Value-Added Investing: *A Framework for Early Stage Venture Capital Firms*

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How do venture capitalists help their portfolio companies create value besides supplying capital? Do they have expertise that can create value and reduce the risk associated with building a successful business? This article explores how one leading venture capital firm, Vesbridge Partners, invests in early-stage technology to add value and reduce risk, both for the companies in its portfolio and for the limited partners who supply capital. Vesbridge Partners has developed a unique framework that focuses on six key areas for creating value and reducing risk. We call these areas *value levers*. In our view, they represent best practices for how early-stage venture capitalists add value to their portfolio companies. The six value levers are 1) Strategy, 2) Team, 3) Customers, 4) Syndication, 5) Industry Category, and 6) Exit. We shall look at each one in turn after we lay out a framework for the overall process.

THE FRAMEWORK

Evolution of a Venture-Capital Financed Company

Exhibit 1 shows a company's changing enterprise value over the course of a venture capitalist's involvement with that company. In early-stage investments, the venture capitalist hopes the venture will make material progress between each successive round of financing, leading to ever-higher valuations. As the company achieves greater clarity in terms of product and market, with prototypes designed and a nascent sales staff in place, the perceived risk of the venture declines and its value goes up.

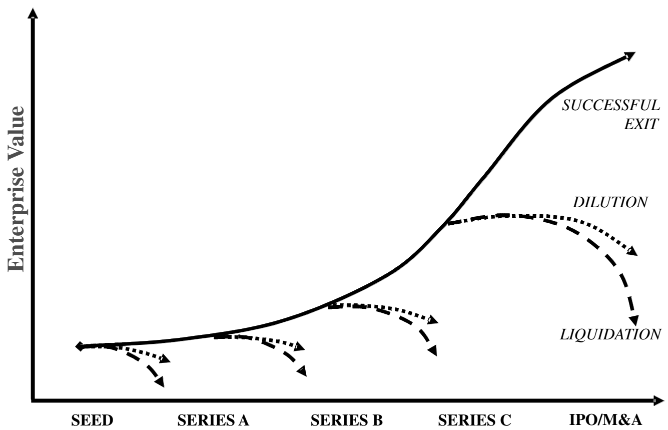
Coinciding with each new financing round, from seed-stage investment through a series of additional rounds, the venture capitalist faces a critical decision: 1) to invest further funds that preserve or enhance the value established in the previous round; 2) to invest further funds even if the value from the previous round is diminished ("a dilution round"); or 3) not to make a further investment.

How the venture capitalist makes this decision rests on an estimation of the company's current situation and likely next stage financing requirements. If the venture's value has increased, the stakes of current holders would be valued at levels exceeding the previous round's valuation, and new capital would be brought in from new and/or existing shareholders. If the venture is deemed promising but current value has not increased (due perhaps to missteps, market conditions, or other competitive reasons), its new round of financing would be valued at less than the previous level. If the venture is perceived to lack promise, the venture capitalist would make no further investment, forcing the company to find funds elsewhere or risk going out of business.

Each time Vesbridge Partners has to make a decision whether to supply additional capital (and at what rate), it examines each of

E X H I B I T 1

Evolution of a VC-Financed Company



the company's six value levers to determine how likely the company is to be successful. Exhibit 2 shows each of these six levers and how investors can use their expertise at each stage of investment to add value to the portfolio company while reducing risk to the fund's limited partners. Thinking about an investment in terms of these six levers serves as a kind of continuous due diligence that allows the venture capitalist to monitor the investment. Deep sector expertise and considerable operating experience are needed to know when and how to pull these levers.

Early stage technology funds use the combined experience of their partners to provide portfolio companies with expertise and contacts that their management would not otherwise have. Vesbridge Partners is the former networking team of St. Paul Venture Capital. It invests in early-stage companies seeking to commercialize technology useful to the telecommunications industry. Before entering venture capital, Vesbridge Partners investment professionals spent many years as operating executives either in start-up firms in the telecommunications industry or as senior executives in the industry's leading firms. Their experience, contacts, and skills allow them to understand how and when to pull the six levers needed to move portfolio companies faster down the experience curve so that returns are enhanced as risk is reduced. (Short resumes of Vesbridge Partners investment professionals are included in Exhibit 3.)

Value-Added Investing

Venture capital investment seeks as much as possible to reduce the agency costs associated with inexperienced managers developing and marketing new and unproven technology. Vinod Khosla, a successful early-stage investor at Kleiner Perkins, claims that when he took an active role in his portfolio companies, his aggregate returns were on the order of 70%. When he was a passive investor and lacked a board seat, his aggregate returns were only 8%. By deploying their expertise and contacts, investors can influence the company's operations in ways that lead to their funds enjoying consistently superior returns.

What follows describes Vesbridge Partners' framework for supplying its portfolio companies with operating and strategic expertise as well as industry contacts a start-up company would not ordinarily have. This framework begins by examining the start-up company's strategy and product and ends with a successful investor exit. This framework is outlined in Exhibit 4 which sets forth the six key areas of value-added investing along with their crucial elements. This next section describes each of the value levers and their crucial elements along with examples drawn from Vesbridge's experience applying this framework to five of its own portfolio companies. Exhibit 5 provides brief summaries of these five portfolio companies.

THE SIX VALUE LEVERS

Value Lever 1: Strategy/Product

The work of a venture capitalist to drive the critical thinking behind a new venture begins before markets have been identified, before products have been developed, before customers and partners have been established, before management teams are fully formed and investor syndicates assembled. All the venture capitalist may have at this point is a venture formed to find ways of commercializing a technology that has not advanced far beyond a research laboratory.

The venture capitalist's first step is to help develop a strategy for this emerging company. The strategy covers seven crucial areas: It defines the product, the target customers, the purchase rationale, the customer engagement model, the crucial partnerships required, the selling channels, and why the strategy will be successful. The strategy describes the practical means through which a new company will exploit a market opportunity for the benefit of stakeholders. Because the venture capitalist has more experience, expertise, and industry contacts than the portfolio company management, he or she takes the lead to develop the strategy.

The strategy is codified into an operating plan that

EXHIBIT 2

Company-Building Model: Value Levers by State of Company

Component/Stage	Seed	1st Rd	2nd Rd	3rd Rd	IPO/M&A
Strategy/Product					
Value Proposition, Strategy, Competitive Opportunity	Conceptual. Not deeply understood or well articulated. Broad.	Early market validation. Better definition of "sweet spot."	Refined presentation, Targeted customers. Better competitive knowledge. Partner validation.	Focused on key targets. ROI models. Value Chain.	Next generation value propositions developed.
Product	Concept.	Proof of concept. Functional specification. Product Plan.	Tangible key elements such as a chassis or functional demo software. Next generation product plan.	Successful trials. Installed base of product. Reliable sales forecasts. Demonstrable capabilities on next product release.	Long-term product vision is well understood.
Team					
Engineering Team	Core team of 3 to 5, including architect.	10 to 12 including e directors. No. of engineers depends of size of project.	Full Team. Relevant experience in key product elements. Unique domain expertise.	Larger team. CTO. VPE.	Proven team.
Management Team	Limited, Acting CEO, Marketing Director. Maybe a CTO.	VPE, VP Marketing, VP Business Development. CEO late in round.	CEO and CFO. Substantially complete management team.	Complete top team. Expanded middle layer management.	Public company CEO & CFO, if IPO is planned.
BOD & Advisors	Limited.	Add credentialed players, respected in the VC community.	Continue to expand & educate. Develop active support & involvement.	Recruit well recognized industry players to BOD.	
Customers/Partnerships					
Customers	Rough idea.	Referenceable contacts. Bigger names mean more value.	Beta trial locations identified. Market segmentation better understood.	Successful trials. Installed base of product. Reliable sales forecasts.	4 quarters of solid growth. Profits or credible plan to profitability.
Strategic Partners	None.	Limited.	Discussions with equipment vendors. Service providers partnerships possible.	OEM or other distribution & co-marketing agreements in place with major telecom equipment providers.	Expand depth and breadth of agreements.
Syndicate					
Investors (Equity & Sub-debt)	Typically Vesbridge Partners only seed investor.	Recruit strong first round partner. Big projects should have 3 substantially equal players.	Target later round investors and strategic partners.	Target strategic partners and prominent I Banks.	Get best brand I banker available. Get strongest analyst possible.
Industry Category					
Category Support	None, typically not recognized.	Limited number of "gurus" predicting emerging market.	Growing support from industry and investment analysts.	Published reports on size, growth, composition of market. Recognized category at industry events.	Broad public perception that category is "hot."
Investor Exit					
Exit	Concept.	Concept.	Concept.	Offer rejected.	Multiple options.
Value	**Limited.**	**Driven by team, BOD & Advisors, customer references, VC market conditions.**	**Driven by team, BOD & Advisors, quality of customer contacts, competition, and market perceptions of the category.**	**Driven by revenue forecasts.**	**Driven by revenue and profit history & prospects.**

EXHIBIT 3
Vesbridge Partners

Raj Alur
Mr. Alur has over 20 years of experience in telecommunications, data networking, and operating systems and software. He joined St. Paul Venture Capital in February 2001 from Lucent Technologies where he served as vice president of strategic marketing. Prior to Lucent, he worked in product marketing at Ascend Communications and in business development and strategy at Stratus Computer. He served as president and chief executive officer for Avian Communications (now known as ProQuent Systems), one of St. Paul Venture Capital's portfolio companies. In that role, Raj helped Avian raise $22 million in venture financing and recruited the company's senior management team.

Rick Boswell
Mr. Boswell specializes in communications equipment and software, specifically multi-service packet infrastructure. Previously he was president of ADC Telecommunications; president and CEO of E.F. Johnson Company; chief sales and marketing executive for a leading manufacturer of medical laboratory instruments and reagents; and co-founder and engineering officer of two start-up companies. He is one of three founding partners of St. Paul Venture Capital.

Bill Cadogan
Mr. Cadogan began his career at AT&T, where he held a variety of sales and marketing positions. He then founded a company that he later sold to Intelsat. In 1987 he joined ADC as vice president and became president and CEO in July 1991. Under his leadership, ADC grew revenues from $263 million to $3.2 billion in 2000. Bill is a former chairman of the Telecommunications Industry Association. In April 2001 he joined St. Paul Venture Capital as a general partner focusing on emerging opportunities in the communications sector, with an emphasis on optical technology.

Zenas Hucheson
Mr. Hucheson began his career in strategy consulting. For 17 years, beginning in 1981, he headed a firm that provided interim management and strategy and financial consulting to troubled, early stage venture-backed technology companies. His roles included directing the investor-exit program on behalf of financial firms that had been original backers. In 1998, he joined St. Paul Venture Capital as general partner in charge of making investments in communications.

Rod Randall
Mr. Randall has more than 20 years experience in strategic marketing, including prior service as the chief marketing officer at Lucent Technologies. He was a co-founder and chief technology officer of Teleos Communications, a network access-equipment provider acquired by Madge Networks. During his time at Madge Networks he served as the vice president of strategic marketing and established the company's strategic partnerships with Intel, Microsoft and MCI. He joined St. Paul Venture Capital as a general partner in November 2000 specializing in wireless infrastructure.

Martin J. Steinmann
Mr. Steinmann joined Vesbridge Partners in August 2003 as a venture partner after a 15-year career in the technology industry. He specializes in marketing and strategic planning. As a venture partner, he served as the senior vice president of marketing for Pingtel Corp., a pioneer in the voice-over IP market. He is also a founder of SIPfoundry, the industry's leading open-source community dedicated to VoIP technology and solutions. Martin's career also includes executive roles at Lucent Technologies, Ascom AG, and Syndesis.

matches subsequent financing rounds to milestones such as crucial hires, product completion, key accounts, revenue targets, and other measures. It reflects the best guess of management and investors as to how much capital will be required to achieve business goals and generate returns.

The strategy becomes the template for organizational development. It defines the professional competencies that must be acquired by the new firm in engineering, marketing, sales, business development, and other functions. Strong alignment of organizational competencies to key elements of the strategy is an essential element of risk management in early-stage ventures.

EXHIBIT 4
Areas of Value Creation

Area	Critical Elements
1. Strategy/Product	• Product • Value Proposition • Priority Customer Groups • Channel Strategy • Customer Engagement Model • Solution Eco-System • Competition • Operating Plan
2. Team	• Core Technical Team • Department Heads • CEO • Board and Advisors • Recruiting Process
3. Customers/Partnerships	• Key Customers • Corporate Partners
4. Syndication	• Investor Targets • Management Pitch • Due Diligence Preparation • Process Management • Structure
5. Industry Category	• Industry Analysts • Investment Analysts • Press/Media Pundits
6. Investor Exit	• Candidate Acquirers • Options (IPO/Sale) • Advisors

While the early stage venture investor's role is to provide input and drive critical thinking, management finally is responsible for executing the strategy. Capable execution requires that the strategy and operating plan are continually updated as market conditions change. The role of the venture capitalist is to reduce management's trial-and-error learning to a minimum. Management has a responsibility to use the long experience of the venture capitalist to learn faster and to make fewer mistakes. Let us take up these seven areas one by one.

Product. One of the most important services that the venture capitalist provides is helping management understand how a core technology can be translated into a marketable product or service. Management may become very familiar with a new technology without understanding how it can be commercialized. This translation into a marketable product or service is one of the most important dimensions of the value that the venture capitalist adds.

Case Example of Product: Granite. Vesbridge Partners was the lead investor in a company called Granite. It developed software sold to telecommunications carriers that enabled the carrier to digitally maintain network inventory. Granite's software object model could digitally represent any network element and its physical and virtual connections to other network elements. The object model incorporated deep domain expertise in networking and was not easily reproduced by other network management software vendors. Prior to Granite, the software model for each network element was separately developed and was difficult to extend as the element evolved. In a calculated gamble, Granite later undertook a major update of its software architecture to extend its competitive lead against established companies and other start-ups. Granite's customers were able to benefit from the new architecture while utilizing existing object models. This preserved significant prior customer investment. Because of its knowledge of software and network management, Vesbridge was able to recognize the value of Granite's robust object model and the strategic importance of a new architecture. Vesbridge played a decisive role in persuading other investors to back Granite's product strategy. Although the company began to generate sales in 1998, Granite knew that its development platform no longer represented a mainstream technology. In August 1999, Vesbridge Partners strongly backed the company's decision to rewrite its software product from the ground up, moving to a state of the art development platform. Granite took an enormous gamble to rewrite its code from scratch while continuing to ship product based on the soon-to-be obsolete platform. Because of its deep knowledge of the industry, Vesbridge Partners understood that this bet was necessary to ensure the long-term attractiveness of Granite's product. Vesbridge also played the decisive role in persuading the other firms that had supplied capital to agree with this strategy. Granite, then, was able to weather the industry-wide downturn of 2001 and emerge with an enhanced portfolio of products. Because Granite's products represented the next-generation architecture, Vesbridge Partners was able to make a very successful exit from the investment.

Case Example of Product: Aegis. Aegis Semiconductor developed a thin film-array technology that was between 5 and 10 times less expensive than the existing technologies and was not easily reproducible. The underlying fundamental technology was applicable not only in telecommunications but also in industrial markets and medical devices. This made the technology exciting for Vesbridge Partners because it could start with one product

Exhibit 5
Portfolio Company Histories

Aegis Semiconductor
This company was founded by a team of scientists at Princeton University in 2000 to commercialize a tunable optical filter technology. This technology was based on active thin-film semiconductors and was first developed for use in telecommunications. Additional applications include non-invasive glucose monitoring, carbon dioxide and carbon monoxide detection, and thermal imaging.

The company was funded with $1 million in seed capital from YankeeTek Ventures. Vesbridge Partners became the lead investor in the Series A round, having been introduced to the company by YankeeTek. Vesbridge Partners was instrumental in helping Aegis develop a viable product, believing that the telecom market offered the most promising prospects in the short term. With Vesbridge leading the round, the amount raised went from $2 million to $15 million. Other investors in this round included Technology Venture Partners and Alta Partners. Vesbridge's presence helped head off reluctance to fund an entity staffed by engineers with no management team in place.

Two more financings took place. A Series B for $17 million took place in March 2003, and a Series C for $10 million in May 2004. The funding from these rounds was directed towards further developing the tunable thin film technology and accelerating revenue growth in the telecommunications market.

Granite Systems
The company was founded in 1993 to provide operations-support-systems consulting to telecommunications providers. By 1998, the company was breaking even on annual revenues of $3 million. To develop a next-generation product with wider appeal, Granite completed its first round of financing in October 1998, raising $2.6 million from Vesbridge Partners.

The key decision in the company's evolution came in August 1999 when Vesbridge supported Granite's decision to rewrite its software even though it was already selling a serviceable one. Vesbridge Partners was able not only to support this plan but to help sell it to the other venture capital firms who had invested.

Based on a revised business plan that reflected this new software, Granite raised $20 million in a second financing round in the spring of 2000. The next year, however, as telecom began retrenching, smaller, less well established players were especially hard hit. Vesbridge Partners encouraged the company to preserve its cash while fostering a continued R&D effort. Vesbridge's role paid off when it began to arrange a third-round financing. Just as this round was closing, with the three key investors from the previous round participating, one of the three, Telcordia, stepped in with a higher offer and bought out the other two.

Mahi Networks
The company was founded in 1999 to provide next-generation optical transport and switching systems with Series-A funding from Sequoia Capital and Benchmark Capital. A Series B and Series C round raised an additional $105 million with Goldman Sachs, GE, Comdisco, and Rho Ventures. Within three years, the company had spent $110 million in cash at a rate reaching $3.5-$4 million/month. It had engaged in successful customer trials but the product needed considerable R&D to achieve proper deployment.

When it became clear that Mahi needed considerable additional funds to bring the product to market, the CEO worked with Vesbridge to put together a plan to raise an additional $64 million which included wiping out the prior investors. The company was recapitalized with $75 million in fresh investment, with Vesbridge and Oak Investors as the two new lead investors. A group of financial investors entered this round because they were convinced the company was on the verge of landing two large accounts. But in the wake of the market crash after September 11 and the after-effects of the earlier excesses in the telecom industry that resulted in carriers stopping their investment, Mahi did not land any accounts at all. Where the company had once expected to hit $12 million in revenues in 2002 and $50 million in 2003, the company actually had zero revenue in both years. The industry downturn, however, allowed Vesbridge, as the company's co-lead investors, to acquire the assets of distressed tech start-up companies that were in even worse shape. In June 2004, Mahi acquired Photuris, a supplier of reconfigurable optical add/drop multiplexer systems. Photuris had spent close to $100 million in R&D but did not land a single key customer and ran out of money. Vesbridge Partners had been following developments at Photuris and when it learned the company was available for sale at bargain-basement prices, it arranged for Mahi to purchase Photuris' assets for a nominal fee. The transaction allowed Mahi to offer two complete product lines with minimal overlap in technology and functionality but sell to the same customer base. Vesbridge arranged for Mahi to receive a further $75 million investment in order to deploy Photuris products.

EXHIBIT 5 (continued)
Portfolio Company Histories

Metconnex
This Canadian company was founded by engineers and executives from JDS Uniphase, Nortel Networks, and Alcatel in May 2002 to develop optical modules for building flexible optical networks based on an innovative, wavelength-selective switching technology. The company secured $700,000 in seed capital from Skypoint Capital, and began product development in the stealth mode, working with several potential customers.

Vesbridge Partners became aware of Metconnex, and several others in the area, via its contacts with a Boston-based venture capital firm already active in Ottawa. Vesbridge Partners was actively looking for Ottawa-based companies, attracted both by their lower cost and significant tax benefits for R&D offered by Canadian and provincial governments. The region also resembled the earlier Boston Corridor, with major universities and companies providing a rich environment for entrepreneurs.

Putting together a viable structure for the first round of financing required accommodating ownership rules and restrictions due to the desire to utilize financial and other advantages of being located in Canada while also making it attractive to major financial players from the U.S. Clearing legal and other requirements to make it workable was a time-consuming process; at the same time, this knowledge would give an edge to Vesbridge Partners when pursuing other similar investments.

In the end, a dual-ownership structure was put in place and the financing round was oversubscribed at $10.6 million. The transaction closed in January 2004; the participants included Vesbridge Partners and Skypoint Capital as lead investors, with Innovacom (the venture capital arm of France Telecom) and BDC Venture Capital also participating.

Pingtel
Pingtel was formed in late 1998. It pioneered the market for highly intelligent IP business phones. In 2000 the company introduced the *xpressa* phone which became the leading IP phone in the market. Adoption of VoIP took longer than expected, and the *xpressa* phone primarily served the early test and concept validation needs of the nascent industry. Only now is the market beginning to achieve growth leading toward becoming a mass market.

As the industry evolves towards a mass market, low-cost manufacturing capacity and global marketing-and-sales capability have outranked engineering expertise as drivers. In 2003 Vesbridge began to reposition Pingtel as a server-side software company providing complete standards-based IP PBX solutions. Pingtel successfully divested its telephone business in 2004 as it focused its efforts on delivering software solutions supporting a variety of standards-compliant hardware.

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or market and then branch off into different markets. The company's strategy is to apply the technology first to telecom while simultaneously developing applications to the medical devices, industrial manufacturing, and thermal imaging.

When Vesbridge Partners first looked at the company, it was basically a bootstrapped science project run by Ph.D. scientists and engineers from Princeton University. The team had a concept and some prototype materials but had little idea of how these could be applied to products and markets.

Even before Vesbridge made an investment, it steered Aegis towards developing a product for the telecommunications industry because telecom presented an immediately applicable market. This guidance was based on Vesbridge partner Bill Cadogan's intimate knowledge of telecom's bottleneck points that were ready for a revolutionary cost-cutting technology. His focus helped the Aegis team commercialize its first product while simultaneously developing a business plan that could be presented to the potential funding sources. Vesbridge Partners eventually led the first investment round.

Case Example of Product: Mahi. After investing in Mahi, Vesbridge Partners was actively seeking investments in complementary technology companies when it came across a company called Photuris. Founded by a team of leading optics Ph.D.'s and designers from Bell Labs, Photuris had already spent $100 million to develop a leading-edge metro optical transport system. Vesbridge Partners invested considerable effort to understand the company's technology and the commercial viability of its products. Vesbridge Partners completed its due diligence and assembled an investor syndicate but at the last minute—because it had doubts whether a sizable market would develop as quickly as the company forecast—Vesbridge Partners backed away from investing. Despite this setback, Photuris thought so highly of Bill Cadogan that he was invited to join the board to add value to the company's overall strategic direction.

Several months later, Photuris' founders indicated they were going to shut down the company because a commercializable product did not seem imminent. Vesbridge Partners recognized the value that Photuris' R&D could mean for Mahi and arranged for Mahi to cheaply acquire assets that took four years and $100 million to develop. Because it would be expensive to absorb Photuris, Vesbridge asked Mahi to raise an additional $75 million and used its due diligence on Photuris to help Mahi do so expeditiously.

The Photuris acquisition increased Mahi's chances of success because it could now offer two complementary product lines. At this point, the Photuris-originated product is not an immediate success but has generated considerable interest from the equipment vendors. The market for each product could be over $100 million annually three to five years from now. Because of the expected convergence of two emerging lines of technology, Vesbridge knew the company would function well. Mahi would never have been able to acquire Photuris without Vesbridge. The acquisition of Photuris for a tiny fraction of paid in capital made Mahi a much more robust asset, helping it to secure its future.

Value Proposition. The value proposition is what is emphasized about the product to sell it to a given set of customers into a defined set of applications through a specified channel and against defined competitors. This is where the venture capitalist needs to envision how the technology can be applied and sold.

Priority Customer Groups. Because early stage venture capitalists work with their portfolio companies to conduct rigorous market research, they learn which customers need to be reached first so that the company can establish its footing in the market and earn a reputation that will enable it to sell to other customers in that market segment.

Case Example of Priority Customer Groups: Granite. Through his own experience and extensive market research, Zenas Hucheson, a Vesbridge partner, helped Granite's management understand that it was easier to close a sale with an emerging wireline carrier than with an established carrier. Granite focused its product and sales efforts on the emerging carrier market with a particular focus on international customers whose software needs were not mission critical. From there, Granite moved into wireless carriers before establishing itself with Tier 1 carriers. Acquiring Telecom Italia as a customer was a key maturing point for Granite because it proved the company could successfully meet the needs of Tier 1 carriers and gave Granite a platform from which to pursue other remaining Tier 1 carriers such as SBC. Had Granite tried to pursue SBC from the start, it would not likely have been successful and would very likely have squandered resources without generating revenues.

Channel Strategy. A company also needs to identify the channel strategy for reaching each of its market segments. An example would be augmenting direct sales with system integrator relationships, where the company serves as a sub-contractor to a firm like Accenture which has the overall responsibility for satisfying the customer. Granite gained a few smaller system integrator relationships but was unable to crack into the major system integrators such as Accenture, Gemini, and SAIC because its CEO did not make a sufficiently aggressive effort, allowing a competitor to beat them out.

Customer Engagement Model. The customer engagement model explains where revenues develop and how customer relationships develop over time. Every major account has a natural process of engagement, and because the venture capitalist usually understands this better than the portfolio company, the venture capitalist can help set up the appropriate infrastructure for the company to support in engaging major clients. The customer engagement model often begins by selling to an autonomous group within a major customer whose work is not considered mission critical. The seller works that relationship over time by continually increasing the scope and scale of what it offers to demonstrate the capability of its service or product. Eventually the product or service is deployed in a mission-critical way throughout the entire customer's operations.

Case Example of Customer Engagement Model: Granite. Vesbridge Partners helped Granite fine-tune how to engage with particular clients in order to develop long-standing relationships. Zenas showed how a small order (in dollar value) in the first year could lead to a larger order the second year, with a corporate-wide licensing agreement coming in the third year. Building credibility with the customer that the software works as promised, that customer support is available, and that a start-up company will indeed be around, is required before a customer is willing to make ever-larger purchases. Such an effort requires a multi-year engagement model. Zenas helped Granite see that building such credibility over time would lead to a larger order rather than squandering resources shooting for such an order in year one.

Solution Eco-System. Many products and services offered by start-up ventures address niches in the market where, without a complementary product or service supplied by another vendor, the customer may not be willing to do business with either company because each company's product or service represents only a portion of the end user's needs. By partnering, the two companies could create a competitive advantage and obtain synergistic benefits over and above what they could realize working alone. Such related companies are part of the same economic system or eco-system. An example of a solution eco-system is PictureTel's small-group, video-conferencing systems which are effective only with a fast, reliable data service. AT&T which offered such data service needed to partner with PictureTel because without video-conferencing systems, fast, reliable data service was not needed. In terms of meeting the customer's needs, PictureTel and AT&T were part of the same solution eco-system.

Solution eco-systems require careful thought. The best partner is often difficult to identify because technologies are evolving in ways that make it hard to see the full picture. The venture capitalist is usually far better positioned than management to recognize partnering opportunities and identify suitable allies.

Case Example of Solution Eco-System: Pingtel. Vesbridge Partners believed that voice-over IP was shifting away from a vertically integrated market in which each vendor offered proprietary call control, to one in which hardware and software components from different vendors could be seamlessly integrated. Vesbridge hoped to speed up this shift by working closely with Pingtel to make its crucial session initiation protocol software available as open source. Having Pingtel's software be available on an open-source basis makes an eco-system of phone manufacturers a crucial ingredient to Pingtel's expected success. Vesbridge saw that the creation of such an eco-system was driven by the public IP telephony market and concluded that this market could be leveraged into the enterprise market. If Vesbridge were unsuccessful in establishing Pingtel's open-source software as an industry standard, established vendors would be able to keep control of the availability of end points capable of serving as interoperable solution components in a modularized market—and Pingtel would need to rethink its strategy.

By pushing Pingtel to make its software available on an open-source basis to every single component manufacturer in the voice-over IP business sector, Vesbridge believes it can leverage Pingtel's strengths in software without having to become a low-cost commodity manufacturer of telephones. Vesbridge understood better than Pingtel that by controlling the software on an open-source basis, the rise of numerous solution eco-systems within the industry would be to Pingtel's benefit.

Competition. Early stage venture investors tend to cluster their investments so that they are related in terms of applying domains of technology to well-understood needs of a particular set of customers. For example, Vesbridge Partners focuses on enterprise data-management and voice-over IP, always looking for technologies that provide improved ways of addressing these two needs of the telecommunications sector. This way of thematizing investments allows the venture capital firm to leverage its industry contacts and expertise. The best clusters for such investing are application domains where the market for the technology is rapidly growing and where the technology is rapidly innovating. Venture capitalists who cluster their investments will usually have a better understanding of the competition than any executives in their portfolio company.

An accurate read of the competitive landscape requires the venture capitalist to have a strong working relationship with the CTOs and CEOs of each company in his portfolio. Ideally nothing important happens in an industry without the venture capitalist hearing about it. Developing outside sources that go beyond what management teams know is an important way of understanding the competition. Venture capitalists must do this well if they are to add value to their portfolio companies.

Operating Plan. Operating plans are pro-forma financials supplemented with a detailed analysis of what the company will do to generate expected revenues and what the associated costs are to execute the venture's corporate strategy, including, for example, the timing and number of new employees needed to be hired. Larger, more established businesses typically have well-thought-out operating plans. Because good venture capitalists frequently have deep sector experience, they are able to help their portfolio companies to build detailed and informative operating plans. Most portfolio companies are rarely able to do this without the aid of their venture capitalists. The venture capitalist may have a more realistic understanding of the coming year's revenues and expenses and how these expectations require the company to be managed than any of the actual management team.

Value Lever 2: Team

Building strong management teams is at the heart of value creation and risk reduction in early-stage venture capital. Great strategy has little value if the company lacks the core competencies and leadership to execute the plan. Venture capitalists often spend one-third or more of their time recruiting management teams whose expertise and capability helps convince Series B investors that the company has a viable future. A strong management team in place during the early stage of a venture's growth can make the difference between a 2× and a 5× multiple in the pricing of a Series B round. Building management teams includes recruiting industry experts and experienced entrepreneurs to become members of the board of directors and technical advisory boards of portfolio companies. Seed- and early-stage investing starts with a strong core technical team and then adds strategic marketing talent, strong outside board members, and recognized industry leaders to the management team and technical advisory board.

Department Heads. The role of a CTO is to articulate a technology vision that addresses evolving market needs. The CTO oversees a core development team building the prototype of a viable product or service. The CTO is the core of management team-building and he or she is often brought in by the venture capitalist soon after the venture receives its original Series A financing. (During this stage, the venture's CEO may be nothing more than a figurehead to be replaced at the appropriate time.)

Once the company is on the path toward a commercially-viable product or service, a vice president of strategic marketing is hired to define how the technical vision bears on generating revenues. The marketing vice president identifies likely customers and lays the groundwork for reaching these customers in terms of sales channels, pricing, likely competitors, and so on. Many experienced venture capitalists believe that understanding and developing the company's sales and marketing capability early on is as important as developing the technology. With the CTO and core development team and strategic marketing capability in place, the Series B valuation can be higher.

Case Example of Department Heads: Pingtel. Martin Steinmann, a Vesbridge partner with an expertise in strategic marketing for the technology industry, served as the senior vice president of marketing for Pingtel, a pioneer in the voice-over IP market. In this role he spearheaded many of the initiatives described in this article under Industry Category, including helping to form SIPfoundry, the industry's leading open-source community dedicated to VoIP technology and solutions.

A sales force is added just before field testing of the product begins with key customers.

Case Example of Department Heads: Mahi. When Mahi Networks needed a management team, Bill Cadogan turned to a number of executives who worked for him in previous positions to fill those needs. He hired the vice president of sales, the vice president of software engineering, and the company's regional heads. Bill is especially strong at hiring strong technology salesmen, as his career in telecommunications has been on the sales and marketing side. Bill's network and reputation allowed Mahi to attract a caliber of executives who might have been unlikely to work for this early-stage venture.

CEO. Start-up ventures can often get by for a long time without a CEO, relying instead on their CTO and CFO. Until the company requires a permanent CEO, which is usually before a Series B round, a venture capitalist with operating experience may run the company. Hiring an experienced, well-respected CEO can substantially improve the pricing on the Series B round. Helping the company find a capable CEO is one of the most important value-adding functions a venture capitalist can provide a portfolio company.

In other cases, the venture capitalist may have funded a venture with an inexperienced first-time CEO. The venture capitalist will often provide the CEO with coaching. Furthermore, as the company evolves, the venture capitalist may decide that it needs a new CEO with a skill set better suited to the company's evolving needs. Some otherwise capable CEOs do not do well when the company grows too large for them to maintain a comfortable span of control and will need to be replaced. An experienced venture capitalist who has worked with many start-ups and who himself has deep operating experience will have the judgment to know when such a change is required and how to bring it about in a way that minimizes the bruised feelings of the outgoing CEO. The venture capitalist accelerates the success of the venture by accelerating the CEO's learning curve.

Case Example of CEO: Aegis. The CEO of Aegis Semiconductor founded the company at age 28 with almost no experience in management. Bill Cadogan, by contrast, had spent 20 years starting and running technology companies. As Aegis Semiconductor's lead investor, Bill worked with the CEO to think through various organizational and management issues in which the CEO had no experience. Bill was particularly helpful in pushing the CEO to think more in terms of sales and strategy and less in terms of technology. Bill's perspective helps first-time entrepreneurs avoid beginner's mistakes. In the case of Aegis Semiconductor, Bill correctly pointed out that the CEO was more interested in technology than in sales and convinced him to step aside to find a replacement CEO whose skills and interests were more closely aligned with the needs of the company.

Often a venture capitalist who is a senior industry veteran can step in when building the company requires skills or energy beyond what the existing CEO can provide.

Case Example of CEO: Mahi. In October 2004, Bill Cadogan stepped in to replace Mahi's CEO who left abruptly. Mahi had previously focused its marketing on smaller regional telecom providers and its sales efforts to gain industry heavyweights as customers had never been successful. Because Bill had earlier built ADC Telecommunications into a telecom powerhouse, he was the ideal CEO if Mahi were to live up to expectations as he had contacts and credibility with key customers. Bill expects to work closely with Mahi's sales and marketing force to win business from top carriers while also forming partnerships with vendors in the same eco-system to jointly call on these same customers. Bill also has the deep operating experience to help Mahi cut costs, which was also important as Mahi's burn rate was still high. One of the ways venture capitalists can add value is when they have operating experience that can be deployed on behalf of their portfolio companies on literally 24-hour notice. In many cases, the venture capitalist coming in as CEO is far more capable than the person he is replacing.

Board and Advisors. A start-up technology company typically begins with a technical advisory board and gets a formal board of directors only after there has been an institutional investing round. The technical advisory board will often work with the company's core technical team to explore issues related to the interplay between a technology and the needs of the market such as improving a product or service concept by identifying important attributes that customers are likely to value and that can be designed in at early stages of a product's development. A well-connected technical advisory board can provide introductions to key decision makers at potential customers or distributors.

Recruiting Process. Attracting first-rate experienced and engineering/scientific talent into an early-stage venture is a key element of a venture capitalist's skill set. The better the reputation of the venture capitalist, the easier it is to attract high-quality talent to one of his or her portfolio companies. Earlier we referred to Bill Cadogan's excellent industry reputation as a way for Mahi Networks to attract executives the company would have had a hard time getting otherwise.

If the portfolio company shifts its strategy, then its management team will likely also need to be realigned. A change in focus from one kind of customer to another, for example, from an enterprise to a carrier may require that the sales and engineering organizations be re-tooled to reflect this shift.

For the past six years, Vesbridge has invested heavily in improving how it recruits management teams into its portfolio companies. It understands better than most venture capitalists how corporate strategy drives management roles and competencies. The company's stage of organizational development, its product, its strategy, its competition, priority customer targets, sales channels—all bear on the specific workplace demands of an executive role and influence the differential strengths and attributes desired in an executive filling that role. This approach reflects the idea that the functional skills required in an executive role change as the company changes. Thinking about a company's strategy and operating conditions in an explicit way allows Vesbridge Partners to target executives who have the background and functional skills needed at a particular point in the company's development. By understanding exactly the link between corporate strategy and management competencies Vesbridge Partners knows exactly when to make key hiring (and firing) decisions.

Taking this thinking even deeper, Vesbridge Partners has worked with Dr. Leslie Pratch, the author and a clinical psychologist with a background in corporate strategy and finance, to explore whether executives who have the desired competencies also have the resiliency to deploy them. This allows Vesbridge to think systematically about the kinds of personality attributes that bear on an executive's workplace performance especially in conditions of high stress. For example, in a recent study on the psychological characteristics of successful CEOs of ventures funded by private equity, there were many personality, familial, and social factors associated with successful leadership (Pratch and Jacobowitz [2004]). However, this and other research showed the importance of matching the particular culture of an organization with the various personality characteristics of the leader and his or her associates (Pratch and Jacobowitz [1998]; Pratch and Levinson [2001]).

A Vesbridge Partners' framework for management team-building will be presented in depth in a future article.

Value Lever 3: Customers/Partnerships

Active business development by venture capitalists on behalf of their portfolio companies is a key element of value-added investing as it both creates value and reduces investment risk. Venture capitalists create value by introducing their portfolio companies to end-user customers and corporate partners. Start-up companies have neither the reputation in the market nor the resources that are required to gain easy access to the decision makers at important potential end-user customers. Customers who balk at considering the portfolio company's technology may be willing to consider it if the company has a relationship with a highly regarded venture capitalist. The greater the company's ability to use the venture capitalist's contacts and reputation to grow revenues, the higher its valuations in subsequent rounds of financing. This, in turn, will lead to an earlier and more highly valued investor exit.

Venture capitalists who invest in early stage technology ventures can help their portfolio companies gain access to and credibility with major customers. For a company with few or no revenues, the most important value a venture capitalist can add is to introduce strategic customers to the company's products and services, and a savvy investor will devote considerable time to this effort. Generally speaking, the larger a company's sales force, the more its customers and the greater its revenues. But start-ups cannot afford to hire lots of well-connected salesmen. It is nearly impossible for a telecom start-up to make a sales call on the CTO of Verizon, for example. No important decision maker at a large carrier will take such a sales call. That CTO, however, will take such a call from Bill Cadogan because that CTO knows and trusts Bill. Bill, for example, introduced Mahi Networks to Bell South, British Telecom, and AT&T, all of which could become significant customers for Mahi, none of which would begin significant negotiations with Mahi without the credibility established by a well-respected, seasoned, industry veteran investor.

One important ancillary benefit of introducing important customers to a portfolio company is that the venture capitalist gains a second opinion on the merits of a portfolio company's technology and perhaps the quality of its management. This provides ongoing due diligence which in turn reduces the venture capitalist's investment risk. By continually monitoring how the portfolio company and its technology are perceived in the market, the venture capitalist has a back-channel way of confirming what management asserts about its performance. It also helps the venture capitalist understand how to strengthen the company's value proposition and more accurately target strategic customers.

Case Example of Customers: Crescent. When Crescent, a former Vesbridge Partners portfolio company, tried to approach British Telecom as a potential customer, it was unable to get in the door. Because Zenas had a strong relationship with British Telecom, he was able to facilitate an introduction. Zenas' long conversations with key executives at British Telecom supplied him with a great deal of competitive information indicating that Crescent's technology was perceived as weak in the market. In particular, Zenas learned that Crescent's technology was not sufficiently differentiated from Cisco, a far more established supplier. Even worse, Crescent's technology did not support RSC 2547, a routing standard within the industry. As a result of these conversations, Zenas decided to not supply Crescent with additional capital, pulling out from what clearly became an unpromising venture. The company later shut down. This is an example of venture capitalists learning something about the company that drives a decision whether to invest or not.

A venture capitalist can sometimes create value for a portfolio company by inducing an end-user customer to compel an incumbent supplier to make the portfolio company's technology an integral element of the product or service the supplier offers the end user. This is especially important in telecommunications where industry giants are reluctant to make a $100 million investment in a leading-edge technology offered by a start-up with tiny revenues and a handful of employees. A company like Verizon would much prefer that a start-up like Mahi partner with a supplier like Cisco as a way to ensure that Mahi can deliver as promised. While such a joint venture is obviously in Mahi's interest, it is the venture capitalist's relationship with Verizon that leads to Verizon making this demand on one of its suppliers. For example, owing to Vesbridge Partners' efforts, a leading telecom incumbent has been recommending Mahi to partner with one of its established vendors.

In other cases, a venture capitalist can foster partnerships between two portfolio companies that allow them to gain business from customers that neither of them would get working independently.

Case Example of Partnerships: Granite. Granite learned through Zenas that a Vesbridge Partners portfolio company called Object of X had a mapping visualization technology that would enable Granite's software to work more efficiently. Granite and Object of X formed a technical partnership that enabled Granite to incorporate Object of X technology in what it offered customers who were reluctant to buy from Granite without the kind of technology Object of X provided. Granite's partnership with Object of X enabled both portfolio companies to dramatically grow their revenues.

Value Lever 4: Investor Syndication

The key lesson of the 2001 to 2003 venture downturn was that strong investor syndicates are essential to managing investment risk. Few early-stage VCs escaped the nightmare of having a solid company backed by a weak venture syndicate that could not fund the company to sustained cash flow-positive operations. The development, care, and feeding of investor syndicates—corporate investors and other venture capital firms—is an essential element of value-added investing.

Vesbridge has learned a great deal about developing strong investor syndicates over a series of venture financing rounds. It has developed a repeatable process to reduce the risks associated with follow-on financing rounds. In general this process can be grouped into three main steps. The first step is to "start with a good investor team," one in which the co-investors collaborate well and share the workload in building the company. Strong prior working relationships are helpful (though not essential). The second step is to know the market: some firms only lead Series A deals in certain industry sectors while others primarily invest in Series B and later deals with complete management teams and revenue run rates of at least $2 million per quarter. The third step implements a strong funding process with the following components: financing strategy (size of raise, expected pricing, etc.); targeted investor list (stage and role appropriate); a compelling investor pitch; an updated and detailed due diligence book; and schedule of regular meetings between the management team and current investors to review progress and make changes as new things are learned. Finally, the lead investor runs the term-sheet negotiations, balancing the needs of new investors, current investors, and the management team. Strong execution is more than half the battle in fund raising.

Investor Targets. One of the most important features of setting up and running an effective investor syndicate is to agree in advance on a set of investor targets. These should match the conditions of a funding round to the milestones that the company management undertakes to achieve. Typical conditions include the progress with product development (fully functioning prototype, first-generation product that meets customer's requirements), marketing (concluded agreements with key clients), sales (revenues, number of customers), on one hand, and funding commitments, on the other hand.

Of course, in a fast-moving world, various outside influences and inside developments will inevitably affect this process. The market development may make the product unattractive for further development even if the company lived up to its promises. Other avenues may open up both due to a market shift and an unpredictable event, such as a competing outfit coming up for sale or liquidation. In these situations, a solid continuing two-way working relationship between company management and the investor syndicate is of utmost importance. Being able to adjust on the run implies trust in each other and commitment to success of the company.

Management Pitch. A lead investor may play an important role in supporting management efforts during fund-raising rounds. Obviously, the investor's role will be affected greatly by such factors as experience of the management team, current availability of funds overall and for a specific market segment (i.e., how "hot" it is), and the experience, abilities, and style of the lead investor representatives involved.

Due Diligence Preparation. A lead investor typically plays a key role in performing due diligence work not just for itself, but also for the whole investment group. The quality of data gathered, covering everything from the target market size and its projected evolution to the quality of engineering and management teams, will play a key role in making the final decision on suitability of the proposed investment. Lead investor's reputation within the venture capital community will ride on the quality of its due diligence work, a major factor in access to future attractive deals and therefore investment returns.

Case Example of Supporting Role in Management Pitch: Mahi. With the market downturn in 2001, Mahi had to refocus its fund-raising efforts. Bill Cadogan and Raj Alur, two Vesbridge partners, talked to carriers and other major customers to build their understanding of how the company could perform. Despite the view among many venture capital players that the telecom industry was gone forever, Bill and Raj believed that the industry would revive in three to four years and that a reinvigorated Mahi would be well situated to be a powerful player. They amassed a wealth of material that could help the management team present a powerful case to other interested investors. That material included information about the product, the market, the financials, as well as an analysis of the competition. With Vesbridge Partners proposing making a $10 million investment, Mahi's CEO looked to build a syndicate for the other $40 million the company needed. Vesbridge Partners pitched potential investors, sending them its due diligence binder and making the case for an investment in Mahi. Mahi eventually closed the round at $75 million at a time when most venture investors were pulling out of telecom. Without Vesbridge Partners' reputation and willingness to make a powerful case on behalf of Mahi, the company would have not been likely to be able to raise as much money as it did.

Process Management. A lead investor will always play a key role in managing the syndication process. It is up to him to sharpen the management pitch for funding, package it into an acceptable format reflected in a term sheet, and then present it, or at least assist in presenting it, to the target audience of fellow venture capital firms, large institutional investors, and sometimes venture capital arms of major players in the industry interested in staying abreast of new developments. In the process, the lead investor has to balance interests of current investors, sometimes from several investment rounds, targeted funding sources, and current management. As a result, integrity, reputation, and ability to hold a disparate group of interested parties together during this process is what distinguishes a true leader in the industry from secondary players.

Case Example of Process Management: Aegis. Aegis was originally seed funded by YankeeTek Ventures, a small VC firm in Boston. The partner at that firm used to work for Bill Cadogan at ADC Telecom. The company had the feel of a science project bootstrap—a great concept but with management having very little understanding of any vertical market. Vesbridge Partners steered it to develop its first product for the telecom market. When Vesbridge Partners announced its intent to fund the company, at least three other investors came in to join the syndicate.

Aegis was a difficult company to get funded because it was run by a group of scientists with no industry experience. Bill guided the company to focus on applying its technology to the telecom market. His willingness to offer the company a term sheet for a round of financing represented a statement of Vesbridge Partners' confidence in the company. Bill's track record of having successfully built large companies gave other investors the confidence to join the Aegis syndicate. Within two weeks of Vesbridge Partners announcing its investment in Aegis, the syndicate was complete. Aegis first sought $2 million and wound up raising $15 million primarily through Bill's vote of confidence. Later, Bill again helped the company through two more rounds of financing with the existing investor group.

Structuring Issues. When setting up a start-up company, a venture capitalist needs to pay close attention to the various legal, accounting, and tax matters. A correct legal, financial, and management structure should accommodate all current and many future needs of the investing companies and the original owners, making subsequent financing rounds and a variety of exit strategies easier to execute. While in itself it is not a guarantee of eventual success, a correctly structured entity adds value to investors by providing proper flexibility and taking advantage of available resources such as R&D grants and tax rebates, preferential export funding, local grants and loans, to name just a few. In addition, one can take advantage of the structure once it is set up and developed over the life of one project and apply this knowledge to new projects.

Case Example of Structuring: Metconnex. In looking to expand outside its Boston/Silicon Valley focus, Vesbridge Partners came across Metconnex, an early-stage start-up in Canada. Structuring an investment in this company involved complicated cross-border issues. Vesbridge Partners created a Delaware corporation as a parallel legal entity so that U.S. investors could buy U.S.-registered shares while Canadian investors bought Canadian shares. Such a dual stock structure was important in case of a sale or IPO as well as to avoid double taxation of U.S. investors. For Metconnex to enjoy a Canadian tax break for its R&D expenses, the company needed to be a Canadian corporation with majority Canadian ownership. The need for U.S.-registered shares becomes apparent if the company files for an IPO and needs to attract U.S. investors and those investors will not subscribe to an issue that is traded on the Canadian stock exchange. The net benefit of a dual stock structure of Canadian and U.S. shares is that the Canadian shares allow the company to enjoy Canadian tax breaks while the U.S. shares allow the company to attract U.S. investors should the company go public via an IPO. Such a dual stock structure, while complicated and expensive to arrange, will greatly benefit Metconnex by making it more attractive for subsequent new investors to come in.

Case Example of Structuring: Mahi. During the telecom downturn of 2001, when it was nearly impossible to interest new investors, Vesbridge Partners co-led a recapitalization round that saved the company. The Series C financing was a restructuring that wiped out the company's prior investors. Mahi started afresh with a new capital structure. (Troubled companies more commonly went out of business during this period.) This transaction was one of the first deals in the venture capital industry that featured such an extreme down-round financing and was one of the biggest recapitalizations in the history of telecom. Vesbridge Partners played the leading role to pull together a new syndicate that recapitalized the company. Because extreme down rounds of this sort had never before been structured, Vesbridge needed to do a considerable amount of working the deal to evolve a model for recapitalizing the company. This model has subsequently become an industry standard.

Vesbridge, which had not been one of the original investors, was able to acquire a stake in the reorganized Mahi on extremely favorable terms. Vesbridge recognized that Mahi had a promising future and that the telecom downturn had stressed its financing structure. With Vesbridge's guidance, Mahi took advantage of the telecom downturn to acquire the assets of a troubled telecom start-up with a complementary technology (see "Value Lever 1: Strategy/Product").

Value Lever 5: Industry Category

A basic tenet of strategic marketing is to redefine the product category so that the portfolio company dominates a hot new market segment. Broad market recognition that a company plays such a role helps build higher perceived value, makes it easier to attract new investors, and ultimately increases exit values for investors. Understanding and guiding the development of a new category is a fundamental tool for creating value in early-stage investing.

Early stage venture investors can play a powerful role to help their portfolio companies create and thereby dominate a market segment. First, venture investors can work with the company to create a compelling message, including a brand identity. Second, venture investors can explain to industry professionals, journalists, and Wall Street analysts why the category is poised for dramatic growth and why a portfolio company will dominate that category. Third, venture investors can be effective spokespersons on behalf of their portfolio companies, speaking at industry conferences, writing articles in industry publications, and talking to customers, partners, and other investors.

Case Example of Industry Category: Pingtel. Vesbridge Partners helped Pingtel create a category called open-source telephony and repositioned Pingtel as the company that so dominated the open-source telephony industry that its technical standards are de facto industry standards. Open-source telephony is software used to run telephone service over the internet and replaces the traditional vertically integrated telecom business model in which there are open interfaces where connectivity is de-coupled from services and software de-coupled from hardware.

When Pingtel was originally formed, its business model mimicked that of the traditional telecoms. As the market for IP telephony matured between 1999 and 2004, Vesbridge Partners understood that the traditional telecom business model was becoming outdated. To succeed in the industry, Pingtel's technical excellence would matter less than manufacturing and marketing competency, strengths that Pingtel did not possess.

With Vesbridge Partners' guidance, Pingtel repositioned itself as the creator of not only a new category but a new market. Where once the IP telephony industry had been a vertically integrated market held together by proprietary call control locking a customer into a specific vendor's solution, Pingtel offered open-source software to a market where components from different vendors could interoperate seamlessly. Such a modular structure significantly changes the rules of the game. Markets now exist on a per-component basis, giving the customer choice and flexibility. Vesbridge Partners helped Pingtel successfully divest the IP endpoint business in 2004 and instead focus on working with third-party providers of IP endpoints such as PBX systems and telephones that use Pingtel's open source software.

Martin Steinmann of Vesbridge Partners played a critical part in this process of creating a new category called open-source telephony that Pingtel would dominate. First, Martin shared with Pingtel his expertise and experience. He knew better than the Pingtel executives that its business model was outmoded and that it needed to go to a business model similar to the existing Linux-based subscription model. Second, he assisted Pingtel in formulating, shaping, and validating this new strategy. Third, he helped form SIPfoundry, the industry's leading open-source community dedicated to VoIP technology, which provides the legal and technical foundation for advancing open-source telephony. As an industry pioneer, Martin was able to shape public debate about this new category and how Pingtel's software and technical expertise provided complete standards-based IP PBX solutions for the entire industry.

Value Lever 6: Investor Exits

The objective of early stage venture capital investment is liquidity for the limited partners at a high multiple of invested cost. The ideal liquidity event is a successful IPO followed by an ever-increasing market capitalization; but the reality is that many more successful investments are sold to larger companies, not into the public markets. Venture investors must be prepared to pursue both paths to liquidity.

Early stage venture investors, through an actively managed investor exit strategy, can reduce investment risk and add value to a portfolio. Of course, a managed exit first begins with a solid strategy/product, a great management team, enthusiastic customers and productive partnerships, a strong investor syndicate, and market leadership in a new category, widely regarded as growing rapidly and becoming large. Company-building leads to higher exit values.

There are four critical steps to managing exits. The first step is to identify the field of prospective acquirers and initiate business development relationships—OEM, joint selling, or co-marketing—with each prospective acquirer, either directly or through the portfolio company. The most likely targets are companies that sell to the same target customer as the portfolio company. This is particularly true if the prospective acquirer's product offering is differentially advantaged by a tight integration with the products offered by the portfolio company. Business development is the keystone for having highly valued exit options. Business development takes time—often several years—so starting early is essential.

The second step is to create dynamic tension between multiple prospective acquirers, ideally where each knows that other potential acquirers exist and are interested. Having multiple interested buyers is essential to realizing the maximum value of an investment. Investments are priced according to the buyer's understanding of its own economics and what the buyer perceives to be the value of the portfolio company's next best alternative. If the portfolio company has numerous strong alternatives, then its value in the market rises. This creates options for the portfolio company. For example, a buyer can be motivated to pay a higher price if the portfolio company is a competitor which is gaining market share. To the extent the venture capitalist can help the portfolio company win high-profile accounts at the expense of a prospective acquirer, the portfolio company will be that much more attractive an acquisition candidate. The venture capitalist must find ways to raise a potential buyer's anxiety level, to increase the buyer's perceived risk that a competitor will continue to gain market share.

The third step is to lead the merger negotiations or retain experienced third-party merger advisors. In all but the largest companies, the CEO will be facing his first sale-of-company negotiations. Most CEOs do not have the level of experience required to conduct negotiations with experienced corporate buyers. Consultants and deal advisors need to be hired in transactions where the venture capitalist may need particular expertise. Vesbridge Partners maintains long-standing relationships with experienced transaction advisors for such deals.

The fourth and final step of an exit strategy is disposing of securities that may have been received in the sale of the company or its IPO. Managing the disposition of public securities can be challenging, especially if hedging transactions are involved. The deeper one's experience, the better one is qualified to manage such transactions. Again, there are third-party consultants who can advise on the intricacies of disposing of public equities, shelf registrations, and related legal requirements.

Case Example of Candidate Acquirers: Granite. Owing to Zenas's relationship with a top SBC executive, Granite acquired SBC as a customer long before it expected it would. Having customers like SBC made Granite that much more attractive to potential acquirers. One interested buyer was Telcordia. Via a venture capital subsidiary called SAIC, Telcordia had invested in Granite's Series A and Series B rounds and was interested in investing in the Series C round. Granite was within days of closing the Series C financing when Telcordia made a surprise offer to buy out the other investors and take control of Granite. Telcordia's preemptive offer owed importantly to Zenas' work to close a complicated Series C financing that would have raised Granite's profile as a competitive threat to Telcordia. Zenas had previously valued Granite by comparing it to a basket of stocks of similar public companies. Telcordia was willing to pay a premium over this price in order to extinguish a competitive threat. The size of this premium was directly related to Zenas' work in the Series C financing to position Granite as potentially dangerous rival to Telcordia's core business.

In addition, Zenas was able to drive a tougher deal with Telcordia because he knew from meetings with the CEO and the investor group of Granite's principal competitor that this competitor would not seriously compete with them in this deal.

CONCLUSION

Early stage venture investors can add value and reduce investment risk by concentrating on six areas post-investment:

1. Strategy/Product
2. Management Team
3. Customers/Partnerships
4. Investor Syndication
5. Industry Category
6. Investor Exit

The two most important areas for value creation in early stage technology ventures are validating the strategy and management team-building. It is in these two areas that the experienced venture capitalist can uniquely and efficiently guide an inexperienced management team to create a winning technology.

ENDNOTE

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