A Call to Arms: VCs Forced to Confront Troubled Portfolios
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Even before Sept. 11, the venture capital market was going through its most painful year ever. Valuations had dropped significantly, fund performance was at an all-time low, and the collective reputation of VCs was the lowest in recent memory. To add insult to injury, most portfolio companies had no real chance of exiting—at least not profitably.

The terrorist attacks only worsened the situation for VCs, not to mention the investor community at large. Initially, the venture industry struggled to find a positive angle. Those trying to remain upbeat often spoke in generalities, using phrases like "We'll get through this," without addressing any of the specific challenges.

But a couple weeks after the attacks, what could be deemed a constructive response—positive just doesn't sound right—started to take shape. Now that the exit market was in even worse shape, and with recession looming even larger on the horizon, a few market pros said it was high time to get serious about troubled portfolios and quit propping up bad investments.

Mark Heesen, president of the National Venture Capital Association, was one of the first to challenge the market, throwing down the gauntlet at an industry gathering on Sept. 26. His message to general partners was clear: You're spending too much time sitting on boards and you're triaging too many portfolio companies with little chance of survival.

"A lot of VCs will not come to grips with the realization that many of their companies will never make it," Heesen said that day. "LPs and GPs must become much more realistic about things, there needs to be an openness. They need to cut bait. It will be ugly, it will be bloody for awhile, but they need to do it."

That ugliness is what scares VCs, most of whom have never had so many underperforming assets in their portfolio at the same time. Despite the market downturn this year, many VCs have been reluctant to cut their losses, in part because they want to continue to be viewed as committed investors.

William Helman, general partner of Greylock Partners, says he isn't about to shutter the many tech companies the firm bought into in recent years because it would be "bad for our reputation."

The problem, though, is that keeping bad apples is starting to have its own effect on the industry's reputation. While VCs may be concerned about the stigma associated with shutting down companies, they're now being taken to task—in some cases, by their LPs—for propping up doomed companies with follow-on rounds (albeit at lower valuations), for funding new dotcoms even after the Internet crash and for simply waiting too long to exit investments.

But now, with a recession more certain, delaying the inevitable may no longer be viable or acceptable. "We're being self-delusional if we think there's a chance for a return to normal in six, or 12, or even 18 months time," says Jim Breyer, a partner with Accel Partners.
This protracted market malaise could also lead to an unwelcome brain drain, as the best and the brightest seek higher ground. "Some of the key people who came from the Old Economy were sitting on the fence, but this may have lengthened time horizons for success and pushed them over," says Doug Chertok, managing director at Hudson Ventures. "Success for some of these companies becomes more difficult if these key people leave."

Killing Time

One side effect of holding onto too many portfolio companies is the immense time commitment. Heesen points out that with GPs sitting on an average of 10 boards, there's less time to focus on potentially promising start-ups. Indeed, with so many companies in crisis mode these days, VCs don't have the option of paying lip service to their investments. "Fifty percent of the companies in our portfolio are absorbing a ton of management time," Greylock's Helman says.

But like Greylock, plenty of venture firms aren't ready to cut their losses just yet. Six months ago, holding on might have been regarded as noble. Today, an increasing number of people are viewing it as borderline irresponsible. "[Some of] these companies are not salable, they are not even giveaway-able" says Helman. "The best option is to shut them down."

Turnaround specialist Patrick Lagrange says he expects a brisk business in the weeks ahead in selling the assets of struggling companies. Lagrange, managing director with specialist Carl Marks Capital Advisors, which deals in distressed assets, adds that his firm is considering adjusting its marketing strategy in light of the events of Sept. 11. Besides shutting a company down, selling to a distressed buyer may be the only option at this point, with the IPO market virtually closed and the M&A market short on acquirers.

Many established corporate buyers, like Compaq Nortel Networks and Intel are struggling to meet their already reduced earnings expectations and thus aren't interested in acquisitions, they say. Shortly before the Sept. 11 terrorist attack, Intel warned that VC losses were mounting and would exceed interest income in the third quarter. The losses, the first since the chipmaker began disclosing VC results in the fall of 1999, could well drain $200 million from the parent's pretax operating income.

What's more, the corporate technology spending that drove prospects for many emerging companies has dropped precipitously in the last 18 months, making valuations based on projected cash flow extremely challenging.

Sectors that look particularly vulnerable are those with an abundance of competitors in the space-optical networking, for one-and categories where there is a considerable capital requirement, such as wireless technology. One VC predicted the next six to nine months will be the worst in the history of start-up companies going out of business.

Already this year, scores of companies have shut their doors. Last month MobileStar Network, a Dallas provider of broadband wireless Internet services, disclosed it was shutting down and laying off its entire staff of 80. MobileStar had formed partnerships with American Airlines, Hilton, Hewlett-Packard, Cisco and IBM, as well as two rounds of funding - totaling about $60 million.

MobileStar, a travel service company founded in 1996, had expected to close on additional financing, but the round failed to close at the last minute, and the company was forced to take action. A spokeswoman blamed a difficult environment for service provider financing and a decline in travel in recent weeks.

Symphonica, a year-old company that offered Internet-based access digital content services, last month ceased operations, vacating an office it was occupying in a Long Island tech center. "We
gave it a one-year shot," said Jack Hoffman, a co-founder. "We tried to raise financing, but it proved too difficult."

Of course, not all VC-backed sectors are on life support. Software companies, for example, have low burn rates because they have minimal capital expenses. Understanding the need to preserve cash, President and CEO Kay Wagoner of Icagen Inc., a pharmaceutical drug discovery company, said hers has a relatively low burn rate of $5 million to $7 million a year. With $56 million raised to date, mostly in late 2000 and early 2001, led by Venrock Associates, Icagen "can hold out for a long time, until the nuclear winter blows over," she says. "But I'm not the only CEO who worries about the [economic uncertainty]."

Sectors like life sciences may also be able to ride out the storm. The long gestation period between birth and profitable exit is a hallmark of life sciences investments, which have become much more popular this year.

**PIPE Dreams**

While they're not sorting out their portfolios, VCs are looking for places to put their money. More and more are turning to PIPEs (private investments in public equities), which provide a safer bet than a private company while also offering liquidity. Under the usual setup, the VCs arrange to buy shares at below-market value and agree to a lock-up period of six months or longer, during which they cannot trade the stock. The companies benefit by getting an infusion of cash.

PIPEs were already seeing increased interest before Sept. 11. But since that day activity has picked up significantly. From Sept. 11 through the first week in October, there were 46 PIPE financings, which raised $367 million, according to Brian Overstreet, president and CEO of DirectPlacement.

The jump in PIPE volume this year has been marked by a dramatic increase in VC involvement. "A year ago I we wouldn't be having this conversation with VCs," Overstreet says. "We have seen a number of VC PIPE investments [recently], notably Bain Capital's $100 million investment in US Internetworking and Oak Investment Partners' $35 million investment in Wireless Facilities."

For some VCs, PIPEs represent uncharted territory that wouldn't have been considered in a stronger market. But now, "with valuations the way they are in the market, and people being concerned with liquidity, that investors can get better valuations here than they can in the private markets and they can get liquidity built into the investment as well," Overstreet says.

And for those who have done PIPEs before, there's a push toward expanding the level of activity. "We've done PIPEs on a selected basis over the past 20 years," says Richard Kramlich, general partner of New Enterprise Associates. "It's usually been when the public markets have fallen out of favor, and it's in companies where we've had a prior investment. Now, with the public markets so decimated and the values really outstanding for public companies, we've broadened our investment strategy to include companies we have never invested in." NEA has invested in 10 public companies during the past two decades and plans to invest in two more this year.

**Looking Ahead**

There's no question that VCs are faced with some tough decisions over the next few months—decisions that will be intensely scrutinized by their peers and their LPs. Market pros agree that the net effect of this painful period will be a massive shakeout in the VC industry.
But that might not be such a bad thing. Michael Guttnick, senior vice president of finance at Memorial Sloan-Kettering Cancer, says now that the dotcom bubble has burst and the terrorist attacks have reverberated around the world, "there will be a major shakeout, and it's healthy for the industry to get rid of these fly-by-night venture firms."

Clearly, the trick for many VCs will be knowing when to pull the plug on their struggling investments. Those that act sooner rather than later may be able to recoup some losses, while those who wait too long could lose big. On the flip side, riding out the storm may prove an effective strategy for some companies. But in any event, the economic impact of Sept. 11 appears to be pushing some firms to action.

VCs expect to see a continued slower pace of new investments in the short term as investors wait and see what effect the attacks and the aftermath have on the economy. Such delays threaten to slow innovation and growth, which the VC industry can ill afford.

The VCs who have stayed the course in previous downturns and unforeseen conflict-maintain a steely resolve. "Risk is woven into the fabric of the venture capital industry," says Roger Novak, managing member of Novak Biddle Venture Partners. "On Sept. 11, the world just got riskier, and VCs will need to maintain discipline and continue to do what they do best take calculated risks that help fuel our economic engine."

VCJ Associate Editor Charles R. Fellers contributed to this story.

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