



VC facing global challenges

The state of venture in Asia and beyond

Just about every indicator of the venture capital business shows a downward trend except for one: the amount of time that partners are spending with their portfolio companies.

The time is going toward huddling in conference rooms with CEOs and entrepreneurs, revising business strategies, financial budgets and forecasts for their startups and emerging companies. It's also being directed to figuring out which portfolio companies deserve special attention, and which are so weakened that they should be sold, merged or allowed to sink or swim on their own.

Tough choices in hard times

Venture capitalists have faced such tough decisions before in performing triage among their investee companies. But the process this time adds new challenges.

In the last downturn of the late 1990s, the economic slide was largely contained among Internet-related businesses. This time, the recession has impacted companies of all types. The smart venture capitalists have been quick to react and work pro-actively with their entrepreneurs. They understand that company startup founders typically have training as engineers or technology experts, not as business managers – and tough times require fast and effective decision-making.

“We tell our CEOs to buckle down and reserve cash, to cut costs to a minimum to ride out the downturn,” said David Chao, co-founder and general partner of venture firm Doll Capital Management Inc. (DCM). DCM advises the firm's investees to have 24 months of cash on hand. If that's not possible, the next best options are to either try to raise a new round of financing if the company's fundamentals are still good enough, or attempt to sell the business as soon as possible.

Swift to respond to the downturn, DCM kicked off an emergency drill last October to assist its portfolio companies with recession-fighting tactics. This early action was a lesson that Chao said the firm's partners learned during the dotcom downturn, when fast response paid off with later wins. Last fall's exercise resulted in the partners classifying investees into emerging stars, potential up-and-comers in need of repairs or a boost, and those with a poor chance of survival.

It also led to lengthy sessions with the entrepreneurs, reviewing business plans with an eye toward conserving cash and reducing capital expenditures. This rigorous process of fine-tuning strategies continued over the 2008 holiday season, but was time well invested.

Chao said that a few portfolio companies required “inside rounds” of finance, or supplemental investment to earlier capital infusions by the initial venture backer. Today, most of DCM's portfolio companies have managed to endure this recessionary period in good shape. Of the firm's 16 active investments, 15 beat their 4Q08 and 1Q09 forecasts.

Other crisis strategies

DCM is far from the only venture capital firm whose partners are working closely with entrepreneurs, counseling them on defensive measures and longer-term growth strategies. Last October, Sequoia Capital drew attention for holding a special briefing for its entrepreneurs. At the meeting, partners gave a 56-slide presentation that warned of impending doom in Silicon Valley, and advised CEOs to cut costs and raise capital if possible. News of the meeting sent aftershocks through the Valley, and soon others followed Sequoia's example of how to coach entrepreneurs, including Benchmark Capital and angel investor Ron Conway.

Today, San Francisco area companies are well prepared to survive the recession and drive a recovery, according to a report recently released by the Bay Area Council. Based on interviews with 56 senior executives, the survey found that managers were quick to enact defensive strategies, cutting costs deeply and swiftly, and placing bets on growth areas and innovation to position their companies for an economic upswing. For example, 75% of those polled have a clear recession plan, 80% have cut discretionary spending, and 63% have laid off staff. Most, too, are using the downturn to increase efficiency and refocus on priorities, with some seeing an opportunity to make acquisitions and attract new talent, said Narayan Nallicheri, a vice president at Booz & Company, which conducted the survey.

There's no secret why venture capitalists are rising to the challenge, determined to help their entrepreneurs come out of the recession stronger than before. Their own fate increasingly depends on it.

The venture capital business faces the prospect of fewer players and less capital, as the VC landscape transforms. Many firms are caught in a bind of no exits and nowhere to turn to raise new capital. While several major firms, including Sequoia and Accel Partners, have raised mega-funds recently, many others do not have solid results to show from earlier funds. With a shortage of high-flying IPOs or M&A deals among portfolio companies, these firms have little hope of raising new funds from already risk-adverse limited partners.

Consolidation forecast

A recent study by Josh Lerner, a professor at Harvard Business School, shows underlying trends that point to a possible shakeout among venture capital firms.

Lerner finds that the median return of US venture funds dating back to 1976 was slightly under 5%. Top-quartile funds weighed in with returns of 28%.

The outlook is not promising, with wide acknowledgment of a major pending winnowing-out of venture capital firms. The mounting evidence includes the aforementioned dearth of recent initial public offerings and M&A among venture-backed companies. In the US last year, there were only seven startups that went public – and there hasn't been an IPO in nearly eight months.

Meanwhile, the volume of mergers and acquisitions dropped 54% to \$23.5 billion, among 325 venture-backed companies. It was the worst year for liquidity since the dotcom bust and subsequent tech doldrums of 2003. The first quarter of 2009 brought no relief, with no IPOs of venture-backed startups in the US and liquidity from mergers and acquisitions of just \$3.2 billion, a 65% decline from the first quarter of 2008 and the lowest quarterly total since 2003.

The trends in venture capital fund raising are similarly bleak. After peaking in the US in 2007, at \$32 billion, according to Dow Jones VentureSource, US venture fundraising slid 25% to \$24.7 billion in 2008, and dropped 64% to \$2.4 billion in the first quarter of 2009, compared to the same period a year earlier.

Following a similar pattern but in a delayed time frame, Asian fund-raising peaked in 2008, with a jump of 8% to \$20 billion in new funds. In the first quarter of 2009, Asian venture fundraising plummeted to \$1.7 billion. The first quarter 2008 comparable was \$6.9 billion, *AVCJ* data shows.

Venture investing likewise continues to retrench. In 2008, US venture investments slid 8% to \$28.8 billion while first-quarter 2009 outlays declined by 50% to \$3.9 billion, compared to \$7.8 billion the same period a year earlier. It was the lowest quarterly total since 1998.

In Asia, investment declined 22% to \$22.3 billion in 2008. The first quarter of 2009 recorded 114 deals totaling \$1 billion, compared to 375 deals totaling \$8.2 billion for the same period in 2008, according to *AVCJ*.

Responses to the numbers

Confronted with such sobering statistics, it's little wonder that venture capitalists are busier than ever working with their entrepreneurs to drive results.

At Allegis Capital, the partners began a portfolio review process as early as July 2008, well before the recession was fully under way. Partners met with each of their firm's CEOs to put together a 24-month forward-looking cash plan, said Spencer Tall, a managing director. The review resulted in a number of follow-on financings for existing portfolio companies.

A majority of the venture firm's financings over the past nine months were insider syndicate-led deals, Tall said, noting that it's a pattern that will continue with upcoming follow-on financings. As a result, he added, "We are very comfortable with the cash outlook of our existing portfolio companies. Strong syndication and cash are kings."

In Sand Hill Road, Tsinghua Software Park, and many other entrepreneurial hotspots globally, the exercise that such thought leaders as Chao and Tall described has become a well-rehearsed practice – and few have time left for the golf course.

"Only if our companies live can we cash in. If they die, we get an F in our report card," said Henry Wong, a venture partner at Garage Technology Ventures. "It's easy to sail a boat in a calm sea, but it takes a very experienced captain to sail through the financial tsunami," he continued.

Key tactics he's employing with some 24 companies in the Garage portfolio include advising managers to transfer manufacturing and software design to offshore locations, primarily India or China. He's also wisely advising managers that if they must do layoffs, make sure to cut the right people from the payroll. Most importantly, he counsels them to figure out how to do more for less. He noted that startups need to make sure they have at least 18 months of cash in their bank accounts to withstand the downturn, Wong noted.

Like DCM and Allegis, Garage has resorted to offering inside rounds of finance to promising portfolio companies that need a boost to clear hurdles before they can rise to the next level and have a chance of becoming a star.

Advice for investees

From Shanghai, Gary Rieschel, founder and managing partner of Qiming Venture Partners, pointed out that he and his colleagues are counseling portfolio companies on cutting burn rates and playing defense to maneuver through the current economic environment.

At Qiming, Rieschel and his partners are advising entrepreneurs not to slow down "but rather to make sure that every activity they are doing is receiving critical mass of attention and resources. Focus and execution win in this environment," he said.

He cited several examples of how a company's resources can be used efficiently, which include: "identifying the best channel to bring products to market, zeroing in on disciplined product development, focusing more on lead generation than brand-building and awareness, and finally, placing greater emphasis on major account management, because the cost of acquiring new customers is dramatically higher and more difficult."

Citing specific examples of companies putting this advice to work, Rieschel said one "investee" in the gaming sector is now figuring out whether their core competence is in game development, game publishing or game operating. Another company, Tigermed, a leading clinical research outsourcing business, recently implemented an account satisfaction review, mindful that its existing customer relationships have grown dramatically in size and scale.

Still another, AllTech, which designed and built a MRI system, voluntarily reduced its burn rates so that it could successfully complete its own new prototype.

On a note of caution, Rieschel pointed out that venture capitalists should not expect their entrepreneurs to take their advice if the partners have not been receptive before or have only interacted with investees when there is a crisis. "This form of crisis management by VCs is analogous to parents raising children who only care about the grades on the report card, and not what or how the child is learning," he noted.

VCs prove their worth

As companies seek ways to improve sales and margins, venture capitalists are also proving their worth to portfolio companies by advising them on manufacturing and outsourcing strategies in Asia. Jim Boettcher, founding partner at Focus Ventures, told how he and his partners introduced one of their portfolio companies, supply chain service PCH International, to Pure Digital, makers of the popular Flip video camera. PCH designed a complete line of accessories for the Pure Digital camcorders, found the best factories in China to manufacture the accessories, designed the boxes and packaging, and shipped the accessories directly to PD customers in about three months' time.

As a result, average online sales transactions doubled while gross margins improved by more than 50%, since the accessories produced better margins than the cameras, Boettcher noted. The punchline of this story is that in March, Cisco Corp. announced plans to acquire Pure Digital for \$590 million in stock.

In another example, Focus Ventures worked with a portfolio company on maintaining strong sales support despite depleted international staffing and resources for a major Japanese customer, NTT. Focus Ventures helped the company set up in a Tokyo facility so that sales servicing could be continued without interruption. "If it had pulled out of Japan completely and stopped support for NTT, it would have very difficult for it to break back into the account," said Boettcher.

Consultants and HR firms join in

In a further indication of the impact the recession has had on entrepreneurial companies, consultants and executive recruiters are being called into action far more frequently.

Kyung Yoon, who runs executive search firm Talent Age Associates, finds that she's spending more and more of her time coaching CEOs on leadership and talent issues in the wake of the weakened economy. She's also called in to help startups to begin preparing for an inevitable upturn, and eventually even an IPO. One frequent scenario she sees is startups hiring an interim chief financial officer to work two to three days per week to help raise the company to the next level of growth. "A new CFO should be able to jump in and add value right away," she said, adding that seasoned CFOs perform more than the routine duties of a controller such as accounting, budget and forecasts.

Net Jacobsson, a former global executive with Facebook who recently took up consulting, is currently working with five entrepreneurs, and gets called upon at least five times per week from the US, Europe and Asia to perform more rescue missions.

He advises company founders to home in on core business, "what really matters and where the money is." Among his key talking points for entrepreneurs:

- "Cut projects that are not currently focused on revenues or aligned with the business model"
- "Work with contractors on short contracts to be more flexible"
- "Look at the data. What is the data telling you?"
- "Put yourself out of business and give back the money to your investors if you don't really believe in your business any longer. Be real"

Those are harsh words for harsh times, but that's the reality that both venture capitalists and entrepreneurs face. - *RAF*