Wednesday, January 23, 2008

Downturn - Now What?

My first year in venture was 2002. The great bull run of the 1990s was over, the dot com movement had come to a crashing halt, and Silicon Valley settled into a year of retrenchment and reckoning.

I remember long and painful board meetings where companies decided on reductions in force, recapitalizations and investor wash outs, and the slow, painful realization that the company's infrastructure, employee base, and positioning had gotten way too far in front of economic realities.

Friends who had accepted start-up offers thinking that they would go to HP or Oracle if things did not work out suddenly found their start-ups shutting down and HP and Oracle closed to new hires. Valuations seemed absurd in retrospect, companies with no sales were sitting on $50m-100m post-money valuations, $30m of paid-in-capital, and absolutely no chance of raising money; save a complete restart. A collective "what were we thinking" rolled through the valley.

The venture industry, like the tech industry at large, slowed down to not only digest "problem" portfolio companies, but also out of fear that large enterprises were no longer buying start-up products. The industry put $100bn to work in 2001 and only ~$20bn in 2002. It is fair to say that it was a bloodbath and billions of dollars were written-off and hundreds of companies quietly shut down. Venture investors largely sat on their hands and net new deals were very few and very far between.

As we all read the economic news this month, key questions are begged....how should an economic downturn impact venture investors behavior?, are there lessons one can learn from the dot com bust that can be applied in the current housing and credit bust?, will a recession hurt our companies, perhaps fatally?

If I take the last downturn as my guide, I can say with confidence that venture investors would be well suited to continue to invest right through the downturn - in 2002 and 2003 terrific companies were formed and funded at very reasonable valuations and with business models that reflected the demand for capital efficiency and economic viability.

Like Occam's Razor, recessions whittle away unnecessary and non-value-added businesses and the capital, purchase order, and resource scarcity inherent in downturns forges companies of real substance and durability.

I do believe, however, that certain classes of company will find fund raising very challenging in this environment. The last few years saw the rise and success of "field of dreams" web companies - ie companies where the business model and economics were secondary to utility, usage, and adoption. Perhaps most famously, Twitter is exploding with the principals publicly downplaying the need to define a business model. As consumers, the innovation possible via a "field of dreams" approach is wonderful, as investors, however, the market's patience to "uncover" the economic model over time and to, in the meantime, fund continued expansion and adoption is a major risk factor.

The last downturn saw the valley swing violently away from consumers to the enterprise - bastions of value, hard ROI, tangible value propositions, enterprise pain points and budgets, etc became the mainstay of investment decisions and the consumer, I kid you not, was literally a bad word.

Partner meetings where an investor said, "I have a great deal - it is a consumer play with great adoption metrics and a plan to work out the business model over the next 18 months," were a recipe for total and outright ridicule.

The valley became all enterprise, all the time.

Now, today's companies can leverage low-cost infrastructure and an ad-market in a way that their predecessors never could. However, I believe the following will occur: new deal investing will slow, perhaps radically, the enterprise segment will regain some of its former glory, consumer companies looking for capital in the absence of working business models will find raising money next to impossible, and employees will be much more scrutinizing of the companies they elect to join.

However, history suggests that capital efficient companies solving well-characterized pain points will continue to be great investments. Valuations, input costs (labor, rent, services) will fall, and future returns will show that 2008 and 2009 were great years to do start-ups. Similarly, in early 2009, as the consumer start-up market finds itself cut off from funding, it will be pay to make bold and brave investments in the consumer space.

None of us can predict the markets or future valuations, we all, however, can understand fundamentals. Businesses that solve real pain points with disruptive technology, a huge value/price advantage, and a scalable business model will work - the kiss of death, however, will be getting the capital structure ahead of those very same fundamentals. Failure is often a function of too much capital and too high prices suddenly running into economic expectations that are materially reduced with respect to market size, market growth, and trading multiples.

To survive, one may indeed need capital. The trick is to stay lean and not to overfund and overvalue companies where the investment only "works" if it eventually trades at 8x revenue and never needs another round of funding.

It way well be that Slide raising $55m from mutual fund companies at $500m+ pre-money will be the "what were we thinking" moment of the current cycle. I think, however, the investor who leads a $4 on $4m Series A in a company with a differentiated technology and a direct tie to hard ROI will feel calm in the storm.

18 votes

posted by Will Price at 5:44 PM

6 Comments:

ValIyObserver said...

Do you see a meta-problem with your analysis? You are implicitly assuming that year 2009 or 10 will be like 2002 (i.e bad times, but good times to follow 3 years down the road). In other words, your mental model calls for 2012 to be "good times" again.

Markets confound expectations. You could have thought (as I did!) in Japan 1996 that recovery was around the corner. We are still waiting ...

The Japanese were not stupid or "unique". They just got themselves into one monster mess by 1990 (which itself was a decade in the making). I submit that America has made one monster mess, a decade in the making.

Consider the alternative thesis. We might remember the "recovery" of 2003-2007 as an illusion built on Fed-inspired, Fed-bankrolled speculation

which made matters only worse, and prevented the natural healing from the previous bubble burst, by blowing an even bigger bubble in housing.
7:32 AM

Wayne Mulligan said...

@ValleyObserver...I have to disagree with you on a couple of points.

Japan is a MUCH different animal than the US. Not only did they get themselves caught up in a ton of over expansion and therefore had a really rough "bust" period. But Japan was also one of the very first low birth rate recessions in the world...nobody could've predicted how that would've turned out or how to cope with it. We're in the very typical "bust" part of the "boom and bust" business cycle we've had in this country for the last century. I don't know if I agree with the general timeline Will puts out there, but I think it's not too far off the mark.

The other thing to consider is we haven't gone through a real 'boom' cycle yet either. 2003 - 2007 merely got us back to even (before the crash that is). The Dow hit 14,000 for a bit and then came back down..we're essentially where we were back in 2001. That's 6 - 7 years of essentially trading FLAT.

If you look at a long term chart of the dow you'll see that we're in one of those long base building periods. Sort of like the calm before the storm, and the "storm" in our case is going to be a multi-year bull market that brings the Dow to a new (higher) sustainable trading level.

-Wayne
11:38 AM

MorePain said...

"We haven't gone through a real boom cycle either ..."

What do you call the real estate bubble? Froth?

The DOW could be "building base" for another 5-7 years (historically, that is about right when you consider the 70's bear market) at the end of which we have Graham/Shiller 10 year P/E reaching 10 or under. That would be a good point to think of an up-cycle.

VCs should be particularly careful, because, as Paul Kedrosky has pointed out, all the VC returns (collectively) are accounted for by bubbles! Without a bubble, VC is a ho-hum business.

5:17 PM

John Rodkin said...

Very insightful post. I agree 100% that investing at reasonable valuations in solid companies with real business models will be productive, even during a recession. One of the sad things is that that discipline goes out the window in the boom times, as we've seen recently (I also agree wholeheartedly with Slide's deal being a watershed moment.) Overfunding companies that don't have solid foundations in good times is just a sure fire way to make sure most of them never become solid. In many cases, it's more like playing musical chairs than investing.

10:55 AM

Don said...

We are probably entering a period of Schumpeterian creative destruction. The great thing about the US is that we tend to get through these periods much faster than other more highly regulated countries. When we come out the other end, we end up being stronger.

11:03 AM

wallstrip said...

Blocking and tacking works well in private investment world. I saw your post from Fred's blog. Great one.

You can overpay in public markets because of liquidity