection points. Today, Software-as-a-Service is super hot and the market leaders are often trading at 13x revenue, which isn't sustainable, but is the current state of affairs. Revenues and valuation don't have a straight relationship over time.

What else? What are some other thoughts about the unusual relationship between revenue and valuation over time?

The Corrosive Downside of Acquihires
bothsidesofthetable.com

For the past 5 years or so Google, Facebook and a handful of tech industry giants have been quietly buying scores of early-stage startups for their talent. And to keep up with the Jones's it seems that Yahoo! has now employed the same strategy.

And who cares, right?

A couple of tech giants throw millions around in either cash (for which they have hoards) or part with some publicly traded stock. And a few teams of super talented, educated and bright entrepreneurs make a few mill. in their 20's. What could be more capitalist than that?

It has even gone so far that we now have evocative headlines in the tech press such as "Buy or Die," which is what got me thinking about this post.

We've been here before – trust me. Every era has its own amnesia for M&A gone wild.

In the end, it doesn't really matter. It's not some big tragedy on a grand scale. But the press (and I suspect many of the senior execs of these companies) don't really explore the corrosive downside of these acquisition.

So I thought I would.

Buy. Or Die.

Really?

If I don't commit to millions of dollars of acquisitions I will … die? I'm supposed to believe that my best innovation can only come from scores of startup founders who just made millions and have now become CVOs at my company? (Chief Vesting Officers)?

Meh.

The Aqui-hire Business

Many buying companies price these deals on the basis of $1 million per engineer on the team for an early-stage deal. And they might give a premium if the team has been around a longer period of time, has built some hard-to-build proprietary technology or has some customer traction.

Usually the location of the engineers matters great so having offshore engineering makes acquihires unlikely.

Let's assume an early-stage company around for 2 years with limited traction. It is probably purchased in the $5 – 15 million range even if you see higher numbers in the press.

Almost certainly the startup would have raised some capital. Let's assume $2 million in seed money.

If the money comes from professional investors it usually has a "liquidation preference" meaning that their money comes out before the founders or common stock. (If you don't know venture economics – there is an overview here.)

While at initial glance this sounds unfair, when you think about it – it doesn't. If you give $2 million for 20% of a company ($8 million pre + $2 million investment = $10 million post-money valuation) that has no product and no customers and it turns around 3 months later and sells for $5 million it would hardly be fair for investor to get $1 million back (20% of the proceeds). That's why liquidation preferences exist – downside protection.

After the liquidation preference the founders (probably 1-3 people) are likely to get 90% of the remaining proceeds and the staff – those engineers that the acquiring company so desperately wants – would ordinarily receive a very small proportion.

I talked about the math of this in this post, "Is it Time to Learn or to Earn."

Mark – doesn't the acquiring company mostly care about the super innovative founders? Those 1-3 you're talking about?

If they do then they're naive. And most buyers aren't. Most founders stick around for their lock-up period (1-2 years) before going on to found their next company.

Think about it – they were the ones most willing and most able to take risk in the first place. They founded their last company with no money in their pocket. Now they get to go out and try again with $2 million in their pockets plus the credibility of having just gotten a big W.

Most founders stay the least amount of time they can.

I know the buyers try the best to believe that [insert well known founder name here … David Sacks, Max Levchin, Dennis Crowley, Keith Rabois] will stay and help lead their company in a totally new direction. But evidence suggests otherwise.

So the buying company usually wants to pay $0 for the company. And wants to structure a huge payout for the employees that will remain. That way investors (dead money for the buyer) and founders (flight risk) don't get all the spoils while the faithful staff who will stick around get nothing.

And precisely because buyers usually prefer to have limited money go to investors – investors almost always have the ability to say "no" to transactions in the terms of their funding documents (aka "blocking rights").

And that is the tension in the acquihire – what is the purchase price for the company, what is the "earn out" if the acquired company hits some performance targets and what is the amount of money set aside for staff retention? And will investors allow a deal to happen in the first place.

The numbers you see announced in the press for deals are hardly ever right.

OK, Mark. We get the mechanics. But what is so corrosive about this?

Why Acquihires Hurt the Acquiring Company

How about if we look at it from the "rest of company" perspective.

You have been at Google, Salesforce.com, Yahoo! for years. You have worked faithfully. Evenings. Weekends. Year in, year out. You have shipped to hard deadlines. You've done the death-march projects. In the trenches. You got the t-shirt. And maybe got called out for valor at a big company gathering. They gave you an extra 2 days of vacation for your hard work.

And that prick sitting in the desk next to you who joined only last week now has $1 million because he built some fancy newsreader that got a lot of press but is going to be shut down anyways.

What kind of message does that send to the party faithful who slave away loyally to hit targets for BigCo?

I'll tell you what is says.

It says if you want to make "real" money – quit.

Go do a startup. Get some famous angel or seed money. Get yourself in a big demo day competition. Woo the press. Hire legions of young, impressionable graduates from the top engineering universities. And then come back and sell me your company.

I know many rank-and-file employees. I've had the chats with them. You rarely meet people who don't resent the scores of entitled acquihirees of their company.

Does Yahoo! et al really have to keep up with the Jones's to build its future?

For the 200 new employees they'll get through acquihires do they unleash 2,000 unhappy existing employees? Sure, most won't quit. Because they know that it's not a slam dunk to start a business and get acquired. But the most talented of those 2,000 will.

What if the $100 million you're going to spend trying to win this alleged "war for talent" in stead went into big retention plans to keep your most talented employees.

You can't "Roll Out the Red Carpet When Your Best Employees are on the Way Out the Door" as I wrote in this post. So why not announce big, hairy audacious goals on recruiting the best mobile talent with sign-on bonuses and retention plans? And reward your existing top 10% of employees handsomely.

I'll bet the ROI would be higher than acquihires.

Acquihires and Venture Capital

I'm a VC. I know I'm supposed believe in acquihires to bury my investments that aren't working.

I would never discourage any teams of people I'm working with against early acquisition if they felt it was in the company's best interests.

But that's not how you make money in the venture capital business. You make money by backing winners that build real businesses.

I look for entrepreneurs who set out on their journeys to do exactly that – build big businesses. Change industries. Not looking for quick flips.

And on many occasions I have passed on deals where it was clear that the founding team was over-optimizing the deal structure to focus on a quick exit.

When I have great teams with products that are taking longer to show traction than they or I would like I usually spend time trying to figure out how we can build a better business versus selling early.

I don't blame entrepreneurs who go for an early exit when it comes up. To the contrary. On many occasions where I've met with teams of people in whom I've never invested I've encouraged exactly that – an early exit at a "small" price. Because if you're business isn't working or isn't likely to work it's obviously better than running into a brick wall or over-capitalizing yourself.

And of course many small acquisitions work for the buyers when there is a clear strategy for owning the asset or a clear alignment with the team you're acquiring.

But as a repeatable strategy for large companies to try and compete with each other it still strikes me as a wasteful strategy. And few in the press are willing to call this out.

Sarah Lacy did. It's why I love reading her writings – she's one of the few remaining journalists in the tech sector (along with Kara Swisher and a few others) who have been around long enough to have earned their critical eyes or cynicism.

She wrote this excellent piece last year called, "The Acqui-hire Scourge: Whatever Happened to Failure in Silicon Valley"

And I thought I'd finish on a quote from Sarah,

> *"Allowing entrepreneurs — and their investors — to save face by saying they were "acquired" instead of failing is nice, but it's a bit like the pre-schools where everyone wins a trophy for showing up."*

Note: image from PandoDaily, clicking it will take you to the article in which I found it.

Company Valuation in a Startup Buy/Sell Agreement « 10,000 Startup Hours – David Cummings
davidcummings.org

One of the things I recommend to entrepreneurs formalizing their operating agreement, which spells out the rules of the business, is to define a simple formula for company valuation in addition to a buy/sell agreement that gives the startup the right, but not obligation, to buy back stock from team member no longer associated with the business. Best practices like a four year vesting schedule, one year cliff, and defining of roles and responsibilities among founders are more important, but having a defined buy/sell agreement is right up there to get in place immediately.

Here's a simple methodology I like to use for company valuation in a buy/sell agreement:

- Take the comparable public market multiples of the business (e.g. 3x revenue for enterprise software companies, 5x revenue for SaaS companies, etc)
- Divide the public market multiple in half to account for lack of liquidity and make that a fixed number in the formula in the operating agreement
- Multiply trailing twelve months revenue times the discounted public market multiple by one plus the trailing twelve months top-line growth rate
- So, with a public market multiple of 2.5, revenue of $1 million, and growth rate of 70%, the company would be valued as follows: (2.5 x .5) * 1,000,000 * (1 + .7) = $2,125,000
- The formula put in the operating agreement would be as follows: 2.5 times the trailing twelve months revenue times the result of one plus the trailing twelve months revenue growth rate

This formula is easy to calculate and takes into account the dynamics of the market, recent revenue

performance, and a premium for growth.

What else? What are your thoughts on having a defined formula for company valuation in a startup buy/sell agreement?

A VC: There Aren't Many Venture Backed IPOs
avc.com

There Aren't Many Venture Backed IPOs

As a follow up to yesterday's post on this topic, here's another chart from Mark Suster:

So using the math I laid out yesterday (roughly 1,000 startups funded each year by VCs), this means that on average between 1% and 3% of venture funded startups get to an IPO.

To recap, 1-3% get to an IPO and 5-10% get to an M&A exit over $100mm. So 85-95% of all venture backed startups will either fail or exit below $100mm.

I am certain the VC industry is not using this probability of outcome in setting valuations right now.

June 23, 2011 –

Tweet

How to value your company for sale (Part 2)
a smart bear

How to value your company for sale (Part 2)

by Jason Cohen on June 27, 2011

In Part 1 I explained how it's senseless for small companies to compute "one correct value" for the company, but rather that buyers and sellers must be considered separately. I covered the buyer side there; now let's tackle the seller.

Are you willing to sell your baby? At what price? Most entrepreneurs would love to be in a position to have to decide!

Most, but not all. There are plenty of folks who wouldn't sell their company for a billion dollars; Jason Fried and Joel Spolsky are public examples from the bootstrapped startup world. I've heard various reasons from these guys and others: "it's the company I want to work at forever" or "it's my mark on the world that will outlast my life," or "I literally don't know what else I would do."

But this article is about selling, so I'll assume that, like me, you're like the woman in the old G. B. Shaw yarn:

> "Ma'am, would you have sex with me for a million dollars?"
> She thinks, then says she would.
> "So," he says, "would you have sex with me for $50?"
> Indignantly, she exclaims, "What kind of a woman do you think I am?"
> He replies: "We've already established that, ma'am. Now we're just haggling over the price."

So let's haggle.

What if someone offered you a million dollars for your startup, right now, check in hand — would you take it? How about $100,000? $10,000?

Better question: **How do you arrive at an answer that satisfies your emotional attachment but also makes economic sense?** How do you even compute the economics at a small company with a scant track record and an uncertain future?

Navel-gazing

Remember how the buyer has his own way of valuing the deal? You need to be similarly selfish in your approach.

You'll be tempted to say things like "How much do you think they'd pay," but that won't help *you* decide what's right for *you*. You're skipping a step — trying to decide if the deal is even plausible — but how can you decide that if all you're doing is thinking about the other side? Let them take care of themselves.

OK, you're ignoring them. Where to start?

Collapsing the possibilities

I just coached an entrepreneur who couldn't decide whether to accept an offer for selling his business of nine years. The conversation went like this:

> HIM: They offered me $X, but I wonder whether I could make the same money if I just kept the company.
>
> ME: How so?
>
> HIM: Well we're growing pretty well now, so I think I could take out $1m/year for myself for the next few years. Then I'd personally make most of what I'd get, but now I'd have an even more valuable company.
>
> ME: How confident are you in that growth?
>
> HIM: I don't know, pretty much, although just last year we were shrinking.
>
> ME: Supposing you do grow, how do you know that in a few years there'll still be buyers around? Or what if we have another stock market collapse or if they shoot down a plane over California?
>
> HIM: When you put it that way seems like I should just take the money. In fact, what if a new competitor pops up in a year and starts kicking our ass?
>
> ME: Sure, but maybe that competitor would further validate and grow the market, which could *increase* your sales and make you even more attractive to a buyer!
>
> HIM: That's true, and besides we're talking to [big company] about a potential partnership that would really launch us.
>
> ME: Of course getting tied up with that might distract you from other growth opportunities, and sometimes buyers don't like that you're dependent on another company for revenue.
>
> HIM: Yeah, in fact one of my best employees doesn't like [big company] and has threatened to leave if we do it, which would make it hard to continue this growth.

This vacillation continued for twenty minutes — what if things go really well, or flat, or they find a great deal, or the economy kills them, or a much better buyer appears six months from now, or a big new competitor appears, or….

Of course **this is unresolvable.** He can't assign a probability to any scenario and almost none of it is under his control.

The way to wrap your head around this is to simplify — to ignore *all* of these hypotheticals and instead to decide *what feels like an acceptable amount*. This isn't as emotional and illogical as it sounds.

My favorite tool for this is called the "box game," already described in this article about why I sold my company Smart Bear. (The following assumes you've read it.) If you have a deal in front of you it's easy to plug in the requisite numbers. If not, it's easy to try a few until you get a good idea of what your minimum number is. If box A holds $5m, are you good? If box A holds $3m and box B holds $100m, do you still take A? Have someone else ask you with different combinations and your true risk/reward profile will appear.

In fact I'll go **one step further than the standard game**: Box B isn't a 50/50 chance. Rather, Box B has a probability *that you aren't allowed to know!* When framed that way, it's even more difficult to

gamble on the future, and even easier to figure out what your "magic number" is.

It's a gut-check, yes. But trying to work out the risk/reward of unknowable possibilities is worse.

It's not the number, it's the whole term sheet

Now I have you fixated on "your number," but actually you shouldn't be fixated on that number. It's important, it sets the stage, defines the ballpark, but there's so much more to term sheets than that number.

Examples:

- Deal A requires you to work for three years at the acquiring company in a capacity that you *know* you'll hate: Answering to bosses with political agendas, watching your beloved employees leave in disgust, and muzzling creativity. Deal B gets you only 80% of your number, but comes with a six-month transition period and you're free to start working on the next fun thing. Would you take a lower "number" to get Deal B?
- Deal A gets to your number in stock options with a 4-year earn-out in a public company whose stock has been uninteresting for the past three years, *plus* an additional third of your number in cash — more than you wanted! Deal B gives you 70% of your number, all in cash, all up-front. Do you prefer Deal B?
- Deal A gets you your number, but your employees get a small signing bonus and no salary raises; they'll resent you for not taking care of them. Deal B gets you 70% of your number, but your employees are well-compensated both upon signing and with their annual compensation. How much is your employees' continued satisfaction and appreciation worth?
- Deal A hits your number; Deal B gets you 60% of your number, and *up to* an *additional* 100% if you hit performance bonuses, which could be $0 if you don't achieve goals. Do you want to continue rolling the dice?

Of course there are no wrong answers! Only personal choices.

The point is that, although it's important to establish your "number" as a point of reference, the structure of the deal matters too.

Except this number

What the box game really does is answer this question: What number do you need to see in your personal bank account in order to be comfortable with the choice. That's post-tax, post earn-out. "Net net," some people say.

One of the best ways to arm yourself going into negotiations is to know this number and be prepared to blow up the entire deal if it cannot be met. That means you have to be *that sure* that that's the number, regardless of deal structure.

Here's why: The acquirer knows that you, the founder, are looking for financial freedom. They know there's a minimum valuation, under which you're not interested. In fact often this is how they come up with their initial offer, and it's why companies with three founders often get more money (all else equal) than companies with one founder. (I've talked with people in the M&A departments of several large businesses who confirm the previous statement.)

Finding this number is more complex than it sounds. Tony Wright (founder of RescueTime) has a great article about it here.

But still, the money truly isn't everything. It's more personal and emotional than that.

The personal stuff

There's a lot of important factors outside of money. Here's a few:

- **Burn-out.** Type-A workaholics like me (and most successful entrepreneurs?) cannot, in fact, maintain the energy and stress level. We laugh at people who talk about things like "stress," but denial doesn't work forever. As Andrew Warner said, "I used to think that only wimps took breaks, so I foolishly worked nonstop until I couldn't keep going. Michael and I sold the business." So yeah, "don't do that," but we do it, and then we're finished. Time to sell. Or maybe just a sabbatical — what if you took 3 months off and let everyone else mind the store, even if that means "not as well as you" and other things? You might feel differently.
- **What's the job you want?** Can you imagine yourself doing anything else? Does the prospect of starting fresh with a new idea sound refreshing and invigorating or depressing and laborious? Do you like the idea of "active retirement" where you keep cashing the checks and relaxing in the corner office or does that sound like a boring, pointless existence? Selling your company means you'd better be up for "the next thing" (after a well-deserved rest period).
- **Lifestyle.** Do you want to stop having to go into work every day? Will the amount of money you get selling the company actually alter your daily lifestyle? Does it even need to alter lifestyle for selling to make sense? Will it change how much time you have for family? Can you can decide to change these things anyway — without selling — or is selling the only way?
- **Alternatives.** For example, If you're sick of being the CEO but would love to continue hacking on the code, it's actually OK to hire a CEO and just hack on code. You could promote from within or find someone externally. Yes, whomever you pick — especially if external — you need to trust and might do a bad job and will certainly behave differently from you and even if they're successful it might not be as successful as you would have been… but it's OK because you're solving for the underlying issue, which is that you don't want to be the CEO. Selling is one way, but not the only way.

It really comes down to something sappy but true: **What makes you happy?** This is the hardest question to answer. Not just in this context, but in life.

I'm still figuring it out, I'm embarrassed to admit; I envy those rare birds who know the answer and know how to seek contentment. I love writing code, but I don't want to be the guy up at 3am on a Sunday when the code breaks. I love writing this blog, but I'm not up for the book deal that was offered me. I love helping other people with their startups, but I don't have the time to do justice to all the requests. I love the idea of funding new startups, but I'm not sure I'm up for the requirements attending profitable angel investment (see the multi-part series from Mark Suster).

If you know what makes you happy, you can make decisions that move you towards it. If you don't, how do you know if you want to sell this company, now, or what else you would do, or why, or… ?

So where does it leave us?

Don't believe anyone who says "it's not personal, it's business." It's your life and livelihood. It's personal.

The money is important, and it has to fit your minimum criteria so you know you're doing the right thing economically.

But the personal, emotional stuff is important too, maybe more so. You hear rich people saying things like "money doesn't make you happy," and your response is "boo hoo, yeah I just want a chance to prove that it won't me happy either."

But it's still true, and when you're facing the decision to sell your company, it's immediately relevant.

If this sounds more like therapy than economics, it's because it is.

If your number, your deal structure, and your happiness coincides with whatever constraints and desires the seller is under, congratulations!

And don't forget to send me $10k after the close for helping you out. :-)

Valuing Company for Sale (Part 2) [31:02] Play Now | Play in Popup | Download

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How to value your company for sale (Part 1)
a smart bear

How to value your company for sale (Part 1)

by Jason Cohen on June 20, 2011

I recently helped a friend broker the sale of his small, bootstrapped company.

This is a smart guy with experience and a logical approach to such things, but the way he was initially trying to value his company was not only wrong, but the wrong way to think about the entire sale.

As you'd suspect, I was similarly ignorant of such things while watching the sale of ITWatchDogs (where I was a co-founder), and still harbored misconceptions as I went into the sale of Smart Bear.

So, once and for all, I'd like to share my own perspective on how this works.

Many people start by looking at "the Multiples." They've heard rules of thumb like "A growing software company is worth 5 times their trailing 12-months revenue." I've also heard "10x profit."

Trouble is, there's such wide variation in these multiples that they're effectively useless. When selling Smart Bear I had an M&A guy pull data about other companies which (a) sold development tools, (b) were sold recently, (c) were profitable, and (d) were growing. Even narrowing the field as much as feasible, revenue multiples varied between 1.2x and 9x. Profit multiples varied even more.

(The "Multiples" argument *does* work well in industries where company's growth and revenue is highly predictable. For example, a laundramat has a well-known set of expenses and assets and can grow only so large. Or a company like Zappos (who was famous, growing, and profitable) still got only a 1x sales valuation when bought by Amazon because of thin margins. As another example, there are standards for valuing professional services firms (e.g. accounting, law, design) where the mechanisms for revenue and profit are well-known. This article assumes we're talking about a volatile industry like software or emerging markets where almost nothing is "well-known" and company trajectories are all over the map.)

Most discussions on valuing companies try to find a "single truth" about what the company is worth, trying to combine things like growth, profitability, multiples, market penetration, etc., but this **is flat wrong**, as the failure of the Rules of Multiples demonstrates.

Instead, the first thing to realize is that **there are two *completely unrelated* pieces to the sale: the buyer and seller**. Each have particular goals, rationale, risk-factors, and yes, emotions. When there's an intersection between what each is willing to accept, there's the chance of a sale.

By considering both sides separately, it will become clear how each will "value" the sale, and therefore whether there's overlap, and therefore what the sale could look like, if anything.

Let's start with the buyer. What does the buyer want with your company? There's many possibilities, each of which will cause a different valuation of your company.

To stoke an existing sales channel.

We entrepreneurs love ridiculing big companies for their inability to innovate, and we're right. But one thing they do have is a "channel," meaning an established pipeline wherein a product can be pushed (often by salesmen) into customer's hands. Maybe it's because the customers trust the company, maybe it's because they're obliged by contract, maybe it's because there's a powerful marketing machine

behind it… whatever the reason, it's there.

But exactly because big companies cannot innovate, they can't create new things to cram into the channel, which means it's hard to generate new revenue. That's where acquisition comes in — if you can't make it, buy it!

They value your company based on how much money they believe they can get from their channel. Notice what I *didn't* say: They don't value your company based on your existing revenues or growth. That sounds silly — after all, you'd reason, won't they get *both* their channel value *and* the customers you'll get "on your own?" Actually, no.

Channels are often measured in the billions of dollars. Even if you've managed to scrape together ten million dollars of revenue over the past five years, that's still just a drop in the bucket, irrelevant, not worth their time. They need to know that they can turn it into $100m through their channel, and do so quickly, like in the next 4-8 quarters, so they get a nice bump on their bottom line and, ultimately, their share price.

In fact, **it's rare that just putting your software into channel alone will be enough!** They need to know that they can sell more of their *existing* product line *because* your product is in the channel. Often a salesman hasn't been able to land "the big deal" with a particular customer, but with the introduction of your product — very likely thrown in for free — the customer is now ready to buy. Complex and indirect I know, but a common case.

So the value of your company in this scenario is: How much of their existing software — because of yours — can they sell through their channel? And that's a quantity that's almost impossible for the seller to compute! (Yet another reason why the two interests must be considered separately.)

To control a market.

Why did eBay (an online auction house) purchase Skype (an online telephone company) for two *billion* dollars before Skype had one cent of revenue? The answer sure doesn't have anything to do with revenue multiples!

They wanted to control Internet telephony, and Skype was the clear winner. Control equals money.

For small companies, "controlling a market" won't be as grandiose as "telephony," but it's still control of something. Salesforce.com recently bought Heroku for $250m because the latter controlled fully-managed Ruby on Rails deployments. Taking a smaller example (I can't reveal numbers), Smart Bear bought a little company because it controlled the market of small- to mid-sized development shops who wanted "just enough" product lifecycle management.

Buyers know how to estimate the value of controlling a marketing they can't otherwise attack and how badly they want to be the only ones playing in that space, but sellers rarely know.

To remove competition.

What's your first thought when you hear that Whole Foods (the largest organic-centric grocery chain) bought out NaturalEats, a local organic food store? Mine is: To eliminate competition.

It happens all the time, in software as much as anywhere else. Sometimes it ends up improving the big company — Whole Foods in particular is known for incorporating good ideas from the stores they purchase, and in fact sometimes don't change the names and branding of the existing stores.

Which makes sense. It's not necessarily about destruction, it's about ownership. It's about not having competition, whether by conversion or just putting everyone's revenue in the same pot. The main thing is: a competing franchise didn't win.

To hire key employees.

Google is famous for snapping up teeny two-person pre-revenue startups for a million dollars. Why would they part with so much money for what is often a completely dead-end so-called "company?" Because Google values talent and is able to spend as much as they want to get it. If those founders are sharp, if the technology they built is impressive, if their entrepreneurial spirit is part of a culture Google wants to cultivate, then it's rational! In fact, it might be one of the only ways to get people like that to join a big company.

In this case, all the typically-valuable things like "multiples" or intellectual property or the customer

base or the product-market fit or the market size are irrelevant.

To “build” a product.

If you have a product that seems to work, and if a big company wants a similar product, the big company has two obvious choices: Build it themselves, or acquire it from you.

Fortunately for you, everything’s more expensive at a big company. A new product needs a product manager, a project manager (I still can’t remember the difference), a team of developers, QA folks, tech writing, sales training, support training, and legal review. Something that took you and your co-founder a year to build — even with those 80-hour work weeks — would take them ten man-years to replicate.

On top of that is lost time. If they buy the product they can start selling it almost immediately. Otherwise they have a lot of planning and hiring to do before the project has a decent velocity, which could take 6-18 months.

On the flip side, entrepreneurs are an unknown quantity which typically doesn’t fit well into corporate culture, so that will inevitably come to a head. Also the product probably won’t match existing company standards, neither in the user interface, the design patterns underneath, the technology it’s based on, etc..

So it’s not a cut-and-dry decision, but it’s clear how your company will be valued primarily: The cost of acquisition + re-culturing versus the cost of build-from-scratch.

To invest.

It’s boring so it’s not covered in TechCrunch, but there are monolithic entities chartered to acquire companies with defined characteristics: Industry, size, growth, revenue, etc..

Sometimes the goal is to find “turn-arounds” which can be had at a discount, then fixed and flipped. Sometimes the goal is to find cash-generating companies that look like they can continue to generate for a decade. Sometimes it’s akin to a mutual fund or hedge fund or even VC fund in that they’re rolling the dice for a chance at a big return.

Sometimes this is literally a VC or private equity firm who, rather than investing in brand new companies hoping for the rare, massive multiple, invest in well-established companies where the upside multiple is lower but so is the risk.

Here the financials and circumstances of the company are indeed more important than in the other scenarios, but there’s still other forces at work. For example, depending on whether they’re just starting a new fund or running out of time on an existing fund they might be under more or less time pressure to get deals done.

Applying this to selling your company

The take-away point is that buyers have lots of reasons for acquisition, and **few of them relate to basic company financials** or your existing customer base. Of course the scenarios above are just examples; there are others, and often it’s a combination of factors.

So when you’re faced with selling your company, step away from the numbers and ask: **Why is this *particular* buyer interested in me?**

Answer that question, understand their motives, and you’ll get your arms around how they’re valuing your company. It’s key for negotiation because it sets a price range and defines what the buyer won’t compromise on. Or it might just point out that the deal isn’t going to work.

The other half: The seller’s angst

There’s two equal but separate concerns, and we’ve only addressed the buyer. Next week in Part 2 I’ll delve into the seller’s perspective, in which we’ll still find financials, while important, are trumped by simple human needs.

Valuing Company for Sale (Part 1) [26:12] Play Now | Play in Popup | Download

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A VC: There Aren't Many Exits Over $100mm
avc.com

There Aren't Many Exits Over $100mm

I was reading Mark Suster's latest blog post (actually its a presentation embedded into a blog post) and I came across this slide.

I don't know what the source of this data is and I don't know if this is just M&A exits or if it includes IPOs as well. It really doesn't matter for the basic point that Mark is making with this slide.

Based on the NVCA statistics on the venture capital industry, there are on average 1,000 early stage financings every year. I suppose a few of those 1,000 financings are for the same company, but I doubt that many are. So we can use 1,000 as an approximation of the number of companies that get funded in a given year.

And somewhere around 50 and 100 of them exit for more than $100mm every year. So 5-10% of the companies financed by VCs end up exiting for more than $100mm.

At at time when the average Series A round is now north of $20mm (based on very anecdotal evidence and not at all scientific), this poses challenges for the VC industry.

The real math is a lot more complicated because of follow on rounds and such, but in order to keep this simple, let's assume all Series A deals are done at $20mm post-money and 5% of them end up exiting for north of $100mm. And let's assume that the average valuation of the exits north of $100mm is $250mm (I think that's a good guess but it could be off). That means you don't get your money back on your entire 20 investments with the one that has a good exit. The simple math is 20×20=400 which is greater than 250.

If the average valuation of a Series A deal is $10mm, then the cost of 20 early stage deals is 20×10=200 which is less than 250. That means the winner pays for the rest of the deals. And that is the model that I know works in early stage VC. Anything else is going to be challenging for the industry.

Are we in a valuation environment that is challenging for early stage VC investors? Yes.

June 22, 2011 –

Tweet

You have acquisition interest – now what? | Hi, I'm David G. Cohen
davidgcohen.com

Through TechStars, my other investments or just at random, I'm often approached by entrepreneurs who want advice on what to do when a potential acquirer first brings up the idea of buying their company. Often, the company being targeted for acquisition is "up and coming" and is very early stage. For that reason, the entrepreneurs are often rightfully concerned that the "acquirer" is really just digging for information. That's a valid concern for many early stage companies. Here's the advice I usually give concerning this situation.

Step 1. Assess the acquirer. First and foremost, you should assess the potential acquirer. Can you really see yourselves working with them? Do you like them? Are you willing to be an employee of that company? Do you trust that their interest is genuine? If the answer is no, recognize that it's either a non-starter or that it's going to take one heck of an offer to pique your interest.

Step 2. Notify the board. Notify your board and/or key investors. If you have a board of directors, you should promptly notify them (email is fine). You might also notify key trusted advisors and mentors. Make sure to mention that the interest is very early, and that you're exploring it. As always, getting mentorship can be key.

Step 3. Set your number. Next, if you haven't already done it, you should have an honest discussion with your co-founders and key management about the minimum number it would take for you to sell the company. When doing this exercise, it's useful to think about the following issues:

- Talk about the stock/cash mix that would be required.
- Talk about how long you'd be willing to work for the acquirer at market salary. Assume at least two years.
- Assume that you'll have no ongoing control of your company or product, and that it just won't be your baby in any way, shape, or form any more.

Recognize that it's very easy to trick yourself at this stage. It's really important to define the minimum number without padding. In other words, you're effectively deciding that if the offer clears this hurdle, then as a team you want to work towards taking it.

Step 4. Engage the acquirer. When you first enter into discussions with the potential acquirer, you should expect them to ask you all sorts of questions before they make any sort of offer. You can expect questions about revenues, expenses, headcount, conversion rates, attrition rates, and all sorts of detailed stuff.

At this point, it will be your natural reaction to ask for an NDA with the acquirer. While this is a good instinct, delay doing it up front. Don't worry – you will use it as leverage shortly. Without mentioning an NDA, provide a few high level answers that you're comfortable with them knowing and when the questions get into the "zone of discomfort" ask them to provide a detailed list of their questions via email so that you can work on them.

Step 5. Ask for the ballpark offer. Now that you've answered just a few high level questions and have a more detailed list of what they're after, it's important to go for the "ballpark" offer before proceeding. Explain that you've received their email, you're obviously flattered with their interest, and that you're happy to answer all of their questions under two conditions. The first condition is that you'd like all of the information that they requested to be covered by an NDA. The second condition is that before proceeding, you would like for them to provide the likely "ballpark" paramaters of the acquisition via a simple email, including the likely cash/stock split.

Most acquirers will happily accept the first condition (not doing so is a serious red flag) but will avoid the second condition. It's important to stand firm on both conditions before proceeding. The acquirer will likely claim that they don't have enough information to make an offer, and that they need their questions answered. Assuming that you've given them basic revenue and expense figures, this is bullshit. Hold firm. Explain that you're very busy working with customers and improving your product, and that you can't afford to distract the company without having at least a ballpark understanding of the offer. Explain that it's obviously non-binding and that you won't hold them to it, but that you're just trying to get a sense of it. Sometimes there is a little dance at this stage, where they will look for a couple more tidbits of information in order to give this ballpark offer. That's fine – use your best judgement. Just avoid dropping your pants completely until you get the ballpark offer. Note that this does not mean sign the NDA and give them all the answers that they're seeking! This is your leverage to get the ballpark offer, so don't give it away. Recognize that the NDA won't protect you from giving the "fake acquirer" exactly what they wanted.

If the acquirer resists the NDA or the ballpark offer, they're probably just fishing. You're not being difficult. You're asking a perfectly reasonable question about ballpark deal terms before wasting your time.

People who are not high up enough in the acquiring company to actually be making this offer will be scared off at this point. That's a good thing. Perhaps they never had permission to be pursuing an

acquisition in the first place. This technique weeds those people out since they have to provide the non-binding ballpark offer in writing via email.

Don't proceed without the ballpark offer.

Step 6. Identify mentors. Now that you have a ballpark offer, you have what I would consider serious interest. Now make sure that you're working with someone who has been involved in multiple acquisitions, ideally on both sides of the table. Perhaps one of your existing investors or advisors can fill this role. It's critical to have someone on your team that can help you negotiate terms, and to help you understand their impacts. I can tell you from experience that when I had my first exit from a company I founded, I left millions of dollars on the table before I learned this lesson. Do not underestimate the ability of experienced mentors to greatly increase your ultimate outcome. If you don't have an advisor, contact someone that you trust that has done this before and ask them to help. It's fine to pay for this help if you don't have other options, but you should only pay in a success case and you should recognize the dynamic that this creates: 1) This person loses nothing if there is no exit other than time and 2) they're motivated to help you maximize the exit at the expense of everything else.

Step 7. Assess the ballpark offer. Take the floor value of any "range" that they gave you for both the total comp and the cash percentage of the stock/cash split. This is all you should "hear" – ignore the rest of the range. The actual offer is very likely to end up being very close to the low end of the range unless there are multiple competing offers. You should now compare this to what you discussed in Step 3. If the offer isn't high enough to be interesting, then your best bet is to simply tell them that and politely decline to provide any other information.

Step 8. Get to know them and answer their questions. At this point, the offer is "interesting." Your goal now should shift to getting some face time with the acquirer and getting to know them on a personal level. It's fine to do this by phone, but find ways to spend time with them physically. This will help you figure out if they are "for real" or not. Ideally, if practical you'll start to this before fully "dropping your pants" and answering all of their questions. It's a fine line between being coy and stalling. You can't stall too long, but you can offer to meet with them personally to go through their questions. Basically, the more time you spend with the potential acquirer, the more you can develop trust and build from there. Provide the requested information under NDA to continue the process. Be sure to mark all information provided as confidential under the NDA. Keep a copy of everything that you provide.

Step 9. Push for a term sheet. Even at this stage, many acquirers will go silent for a long period of time. Sometimes this is normal – these things just take time. Internal fires that have nothing to do with you come up. People go on vacation. Things always move slowly. Do not assume this is going to happen. Keep building your business in the meantime. Continually push for a term sheet fully describing the acquisition. At every meeting, ask what information you can provide to work towards getting a definitive term sheet describing the acquisition.

Step 10. Decide. If at any point in the discussion you decide that something is not right, just stop. Ask for the return of confidential information, and politely bow out. If the deal happens – congratulations! Assume it won't until it actually has.

Good luck! I'd love to hear your thoughts and experiences in the comments.

Don't Try to "Pull an Instagram." Here's Why …
bothsidesofthetable.com

Instagram. It's understandably on everybody's mind these days. Clichés abound about, "You know what would be cool? …"

I'll write soon on my views of why I believe Instagram took off as a social network and what I think comes next. Instagram happens to be one of the few social networks I regularly use along with Twitter. I use it much more frequently than I've ever used Facebook and have done so since inception.

Still, there will be a "next." I'm just back from Spring Break with the kids so I chose not to weigh in during the fracas. I will weigh in with some thoughts soon.

What I want to talk about today is one of the insider baseball discussions of our industry this past week: The odd fact of the $500 million financing round completed just before the company sold for a B. This head scratch was best captured by Alexia Tsotsis in her post on TechCrunch.

Was this a good thing?

Did raising money at a $500 million valuation help secure the $1 billion deal? And what can we – as the entrepreneurial community learn from that?

99.9999% of you won't be contemplating raising capital at $500 million any time soon or selling for a billion. But a healthy percentage of successful startups have potential buyers "showing interest." And because most startups have 12-18 months' cash-on-hand at any point in time (usually less that 1 year, actually), the age old neurosis of whether to fund raise now or "wait and see what buyers might propose" comes up.

I've lived this personally. It sucks.

My friend Christine Herron of Intel Capital weighed in on the issue

> *"it's smart to use an impending investment valuation to drive a higher acquisition valuation"*

I would like to amend her statement slightly to read, "it's smart to use an **impending** investment valuation to drive an ~~higher~~ acquisition."

Emphasis placed on both "impending" and removal of "higher." In this week's discussion with entrepreneurs I think the word impending wasn't used often enough.

Christin goes on

> *"If the company was able to use the Sequoia deal to drive its Facebook acquisition value higher, then in theory the founding team's smaller share of a larger $ pie is greater than the larger share of a smaller $ pie. A nice play if you can make it."*

A nice play if you can make it. True.

Let me be clear – you cannot. You are not Instagram.

Let me explain

"Impending" valuation

Let's say your company is currently valued at $15 million. You've found yourself in a super hot category and – let's face it – it's still a very frothy venture capital funding market so you may have loads of VCs chasing you. You think you are now ready for your $20 million round. In a perfect world you'd like to hit your always-dreamed-of valuation of $100 million pre. In the "worst case" you'd settle for a cool $80 million pre.

But you've had tons of inbound interest from potential acquirers. You don't know what they'd be willing to pay but they've been courting you. But they are SO FREAKING SLOW. Maybe you should just close your VC round? They seem to move a bit faster. And maybe that would force the big buyer to finally get off their butts.

And, hey, maybe you could just "Pull an Instagram." You know, close your $100 million round so buyers will come in at $200 million.

Let me remind readers as I outlined in this post, there are VERY FEW M&A transactions for early-stage startup companies above $100 million. Many – MOST – are done in the $10-30 million range. Closing a VC round might just be the right move for you. But if you raise the money at the big price (or any price) please go in with the expectation that you are going to build a large, long-term business. Not as an enticement to get a buyer to pay up after the deal.

Think about it. You are either bought for stock or for equity. Let's say you target LinkedIn to buy you. They're worth $11 billion as of today. So $200 million would represent 2% of the entire company's value. Is your crappy little 12-person company really worth they and their shareholders diluting by 2% given more than a decade they've put in building one of the Internet's most solid

business social networks? You better be a very clear improvement to their bottom line to pull this off.

Oh, I know – we'll just ask them for cash!

Doh. Just checked their balance sheet. They have $339 million in cash on their balance sheet. Your $200 million "small acquisition" is a cool 60% of all of their cash. Uh… yeah.

And most likely your potential buyer is some other company with a much lower valuation, much less secure position in the future and probably less cash on hand.

Which is why the mega valuations you read about are almost always by companies with enormous valuations and/or cash on hand: Google, Microsoft, Cisco, etc.

And stating the obvious – Facebook's valuation is estimated at $100 billion.

Hang on, Mark. You just said, "nobody would take 1-2% dilution." No, I said you'd have to be really freaking awesome for them to do so. I believe Instagram was. Is. And represents great defensive value for Facebook as Chris Dixon aptly pointed out on Twitter

> *"Giving up 1% of your market cap to take out biggest threat is a savvy move."*

So my point. Raising a large round at whatever price will almost certainly take many potential buyers off the table. At least for a couple of years until you've grown into your new valuation / made enough revenue / captured enough customers / etc. to justify a "strategic" price.

Strategic must be a hugely defensive move or a move that the management team of the buyer believes could drive a huge increase in future revenue to more than cover the costs of having acquired your company.

If you ARE thinking about the possibility of selling – the most important word Christine used (which I fear was lost on the entrepreneurs with whom I spoke recently) was "impending."

Getting a term sheet on the table is the second most sure way to get a potential acquirer to move faster. The first being a competitive acquisition offer from a fierce competitor. But that's another story.

A buyer who has been thinking about acquiring your company will suddenly realize that within 30-60 days the potential purchase price for your company will go up significantly and if they want to take a look they had better do it sooner rather than later. I see this all the time.

Are You Screwing These VCs?

Unsurprisingly I recommend transparency with your incoming VCs. I would simply tell them,

> *"We are deeply committed to building a long-term, valuable business. We wanted you to know that we have, as you would imagine, have inbound interest in acquiring our company. We would like the opportunity to carry on these discussion for 30 days. I doubt we would consummate a deal. But I owe it to my existing investors and co-founders to listen.*
>
> *In the event that they do purchase us now I would obviously pay all of your legal costs associated with this transaction.*
>
> *And I want you to know that if we do complete the funding as we intend to – we're not looking back. We're not going to keep up the M&A discussions at a small mark-up to your round. We plan to double-down and build the huge company we know we can."*

What about "Higher" – Why Did you Strike That Out?

Well, of course you should use your "impending" valuation to get as high of a price as you can. But often times M&A is a yes or a no. And using the term sheet to get to a "yes" is a huge first step. The justification for the purchase price of the acquirer will likely not be determined by the price the VC was willing to pay.

Appendix

When I write quick posts and don't have much edit time I feel I am often misunderstood or misquoted. So I want to be clear on a few points

- I am not saying all companies should be for sale. If you're passionate, are enjoying what you're doing, believe it can be much bigger – stay heads down. That's obviously what we're all shooting for

- I am not saying you should artificially talk to VCs and to game them to get your M&A deals done. That's bad behavior. You should talk to VCs if you think you will – or might – genuinely raise money. Most startups are always less than 12 months from their next funding round so you are likely always in need of more money to grow. And so this situation of having VCs and acquirers present is a common one.
- If you think you might be acquired by a company – do your homework. Some tech professionals are helplessly naive about financial transactions. They never stop to think, "what is the market cap of my acquirer, how much cash do they have, what would their investors think about dilution, etc." In most cases the numbers in your head are fantasy land.
- We read, discuss, envy, model behavior after the 0.1% of deals that are enormous outcomes like Instagram. I am a HUGE fan of what they've built. If one day that's you – congratulations. But since it's not what normally happens I encourage all other companies to do the harder work of finding out what happens in the 99.9% case, which is what is often never written in the annals of the tech news media. But mad knowledge exists inside of every founder who has sold a business. I promise you the answers won't be anything like what you'd imagine.
- Yes, there must be terrible typos in this post. I'll fix them all later. Don't be annoyed. It's a day with my family at Griffith Observatory today – or – fixing typos. So …

Everybody Wants Their Pound of Flesh (Negotiating with Buyers)
bothsidesofthetable.com

I recently wrote a post about negotiating with suppliers called "The End of the Mexican Road."

The post talked about how to find the lowest acceptable price & terms in a deal through testing.

In the post I made clear that I believe that all negotiations should seek to find fair deals where both parties can feel good about the outcomes. But that doesn't mean always just saying "let's split the terms 50/50 down the middle." Often that doesn't make sense.

But what about when you're negotiating with buyers and not suppliers?

This process is obviously very different as you will likely have much less leverage.

Most people claim to not want to deal with the hassles of negotiating. I think most of us feel this way, really. But it's not a reality in business. While you may be able to offer a price & terms for your service and not ever negotiate (especially if you're an Internet company that sells cheaply to small businesses over the web and without onsite support & service) – you'll still likely have to negotiate on business development deals. So please see this post through that lens – at some point when you deal with larger companies: enterprise buyers, biz dev partners, VCs or one day acquiring companies – you'll like encounter these negotiation issues.

I could sum up my negotiation mentality as a seller in one phrase that I've used as short-hand for my portfolio companies for years, "Everybody wants their pound of flesh."

It's short-hand for showing that despite our aversion to the process of negotiations – as buyers we're conditioned to it and even rewarded for it.

Here's what a big company negotiation looks like:

1. Your Primary Buyer

You obviously start your process with a primary buyer. This is the person who is sponsoring a deal with your company. You need to know that unless you're selling into a CEO this person has a cast of characters behind her that need to approve her decision – even if she holds the budget.

And like it or not, one important way that she will be judged by others is her ability to commercially negotiate a deal with you. If she is seen to accept your initial offer on: Price, payment terms, service-level agreements, remedies for service problems, cancelation clauses, indemnities and all of the other terms of a standard agreement then she will be seen as weak.

So whatever terms you offer her, she will likely push back. She's already built in an assumption that

your first offer isn't likely your best.

Yes, I know it would be much easier and frankly more pleasant to just be able to put in THE offer and say, "I know that most sellers (or biz dev partners) negotiate. We hate playing games so we don't negotiate. Our offer is our offer."

Good luck with that.

I swear after all these years I've tried just about everything including trying to cut to the chase with the, "no really, this is the deal we want to do" kind of offer.

People are genetically programmed to negotiate anyways.

And they have the incentives to show their colleagues and superiors that they got you to move from your original offer.

Everybody. Wants their pound of flesh. Everybody.

So as distasteful as it might be to you, you've got to build in a buffer into your negotiations. You've got to have some wiggle room on price and on terms. You've got to have both substantive points in which you're willing to be flexible and also some "throw away" points you really don't care about but which will become part of your negotiation.

If you don't, I assure you that you'll cut into muscle or lose deals for seeming inflexible (rather than the honest, non-gaming-playing executive that you were hoping to be).

2. Your IT Reviewer

So your buyer put you through the ringer to show her independence. She got you to drop price and include more licenses for free. She got you to offer free storage and discounted training. She got you to remove your 6-month cancelation clause (heck, you never really expected 6-months cancelation, did you?).

But now your deal needs to pass through IT. This is the "deal prevention" team in many big corporations. And not that I blame them. They've had years of business-unit managers buying software solutions they didn't need and that eventually become shelfware. Or they have internal tools that they want you to use but you prefer the sexy tools offered on the market.

So IT will both chop your deal off at the knees and if they let you through they'll extract their pound of flesh. They'll push you on your uptime SLA, they'll push for harsher penalties for non-compliance, they demand security reviews … heck – if you're small enough they'll push for "source code deposits." That can be brutal.

If you leave no room for IT negotiations you'll take an unexpected haircut.

3. Procurement (or Biz Dev Team or M&A Department)

Up until now you've done fine. Your business unit buyer isn't used to negotiating software and if you won over the IT team with your prowess then you're feeling pretty good.

Now it's time for the real leg breakers. If you're selling to small businesses they may not have a procurement team. But all large companies do. And when they get involved all of your non-standard terms go away. You get people who don't care at all about "relationships" with you. All of your sales training techniques are useless to their procurement Teflon. Procurement departments are professionally aloof from sales processes.

I would have lines like, "if GoToMeetings is willing to sell for price X, why should I pay more for you?"

Me, "well, let's look at the business case for our software implementation. We believe we'll be saving you more than $1 million per year for 5 years and this was prepared by *your* team."

Their bullshit meters are too finely tuned for that type of negotiation.

"I don't care about that. I don't want to pay more for your product than I pay for similar products."

That's their job. No procurement professional gets ahead by saying, "hey guys, I read their terms. This deal is actually pretty fair. Let's just approve it."

Everybody is judged and promoted based on their ability to extract their pound of flesh. In fact, if your primary buyer doesn't champion you through procurement you're pretty much screwed. You have to look for a buyer that knows that procurement will demand unreasonable terms and who wants to

work with you badly enough that they'll push procurement to be fair.

Still, procurement must be fed. They need some wins.

Biv Dev teams? Same. Born to negotiate and trade terms.

M&A? Do they want to tell the CEO that they bought you for your asking price? And no lock-in? No earn outs? No risk to you for non performance? Naw. M&A needs flesh.

4. And so on Down the Line

Your buyer's boss. Have you ever met a boss who looks at an agreement and simply says, "Yeah, I'm fine with that. Go ahead!" And just wait until the legal department weighs in. You'll have all sorts of terms added that you've never even heard of. Remember that clause about your customer doing a big press announcement about the deal? Not so much. The marketing department will cut that off at the pass. And then, of course, there's the CEO or SVP if your agreement is large enough or if it's an M&A transaction. Even the big boss want's her piece of flesh.

So What do Do About it?

By now it is a small miracle that you still have a deal on the table. If you started the process with your "best & final offer" at this point your deal is probably upside down. As you get through the multiple stage-gates people will demand their toll – whether you have something you feel you can offer or not.

So start with your final position at your own peril. I know your gut would tell you, "Don't play games! We all hate games!" we tell ourselves. Mine, too. But then there's reality. The sooner you accept realpolitik the sooner you realize that the incentive structures of dealing with companies, organizations and political structures (not to mention human nature) requires you to play the game. It requires you to start with some fat in your deal.

- Have some room to compromise on pricing. I usually recommend that you even signal to your buyer that there is probably some room there. Why? You don't want to be knocked out early because your prices are way out of the ballpark. Let them know there's probably some flexibility. Actually, if you realize their internal incentives you are ironically doing them a favor by having some fat on price.
- Have some terms that you would love to win but aren't wedded to. Perhaps it's having your customer pay annually in advance when your goal is really monthly in advance. With your first buyer you might agree quarterly in advance. Somebody later will negotiate you down to monthly. And beyond that to monthly in arrears
- Have some room in the SLA for the IT department, some room on legal terms for the legal department

After all, if everybody wants their pound of flesh, you're screwed if you start with only muscle.

I know it sucks. The people most averse to this message are often young, idealistic professionals who haven't yet realized the world works this way. Or hackers who want an ideal world in which you build beautiful software and people just pay what's fair.

But don't hang the messenger. I've seen this enough first hand to know that … the world just is the way it is. Organizations are not static. They're filled with people, politics and incentives.

Happy negotiating.