Managing for Business Survival in Challenging Economic Times

-Some harsh realities for VCs and their portfolio companies-

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Only one in three of the venture backed firms in the US will make it during this economic downturn. Oh you say, that doesn't sound so bad, I thought the number was 10-30% - that only between one in ten to three in ten venture deals succeeded in normal economic times. Well, there is a new reality – only one-third of those deals that might have succeeded will succeed in this market environment. It is not unreasonable to think that we may even be optimistic!

In some cases, since as early as last fall, managers and investors have been taking logical steps to tighten belts and stretch out the runway. Unfortunately, in many cases this will not be enough and may even be counterproductive. Venture investors are nervous, especially those that need to raise new funds and management teams are discouraged at having worked so hard to now be bitten by an economy they have no control over.

So where does this leave us? The objective of this white paper is to suggest a new approach to managing your portfolio and your company(s) over the next 18 to 24 months. These are not primarily operational or financial recommendations, these are not of the belt-tightening or cash conserving variety. These new strategies are about the very nature of new company formation and venture capital investment. Managing for challenging economic times requires stepping back and taking a fresh look at each company, at its technology, at the market it is addressing and at the manner in which venture investing gains its returns.

We see four key considerations that today's venture backed companies and their capital investors must address:

- Is the business being funded a product or a company? Does it have the market opportunity to scale to be self-funding and go public? Are the revenues and profits likely to sustain a full-time sales and marketing team? Are the revenues and profits likely to sustain successive investments in R&D to develop a suite of products? Or is this really a product or an application that will logically be purchased by a company in a complementary market space? Many VCs have a preference for an exit via a sale because of the challenges of taking a company public and the restrictions on their ability to sell their stock. But they often have been indifferent to addressing the product vs. company question until the funded entity begins to develop and prove its market position.

These times demand an earlier review of this vital question. Weak markets will, at best, dampen growth. Even companies which have been on a positive trajectory are now almost certainly behind plan. This means that companies that were aiming at going public may well not make it. And companies that are more of a product or application will find fewer buyers with lower pricing targets if those buyers are interested at all.

- In a slow market, generations of technologies will be skipped. Technology, applications and product investment has a logical pipeline to functional readiness and then to commercialization, market acceptance and profitability. Successive next generations are in development – whether that be in the idea stage, the lab stage, the beta stage or the market acceptance stage. But in bad economic times, generations get skipped.

  Skipping technology generations means that some investments that are in the pipeline won't see the light of day. Spending the last 25% to complete readiness and take a product to market is a bad bet when customers have cut back their spending on the previous generation. If customers don't even want what you have to offer, what makes you think they will pay the current price or pay a premium for the next generation? And why would you take the risk to complete the product if there are competitors who are cycling to a product roll-out of a more functional product than yours but with a launch target of 18 months later, when the economy may have rebounded? In normal times you would have a jump start on the competition that will likely yield your company some pretty handsome profits…but not in these times! Remember customers aren't buying.

  On the other hand, if your company has the right technology for today's market (and you can maintain a reasonable level of sales) and it has R&D products in the pipeline for commercialization in 18 months, you may be extremely well positioned. Timing in this market will be more vital than ever.

- Very few companies stand alone in totally new white space. Most applications, new products and new companies are developing business pieces that fit with and complement existing businesses products and applications. This raises the logical question of where your company fits. If many companies won't make it in these economic times, then can your enterprise be combined with another company to improve both companies' chances of success? Clearly it may be more desirable to be acquired by a company with deep pockets that can keep funding the start-up. But in these times, all options must be explored. Being able to distribute SG&A over a larger revenue base to gain scale is vital. Can it be done? Sharing an already built sales force or distribution channel, by combining with another company, might dramatically improve time to and cost to market.

Often management teams and investors let their egos get involved in trying to answer the question of whether the company is a buyer or a seller before they begin to have conversations with complementary partners. And often companies also try to estimate valuations before they begin these conversations. We believe these times demand more openness and more pragmatism. Don't delay and don't posture - start talking and exploring how to survive and how a combination of interests may allow the companies to weather the current storm.

- The days of doing deals aren't over. But it is no longer a seller's market. The practical reality of current market conditions is that only the golden goose will fetch princely sums. This requires a change in mindset and a change in approach. Portfolio companies and their investors must define their strategy for exit now, not when they might have targeted that exit in 6, 12 or 30 months from now. This doesn't mean that an exit must be taken, but an exit must be defined. It also might mean that there are multiple steps to a final exit. Combining complementary and even competing companies sooner in stock deals might in fact create a long term stronger company with an associated stronger exit for the combined investors later.

Many portfolio company management teams and many VC investors will anguish in the coming months. These are challenging economic times. A few new companies will get funding. And some existing high potential enterprises will receive subsequent rounds. But for many portfolio companies, the best steps to take are to reduce the costs, review the company's operations, review the four considerations elaborated above and move quickly to develop the right strategy for as soft a landing as possible.

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