Why Md. tech startups sell and whom they sell to

By: Tim Curtis Daily Record Business Reporter September 17, 2017

Fractal Tech co-founders Alex Sharata, left, and JR Charles. (The Daily Record / Maximilian Franz)

Last month, Baltimore cybersecurity analytics startup RedOwl announced it had been acquired by cybersecurity firm Forcepoint, a subsidiary of Raytheon. For the most part, the acquisition was a validation for both RedOwl and the Baltimore tech community in general. RedOwl had attracted nearly $30 million in investment and had now reached a successful exit.

For many startups, the decision to sell can be an affirming moment. It means the company was a success. But it can also be a difficult or emotional decision for the founders to make. They built something but are now relinquishing control to another party.

"I have always weighed four factors in every major strategic decision we make around funding or acquisition — our ability to achieve great technical things, the return to our investors, the impact to customers, and the benefits for our people," Guy Filippelli, CEO of RedOwl, said in an email to The Daily Record. "By joining forces with Forcepoint we felt we could continue our mission, build out our innovation and become a strategic piece of Forcepoint's business."

The sale to Forcepoint represented a process many startups can go through as they reach an opportunity to sell, especially to a company that shares their goals.

Synergy

Guy Filippelli, CEO of RedOwl. (Submitted photo)

RedOwl's sale to Forcepoint came about through a partnership that existed for years before the actual acquisition. The companies were already working together and attracting business, Filippelli said.

It turned out that their strategies were aligned. Forcepoint focused on building out its human-centric cybersecurity system and brought RedOwl on to help with data analytics.

"Forcepoint and RedOwl coming together was a classic case of one plus one equaling 3," Filippelli said. "Independently both companies reached the conclusion that the best way to protect any organization, commercial or government, was to focus on people and the reasons why, where and how they use data and what that data represents."

Partners coming together can be a common way startups get bought by other companies. Fractal Technology, a small startup out of Johns Hopkins that created a "middleware" to help streamline security standards for mobile applications, was bought this month by Sunayu, a small defense contracting firm based in Annapolis Junction.

Prior to the acquisition, the two companies had been working together. As Fractal looked to license its technology, it found that getting into the government would be a "monumental challenge." But Sunayu already has government clearance.

"It made sense for us to go under their umbrella," said Alex Sharata, a co-founder of Fractal. "I don't think we would have sold now if the buyer profile wasn't like Sunayu."

Sell or seek investment?

Selling a startup represents one of the probable exit strategies for a new company. It can be just as much a validation for the company as drawing investors and an increased valuation.

"I think most of tech startups are very clear that the buyout is one of their exit strategies," said Hung-bin Ding, an associate professor of management specializing in small business at Loyola University's Sellinger School of Business. "The buyout decision is part of their grand plan or the overall future of the company."

To gear up for that point, Ding suggests, companies build their value through the same process as if they were going to draw new investment.

"It's pretty much like preparing the business for an (initial public offering) or seeking angel investors or venture capitalists," he said.

Beyond that, if a company has attracted venture capital, those investors want to see a return, and sooner rather than later. If investors have seats on a company's board, it can create additional impetus to the decision to sell.

On the other hand, if the investment is recent or the investors still see good growth potential for the company on its own, that venture capital could sway a company against a decision to sell.

"It really comes down to risk-reward tradeoff," said Andy Jones, managing director of the Maryland Venture Fund. "There's always execution risk selling a business. But you have to identify those risks and weigh them with the current value of the business."

Deciding where that line falls can be an emotional decision for a business, especially tech businesses where there's a steady stream of investment money available. But that decision has to be weighed against the reality of the market.

"Any entrepreneur wants to keep building and build the next unicorn," Sharata said. "In the enterprise software space it is totally different. It's hard to get a hit like that. Not to say we don't think we couldn't have been incredibly successful … but it made sense at the time."

Keeping the team?

Decisions to sell the company involve more than a transaction of assets. Often acquiring companies are looking at bringing on not just the company but the people and services they offer.

With RedOwl, the company was brought in to bolster Forcepoint's analytics to help improve security. RedOwl's Baltimore headquarters will become Forcepoint's center for analytics excellence, keeping many of the same people in place.

"That's a huge testament to the specialized talent of our people and the technology we create," Filippelli said. "You work extremely hard, beyond the transaction, to make sure that they're integrated, taken care of, and excited about their future."

That type of integration can be an important point for an acquiring company. They need to make sure that they are getting what they put their money into and that it will perform as well for the new company as it did for the original company.

When Sonayu bought Fractal, it bought more than the software. It brought in JR Charles, Sharata's co-founder, to work at the company. (Sharata is completing his degree in computer science at Johns Hopkins.)

While they could not reveal the terms of the deal, Charles and Sharata said they received a stock and cash deal, allowing them to maintain some ownership over their company.

Deals often contain incentives to help make sure people stick with the original company, Jones said. But companies also need to make sure they maintain a culture acceptable to employees.

“Integration is a really important aspect of buying businesses,” he said. “You have to think about how you integrate these businesses into your corporate culture. … Otherwise you’re going to screw yourself up and dissipate the value of the acquisition.” If that happens, the buyer could end up with nothing of value, something Jones called “a buyer’s worst nightmare.”