Alternative Models of the Venture Investing Process

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“IT Doesn’t Matter”

Nicholas Carr
Harvard Business Review
May 2003

- Technological infrastructure has been commoditized
- No competitive advantage from investing in IT
- Spend less and cut costs
- “Focus on vulnerabilities, not opportunities”

The Fifth Wave

Carlota Perez

Technological Revolutions and Financial Capital

- The Bubble of 1999-2000 marked the MID-POINT of the “Fifth Wave” of transformational technology
- Like railroads and electrification: two phases
  - From infrastructure to applications
  - From experiment to existence proofs
  - From speculation to common sense
- The promise of technological revolutions is transformational
- Speculative Bubbles are endogenous

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The "Killer Apps" of the Fifth Wave

- The Bubble financed experiments in:
  - Customer self-service
  - Straight-through processing
  - Real-time intelligent transactions
- The vehicles for the Fifth Wave's productivity revolution
- The sources of major market discontinuities in IT infrastructure and applications
- Two decades to mature/two decades to deploy

The Status of The Technology

- Standardization is in process (and costs are falling)
- BUT:
  - Complexity rises with convergence
  - Computing vs. communications paradigms
  - Integration costs more than development
  - Syntax versus semantics
- Required: Higher levels of abstraction
- Required: Technological innovation
- Required: New ventures to bring innovation to market

Two Models of Venture Investing

Round-by-Round

Fully Funded

Round-by-Round VC Model: 1

- Focused on product innovation
- Start with intersection of: Well-defined market
New technology
- Specify an innovative product (faster, cheaper, better)
- Add management as needed
- Achieve liquidity ASAP: IPO or sale

Round-by-Round VC Model: 2

- Fund in multiple rounds/multiple investors per round
  - Each round validates (or NOT) continuing investment
  - New investors leverage returns for earlier ones (and for entrepreneur)
  - Value at each round = f (operational progress, *Capital Market environment*)

Round-by-Round VC Model: 3

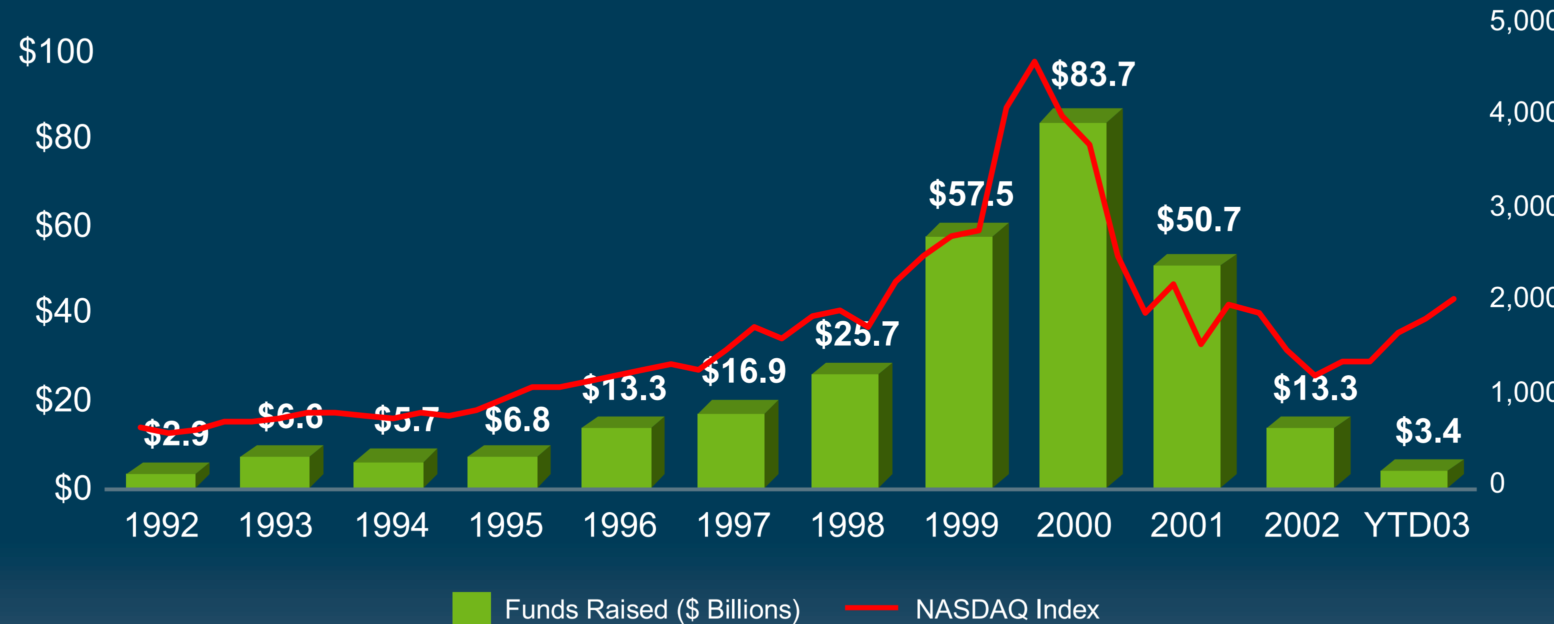
- Key attributes
  - Goal = Deliver product to market
  - Risks = Operational *and* Capital Market
  - Time horizon
    - 12 months per round
    - ~3/4 years to liquidity event
- Key exposure: Capital Market volatility

Capital Market Volatility

- The round-by-round VC model evolved to manage operational risk
- But every new venture is also exposed to Capital Market risk
- Ability to respond to Capital Market risk
  - Potentially compromised by multiple VCs
  - With diverse cost bases, availability of capital
- What the Bubble gave…hath been taken away

Fundraising Barely Noticeable in 2003

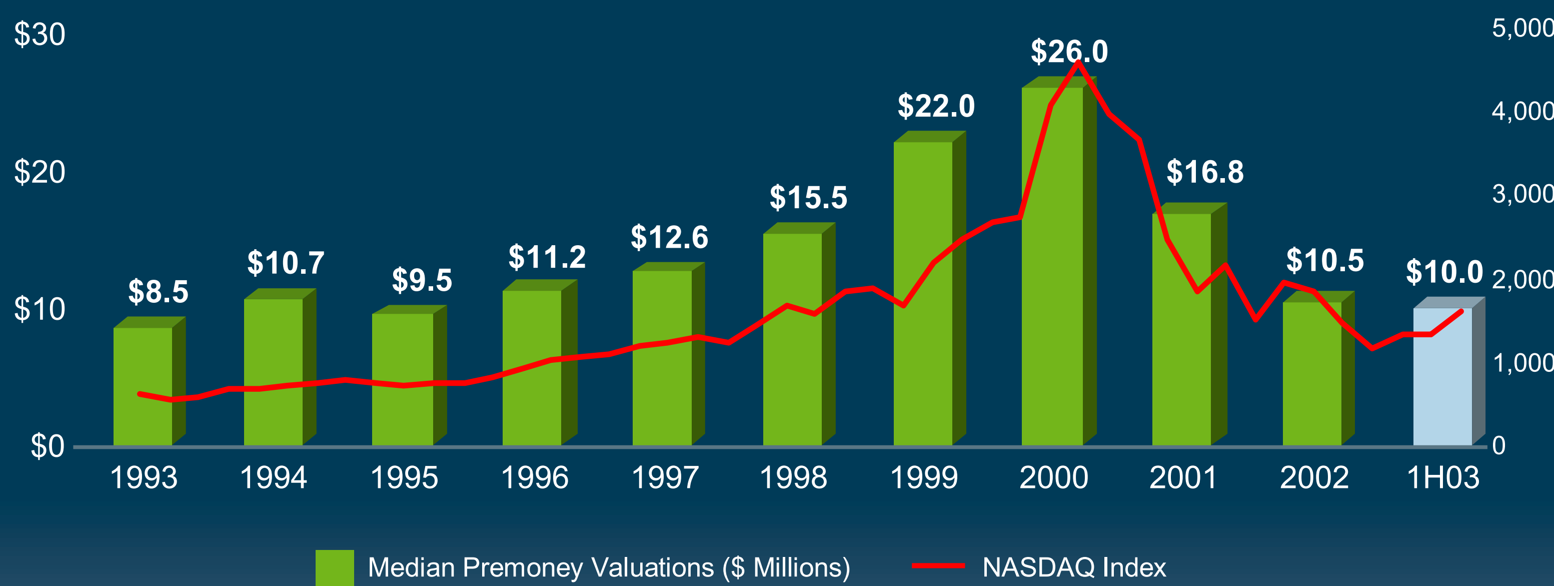
Commitments to Venture Capital Funds



Underlying data available in *VentureSource*

Valuations at Mid-’90s Levels

Median Premoney Valuations by Year



Underlying data available in *VentureSource*

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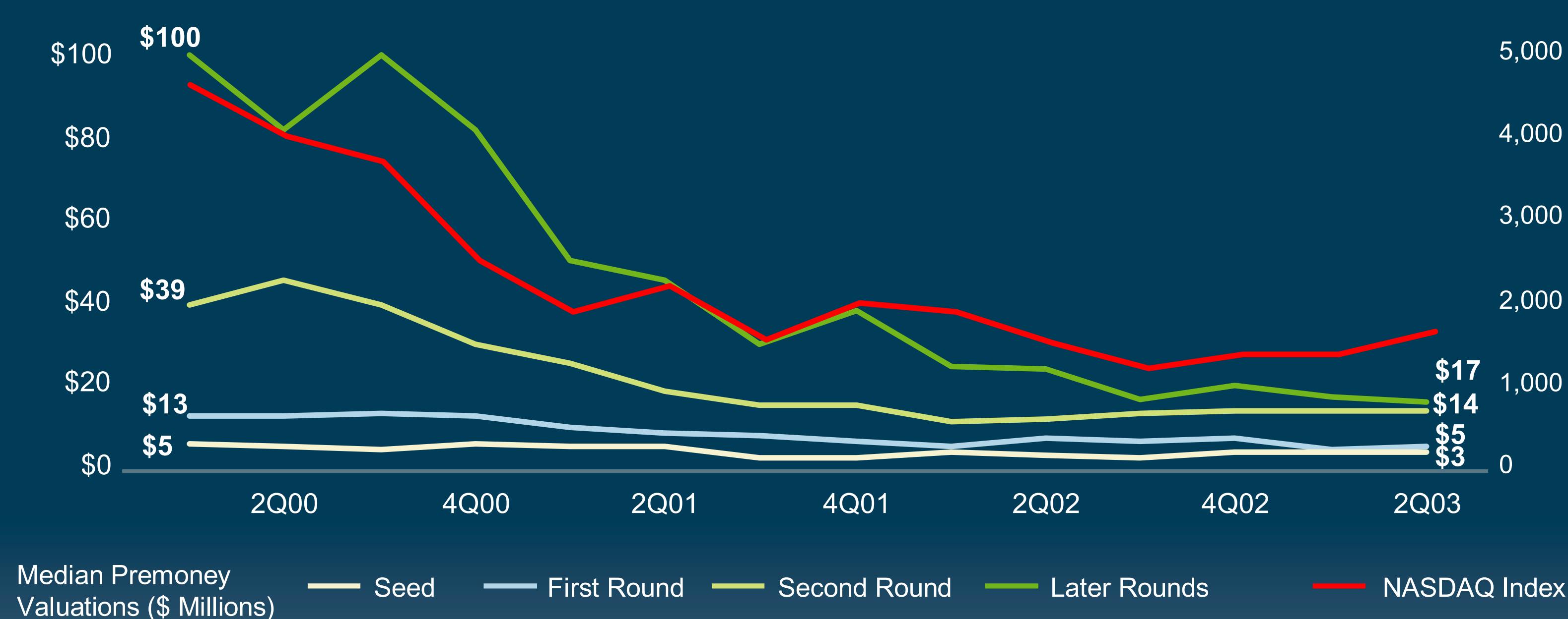
Valuations Regress Toward Overall Median

Median Premoney Valuations by Round Class



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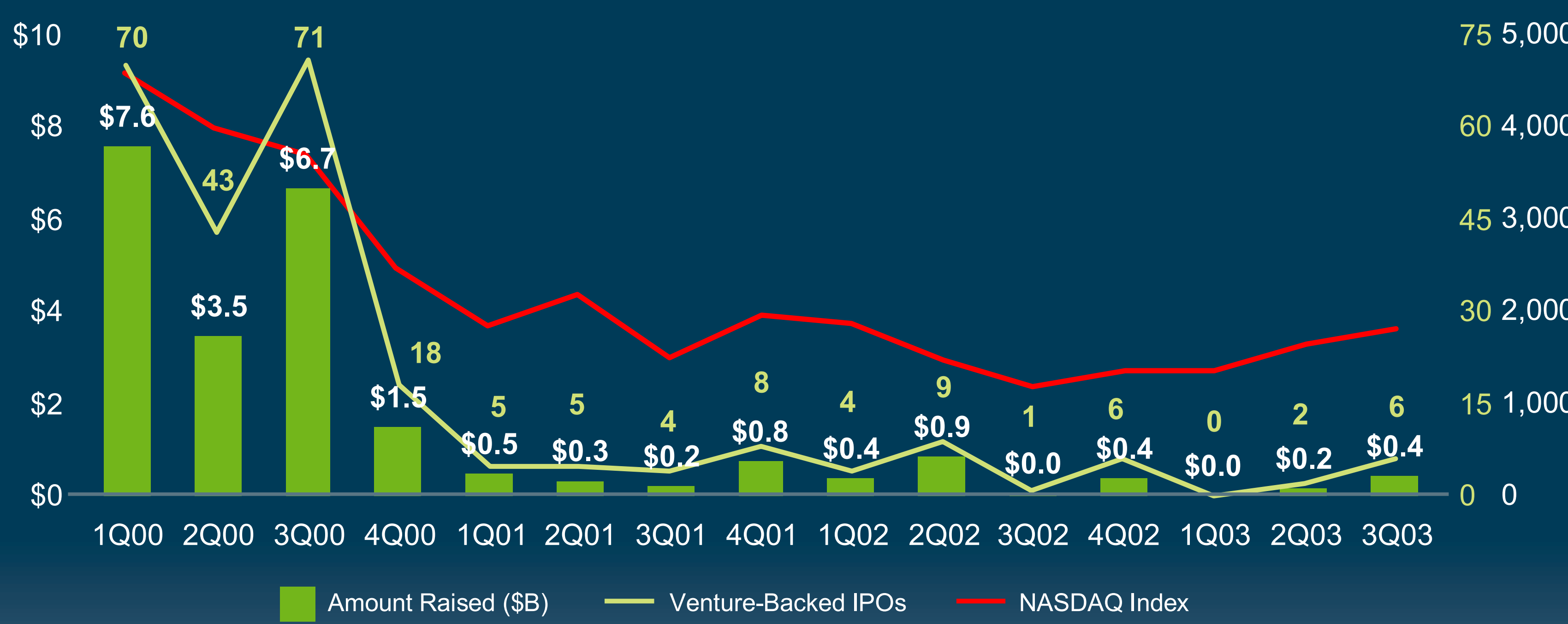
IPO Liquidity Has Been Rare, now Recovering

"Normal" means ventures can go public that don't need to



Underlying data available in *VentureSource*

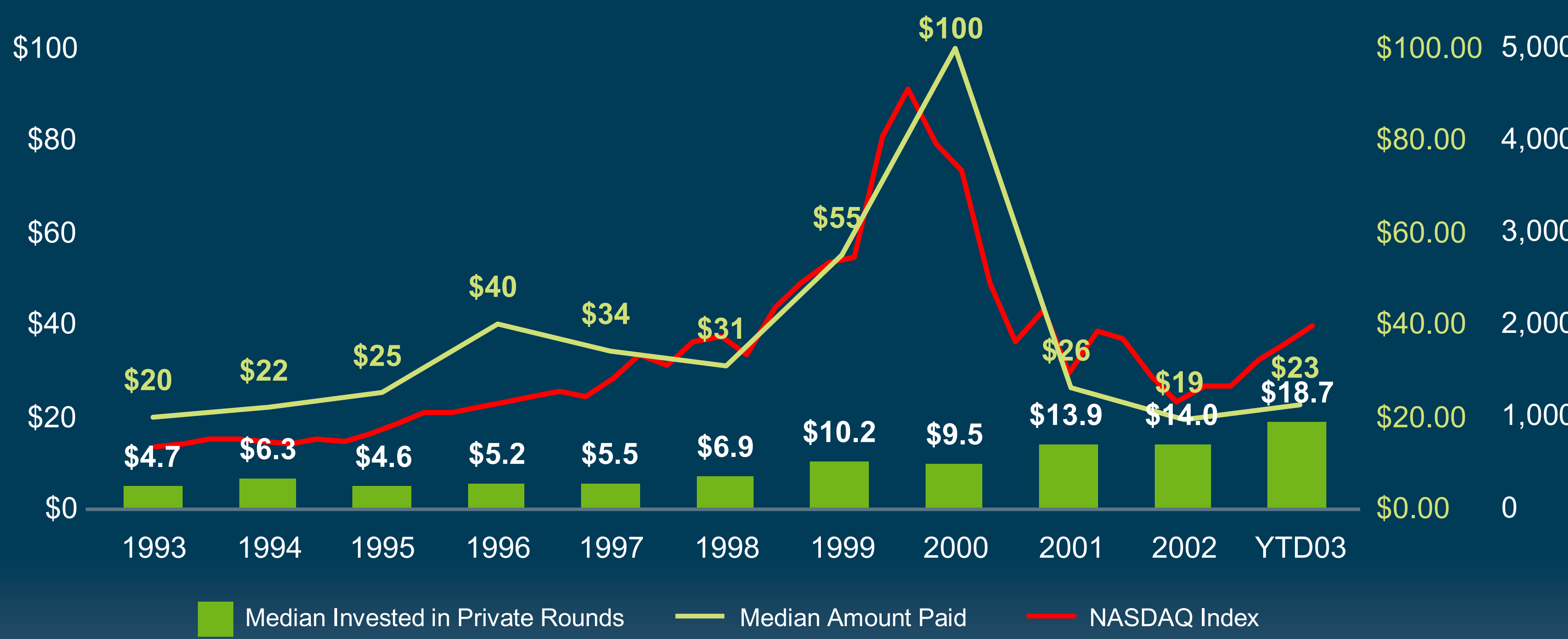
IPO Companies Older

Time from Initial Equity Funding to IPO

Underlying data available in *VentureSource*

Less Gains in Current M&As

Median Amount Paid in M&As vs. Median Invested in Private Rounds Prior to M&A



Underlying data available in *VentureSource*

Two Models of Venture Investing

Round-by-Round

Fully Funded

"Fully Funded" Alternative: 1

- Focused on market discontinuity
- Partner with proven management team
- Define business strategy:
  - "Buy what you can/build what you must"
- Estimate capital needed to cash flow break-even
- Negotiate price and availability up-front

“Fully Funded” Alternative: 2

- Evolved to address Capital Market risk
  - If markets move favorably, can always take advantage of them
  - If markets move unfavorably, keep building the business
- Management of operational risk = Continuing responsibility of financial and operating team
- Operating team wholly focused on building the business

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“Fully Funded” Alternative: 3

- Key attributes
  - Goal = Positive cash flow from sustainable competitive position
  - Risks = Operational only (Capital Market risk insured)
  - Time horizon
    - 4-7 years
    - Liquidity event = “Nice” *NOT* “need” to have
- Added benefit: this model was totally irrelevant during the Bubble!

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Where are we now?

- The existence proofs are evident: Amazon, Dell, eBay
  - The innovators have proven their case
  - “Main Street” has no choice but to follow
- But transformational technology only becomes universal when it becomes transparent
- Transparency requires higher levels of abstraction

Levels of Abstraction

- How to drive a car
  - “Turn steering wheel 10 degrees to left”
  - “Take Uncle Bob to the airport”
- From railroads to railway express
- From electrification to the assembly line
- From distributed computing to resource virtualization and web services

Abstracting the Infrastructure

- Fundamental paradigm change:
  - From bus-based to router-based processing: IP everywhere
  - From remote calls to messaging: XML everywhere
  - From the “smart” SMP system to the dumb crowd: numberless nodes
- New architectures are needed:
  - To manage heterogeneous, distributed resources
  - To make them work as an application platform
- New architectures are the context for new point products
- Delivering new architectures requires building sustainable businesses

Abstracting the Application

- Fundamental paradigm change
  - Composite applications: Functionality = Service
  - Value from business process understanding
    - Ease of customization
    - Ease of incremental extension
  - Payment for value delivered over time
- New business model means new investment model
- New product = $15 million-25 million
- Sustainable business = $75 million-100 million

Conclusion

- The “fully funded” alternative is relevant again
  - (f) The post-Bubble capital market environment
  - *AND* paradigm change at the infrastructure and application levels
- But only for a sub-set of strategic ventures
  - The entrepreneurs are self-selected
    - Build a business *versus*
    - Deliver a product
- When the capital markets are “normal”, IPOs are available to the businesses that *don’t* need them
- Strategic ventures require long-term capital