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A VC Model for the Recession

Today's economy means venture capitalists and private equity firms must map a new course.

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Aug. 25, 2009

Our economy relies on a steady stream of venture-backed companies, who collectively produce more than one-fifth of the US gross domestic product. In fact, public companies that were VC funded currently account for more than 12 million U.S. jobs and $2.9 trillion in revenues. Research firm Global Insight estimates that 92 percent of job growth at these companies occurs once the company enters the public market.

However, economic uncertainty, and an adversity to risk has substantially reduced the IPO pipeline, and broken this cycle. Instead, VC-backed companies today are currently struggling to maintain cash sufficiency, which leaves investors holding the bag.

The problem is investors have abandoned long-term strategies in favor of short term returns, and this shift to much more conservative investing is stifling innovation. As a result, investors may well be passing up on what could be the next Google or Facebook. In order to survive, VCs need to re-think *how* and *where* they can help their portfolio companies remain innovative and profitable in the current economy.

A VC/PE Model for the Recession
This has driven venture capital investing down 30 percent since 2006, according to a recent report from The Ewing Marion Kauffman Foundation, and they expect it to continue to decline.

Seven IPO filings in Q2 of 2009 represent an upswing from only one in Q1 of 2009. This indicates that the IPO market still has a pulse, but it is not enough. Even VC-backed Open Table and SolarWinds have maintained a flat share price since their IPO date. The IPO market has simply not recovered since the recession began, and VC-backed companies need to adapt if they want to succeed.

While traditionally investors were focused on capitalizing on market opportunities, and leading with financial re-engineering it is our view that we must now shift our focus to operational excellence. Organizations at any point of their growth path, that move fast and achieve much with few resources, will provide venture capitalists with the best returns when discretionary funds are low. However, many firms funded during the good times face a dilemma to achieve scale and escape velocity to reach a strategic liquidity event either via IPO or sale.

Rather than waiting for the market to re-energize itself over time, there are several steps that private equity or venture backed companies can take to improve their strategic options while mitigating the risk of more capital deployment to get to a liquidity event.

The venture capital and private equity industry can influence valuation today by focusing their attention on the operational performance of their struggling portfolio companies. Much as the credit crisis has fundamentally changed the banking industry, a shift must now take place for venture capital and private equity firms, as they seek a shorter timeline to profitability and leaner, more efficient portfolio companies.

This approach also provides a clear path to increasing enterprise value, and reducing dependence on ongoing funding for many venture and private equity backed enterprises. Rather than waiting for government and financial institutions to step in and the IPO market to re-energize, it is essential that underperforming companies take decisive action to improve their situation.

In order to create jobs in our new economic reality, it is important that money-losing enterprises streamline their operations through business process re-engineering and strategic outsourcing. For successful execution Following are a few simple steps companies can take to begin to streamline their operations:

- **Redesign Processes** - Recreate the organizational structure of the portfolio company, which would include outsourcing key functions to a third-party company that acts like a VC/management consulting entity. The functions to be outsourced should be operational tasks that are digital, distributed and repeatable, which will allow for substantial reinvestment in market facing resources in North America to spur growth. Establish Execution Excellence with quality metrics and set CSAT Improvement as a key focus.
- **Optimize Costs** - Cost is an outcome of the process. A solid process redesign will drive substantial cost optimization for the company. Implementing a robust transition plan to ensure that the company could maintain "business as usual" while the transformation took place will be essential.
- **Revenue Acceleration** - Optimizing costs and reinvesting savings into the business will set the stage for efficient and profitable operations and revenue acceleration. By generating measurable cost savings, companies would be able to redirect capital into sales and account management. This would result in stronger client relationships, an effective and efficient sales team, and more customizable solutions. This approach also provides a clear path to increasing enterprise value, and reducing dependence on ongoing funding for many venture and private equity backed enterprises. It is essential that underperforming companies take decisive action to improve their situation, rather than waiting on the sidelines.

Real World Example: How to Orchestrate a Dramatic Turnaround

Ontario-based Avotus is a leading provider of telecom expense management solutions. Avotus

had many strengths including a high percentage of recurring and predictable revenue serving leading global companies such as Motorola, HSBC, Merrill Lynch and many others. However, Avotus was facing accelerated losses - driven by their original "build it and they will come" philosophy better suited for more upbeat economic times. As a mid-sized telecom expense management (TEM) provider, Avotus had great promise but was underperforming financially and burning significant cash.

The company and its investors faced a dilemma that many VC/PE backed companies are facing right now - more investor capital is no longer a viable option to turnaround broken businesses. The investors could try to bail, but getting any value from a negative cash flow business in this environment means tremendous write downs of asset values or just shut the business down to stop the bleeding.

Another choice for the company was to embark on a radical business transformation - not a traditional cost cutting measure to save 10-20 percent - but fundamentally transforming what we call the "physics of the business". The Conjoin Group helped change the business. They inserted new leadership and outsourced 80 percent of the company's resources, making the business economically viable and exponentially more scalable.

ConJoin architected and executed a transformation in which operational tasks that are "digital, distributed and repeatable" in nature has been transitioned to the Conjoin team in Mumbai, India. This has created more than $12 million swing on the EBITDA line - while expanding capacity on almost all value creation areas of the business. The company is now reinvesting in areas like software platform development, New Product & Services and increase the market-facing North American resource three-fold.

The transformation of Avotus was executed in two phases. During the first phase of the transformation, non-value adding activities that did not provide value to the clients and company were eliminated. In the second phase, Avotus invested 4,000 hours of analysis, spread over 12 weeks to an in-depth review of managing operations. Current assessment of the company's strengths and weaknesses and an actionable roadmap that included operational redesigns and future process recommendations were developed. The effort resulted in the design of a new operational architecture and recommendations for improvements included a comparison of operating from within the U.S. versus other lower cost locations (India),

Along the way some short term improvements were also achieved. For example, as part of the TEM analysis provided to customers - the legacy organization would read through several lines of of documents and needed to pick specific pieces of information based on a pattern. The

ConJoin team automated the process based on the pattern and reduced the process time from a few hours to less than two minutes. This also eliminated the risk of human error inherent in the legacy process.

As part of the transition process, By identifying best practices and tools, a framework was established to accelerate what needs to get done, so that the Company's TEM solutions reflect many years of unique expertise. The new Avotus team, staffed by Conjoin Group personnel were trained on the nuances of TEM and unique customer specific exceptions for improved client service and a more efficient operations. In addition to cutting costs, retaining Tem expertise and establishing a higher level of efficiency, a balance scorecard based performance metrics were developed for measuring and improving. Quality metrics were established and CSAT Improvement was set as a key focus. Conjoin is also working to implement ISO 9001 and 27001 certifications together with 6 sigma methods for increased operational performance.

Optimizing costs has set the stage for reinvesting money into the business for achieving improved operational efficiencies and business growth. This would result in stronger client relationships, an effective and efficient sales team, and more customizable solutions, which delivered the right product to the right customer segment, as well as the right managed service into the offering.

The Bottom Line

Conjoin helped Avotus improve EBITDA by more than 300 percent in less than 3 quarters and achieve financial viability. With the improvements, Avotus began investing more heavily in sales, new products and services, while exploring new potential markets. This has now enabled the company to be self sufficient much sooner than it could have under its legacy structure while simultaneously setting the stage for the company to now leverage its core capabilities. The ConJoin team orchestrated leadership to set a course of profitable growth regardless of the macro economic environment. This all creates enterprise value and options for future shareholder returns much brighter than what were the alternatives.

In this challenging economy, it is critical for venture capital firms and startups alike to develop on new models to deliver value to their investors and maintain their position of influence in the next era of business innovation.

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