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Why M&A Drives Venture Exits and What that Means for Startups

When entrepreneurs first start dreaming about exits, most of them conjure up the glamour of an IPO. Something about taking a company – your company – public just strokes the entrepreneurial ego in a way that no sale of their business can quite match. Still, even with the IPO window wide open again, and high-profile Unicorns jumping through it on a fairly regular basis, most exits are via the M&A window.

Dreaming about IPOs is understandable, and there is even some utility that can be milked from those dreams. Building a real business, and not just an exit vehicle posing as a business, is something entrepreneurs should always be thinking about. At the same time, the truth of the matter is that most exits, even when most exits when the IPO window is wide open, are as noted above M&A transactions.

As it turns out, the popularity of the M&A exit route is baked into the venture capital investment paradigm. Folks, including venture investors, may preach the virtues of building a sustainable business to entrepreneurs; but in truth, most folks, and most particularly venture investors, seldom practice what they preach – at least not enthusiastically.

The "real business" vs. "saleable asset" conundrum is rooted in something else venture investors spend a lot of time preaching: focus. On well-defined target markets, and on core competencies. Define the ideal customer carefully and go after it with all of your sales/marketing resources. Understand what your supposed sustainable competitive advantage is and make sure to focus your investments on maximizing and sustaining it. Don't waste precious resources on parts of the business that aren't mission critical and can be outsourced on acceptable terms.

The focus mantra preached by so many venture investors should take pride of place against the "build a real business" mantra. With the anomaly of exceptionally well-endowed startups – exceptions that clearly work for a few, but often end up badly when business/venture cycles take a turn for

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the worse – most startups are mostly resource constrained. As such, they should focus on building depth in one or more areas of competitive advantage rather than breadth across multiple competitive dimensions. It's the depth that most interests potential buyers, not the breadth.

At the same time, though, the focus/build-a-business choice is not so much an "either/or" paradigm as it is a "both/and" paradigm. Startups are resource constrained, and thus it's wise to put those resources to tasks that add the most value – even at the cost of building out strong complimentary assets. But when venture and public markets are in any state short of frothy, the emerging company that takes its eye too far of the bottom line (cash-wise) is playing with fire – and even more so for emerging companies distant from the white-hot center of the froth.

So it is true that startups should focus on key strengths that can be best leveraged to build and support a competitive moat around their business. It is also true, though, that in the event of sustained capital challenges, those startups that survive will be the ones that build castles inside the moat capable of fending for themselves for longer periods of time. Which means, more prosaically, that the survivors will have built enough of a "full-up" business to fall back on – at the expense, no doubt, of short-term growth and likely even some deterioration of offensive competitive strength – to see the situation as a strategic setback rather than a life-ending Gotterdammerung.

If all this is a bit confusing, I'll sum it up this way. Entrepreneurs should recognize that however grand their vision, what they are likely building is an asset to sell, not a business to run. At the same time, given the volatile nature of the business cycle, they would be wise to build enough of a business around that asset to wait out unfavorable M&A markets – and, opportunistically, maybe even find themselves positioned to live their IPO fantasies at some point down the road.

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