Inside the Minds:
Telecom & Wireless Venture Capital

Nationwide Book Published by Aspatore Books

Rod K. Randall
Vesbridge Partners, LLC
Senior Managing Director
rod@vesbridge.com
www.vesbridge.com

Rod has spent over 20 years in the networking industry as an entrepreneur, senior executive and venture capitalist. Prior to forming Vesbridge, Rod was a General Partner with SPVC where he led investments including Dynamicsoft (acquired by Cisco), Bitfone and Visage Mobile. Before becoming a venture capitalist, Rod had been Chief Marketing Officer at Lucent which he joined in 1999 upon the acquisition of Ascend (by Lucent for $24 billion) where he had been the Vice President of Marketing. Prior to Ascend, Rod was Vice President of Worldwide Marketing and General Manager of Telecom Infrastructure Software at Stratus Computer (acquired by Ascend for $833 million) and Vice President of Strategic Market Development at Madge Networks.

Prior to Madge Networks, Rod was a co-founder of Teleos Communications in 1987. During the nearly 10 years Rod was building Teleos, he held several roles including EVP and CTO, Vice President of Marketing and Business Development and Vice President of WAN Access Technology. Rod helped guide Teleos until its acquisition for $165 million in 1996 by Madge Networks which provided a solid return to investors on $27 million raised. Rod began his career in technology in 1981 as a Member of Technical Staff and later Supervisor with Bell Labs, and has been awarded several US Patents.

Education: BSEE with Highest Honors, Georgia Tech; MS EE/CS UC Berkeley

The Second Derivative:

This chapter is dedicated to my partners and colleagues at Vesbridge Partners, and to my wife and kids, for indulging me the privilege of pursuing my ventures.

The Second Derivative

By Roderick K. Randall

The Venture Capital Mantra: No Risk, No Reward

The goal of high tech venture capital is to seize the opportunity to catalyze the creation of economic change agents, which create new winners and losers, but whose principal benefits accrue to the innovators. Sometimes the winners are the established companies extending their dynasties. Other times it is a new company which breaks the mold, led by a creative dynamo who not only sees things as others do, but more importantly as others do not. Venture Capital provides the fuel and guidance for the growth and nurturing of these new enterprises. This is not a guarantee, but it is an opportunity.

Venture Capital is a very personal business, especially early stage venture capital. The earlier the stage, the more sector knowledge is required of the VCs involved, and also the more company building expertise is required.

This chapter will first touch on the "moose on the table": after the tech bubble burst, why would anyone start or invest in a telecom company? [One answer – as I write this, it was announced that Skype is to be acquired for $4B by eBay – there is still a lot of money to be made, and it can go to new entrants.] We will next focus on where the deals come from, and by inference, how to get into that stream if you are an entrepreneur looking to get funded. This will lead to a discussion of an insider's view on the deal assessment criteria from a VC perspective. We will then discuss the financing life cycle and the company building process of value added investing. We will then move on to cover exit strategies and recycling.

The road to entrepreneurial success and stellar venture capital returns is not a smooth one, nor is it an easy risk free one. But it is well traveled by the engines of innovation and wealth creation, and it is well worth the journey.

Why Telecom? Why Now?

The unprecedented crest of growth and economic value within the Telecom industry during the late 90s was followed by an even more unprecedented fall and virtual destruction of some of the industry's most known bell weather names, spanning both carriers and equipment suppliers.   The dynamics that created the surge, including, but not limited to, global deregulation, the creation of the internet, fiber optic backbones, and broadband access, have in fact lead to a dramatic restructuring of the industry with new industrial giants such as Amazon, eBay, and Google.

Though many of the Competitive Local Exchange Carriers, or CLECs as they have been called, have collapsed and disappeared, many of the surviving incumbents have consolidated and emerged even stronger. The global Telecom Services Market grew to $1.42 Trillion in revenues in 2004, with a supporting equipment business that exceeds $360 Billion per year. Some changes within that macroeconomic envelope is a move toward IP services and Broadband access as well as a move to more mobile services from predominantly fixed.

As the mobile networks and devices get increasingly sophisticated and broadband data-enabled, along with the fixed networks becoming increasingly broader bandwidth, including the support of entertainment TV, there is an ever increasing set of new business innovations that will soon become viable. These will produce a new bumper crop of entrepreneurial endeavors, and is a rich environment for successful venture investments. These new ventures will typically not be based on new science invention, but more likely new applications of now doable capabilities.

These new investments will likely be what I like to call “Second Derivative” opportunities. The base level structural change that created a surge in telecom opportunity was the build-out of the internet infrastructure around the world, starting with narrowband and moving to broadband. The first derivative opportunities that resulted from that were internet based companies such as AOL, Amazon, Yahoo, Google, and others.

On the mobile front the base level structural change is that there are now almost 2 billion mobile subscribers globally, with almost 700 million new devices sold annually. This is more than the world’s landlines. Mobile opportunities lag fixed by 3 to 5 years, but they have a unique twist. The first derivatives were utilizing simple data capabilities for messaging, ring tones, and games. Now we have higher speed data links and sophisticated handheld mobile devices with more compute power than most people had on their desks in 1999. That provides a veritable primordial soup for the next phase of innovation.

The Second Derivative plays will be companies that utilize the now pervasive set of underlying capabilities of internet based services and broadband mobility, and combine them together in new ways to create new services which were previously undoable or impractical. An example of this is Skype, an internet based voice telephony service that functions with an Instant Messaging like “presence”, which was just announced, as I am writing this, to be acquired by eBay for up to $4 Billion. In the mobile space there are likely to be mobile versions of Google, eBay, and Amazon, with a twist, and others which we can’t even imagine yet. After the 2nd Derivatives will be the 3rd Derivatives, and so on.

The question now is: What will the next killer opportunity be, and where will it come from?

Deal Flow: Where Does It Come From?

The preponderance of high quality deal flow into most VCs comes from entrepreneurs themselves, or from other VCs who have met with the entrepreneurs and would like to team up on the project to get the benefit of specific sector expertise, experience, or contacts. In fact the most reliable deal flow is from previously successful entrepreneurs who are going back at it again.

The question new entrepreneurs often ask is "How do I get onto a VC's radar screen?" The short answer is "anyway you can". But there are approaches that are more reliable than others. For instance, the best way is to be introduced by someone the VC knows or trusts. Another approach is to be an outspoken industry leader at conferences or trade shows, which can make you a known entity. In fact, many new company ideas come from combinations of functions or technologies in existing companies, which are organizationally ill equipped to nurture the new paradigm.

Also, many of the more prominent VCs are asked to speak at conferences themselves, which then often presents an opportunity to meet them face to face. You can often tell from their speeches what kind of projects they are currently interested in, and it is best if you target your efforts to VCs who are indeed focused on your particular industry, stage, or model. You would ideally find a VC that not only understands the dynamics of your target market and/or technology, but also has valuable connections into customers and partners in the space, and has the ability to attract high caliber members to help build out your team, advisors, and board of directors.

Once effective contact has been established with VCs with the right focus or specialty, the attention turns to effectively communicating your deal such that the VC will be able to assess it properly. This will potentially lead to a positive decision to invest, which will in turn, hopefully lead to a successful entrepreneurial venture. But Hope is not a strategy, so let's look at some of the factors that affect a deal's assessment.

Deal Assessment

The deal assessment process varies from firm to firm, and often from partner to partner within a firm. Some use what may effectively be called "gut feel" or a "nose" for a good deal, which is in effect an integrated accumulation of all of their experience into one assessment outcome. Others use a more systematic process to inform different aspects of a deal consideration.

There is no single recognized best way to assess a deal, and there is no way to guarantee that if a deal passes certain criteria that it will be more or less of a success than one that does not. There are, however, some factors that can be considered, which can help to inform various aspects of the current, or *likely*, strengths of the program, along with the level of development necessary, and the dimensions and degrees of risks in the project.

The spreadsheet in Table 1 is an example of a potential Deal Assessment Template, which provides a view of some of the elements that are considered in an initial investment assessment.

Now this may not be appropriate for all sectors or approaches, and the weighting or thresholds are not necessarily the right ones, they are just placeholders for discussion. Also, it does not necessarily provide an "answer", as no particular numerical score is in and of itself conclusive (and actual mileage may vary), but it does inform an indication of degrees of risk that is being taken on, and must therefore be managed, in the project. It is also a good tool for targeting the due diligence efforts to further inform an investment decision.

Note that different VC partners may view the same information differently, depending on their levels of risk tolerance or belief in the potential of the opportunity, and different firms tolerate various risk elements differently, depending on a number of factors.

Deal Assesment Worksheet								
	Weight	Ratings		Early Stage Partial Sums		Later Stage Partial Sums		Threshold Criteria (VC Firms may have different Threshold criteria)
Candidate Company	Sub	Initial	Likely	Initial	Likely	Initial	Likely	
Management Team		1 to 5	1 to 5	15.0%	15.0%	30%	30%	
CEO	50%							
Technical Team	35%							
Business Team	15%							
Subtotal				0	0	0	0	
Market Attractiveness				35.0%	35.0%	25%	25%	
Market Size/Potential/Growth	50%							
Competitive Environment	30%							
Market Timing/Risk of Slip	10%							
Overall Industry Structure(Porter)	10%							
Subtotal				0	0	0	0	
Product, Value Proposition & Eco-Sys				25.0%	25.0%	20%	20%	
Dramatic Benefit to Target Customers	35%							
Limited Reasonable Comp. Alt.	20%							
Proprietary Know How	20%							
Accessible Buyers with $	15%							
Complete "Product" Known & Available	10%							
Subtotal				0	0	0	0	
Financial and Business Model				20.0%	20.0%	20%	20%	
Exit Value/Multiple	50%							
Pre-Money								
Syndicate Strength	10%							
Channels Identified and Motivated	10%							
Financials/Business Model Work								
Factored Revenue Plan ($M)								
Viable Exit Scenarios	10%							
Total Capital Required	10%							
Time to CFBE, Max Burn	10%							
Have They Made Their Plan?								
Subtotal				0	0	0%	0	
Fund Strategy Fit				5%	5%	5%	5%	
Stage	20%							
Sector	20%							
Board Seat	20%							
Subsector Clustering	10%							
Geography	10%							
Ownership	10%							
Size of investment	10%							
Subtotal				0	0	0	0	
Totals								

Table 1. Deal Assessment Worksheet

The table is broken down into 5 major sections, including Management Team, Market Attractiveness, Product/Value Proposition & Ecosystem, Financial/Business Model, and Fund Strategy Fit, where the candidate company would get a rating for each section. Each section has a number of sub categories of consideration which are in turn weighted to arrive at an aggregate rating for the section.

The sections are themselves weighted to reflect differences in importance, which may vary depending upon situation, such as an early stage company may be most critically dependent on the Market Attractiveness, and a later stage company may be more heavily weighted on the Management Team, where the strength of the CEO may be the most heavily weighted criteria. The relevant strength and experience of the technical team is also an important consideration, though not as much as the CEO.

A very early stage project, on the other hand, may be most heavily dependent on the Market Attractiveness and the Strength of The Value Proposition. Sub-elements such as the size of the target market, the competitive environment, and the existence of a dramatic benefit to the target customers are key considerations. Additional factors such as proprietary know-how, accessible buyers, and completeness of product ecosystem are secondary, but still important.

The existence of a financing model that works is also a critical element in all deals. The deal should have a viable exit model that can make money for the investors without requiring a major mismatch of invested dollars to potential returns. The syndicate should be appropriate and strong. And the revenue model should be consistent with the expectations of returns on investment.

There is also a facility to assess where the company is now, as well as an assessment of where it will *likely* be after development, given all the other factors in the deal. For example, two lone entrepreneurs (e.g. Larry Page and Sergey Brin) with a fundamental breakthrough which has huge economic benefit to a large group (effective ranked search), may not initially have any of the management team, product, or financial business models worked out, but due to the strength of the technology and the size of the market, they are *likely* to attract the highest caliber management (Eric Schmidt) and excel in the other aspects that allow them to build a highly valuable company (Google).

Finally there is an important column at the right for Threshold Criteria. This reflects the fact that many VCs won't take on the risk of a project, as a result of their experience, if it does not at least reach a threshold of strength. For example the company may need to address a market of a certain size, or have defensible technology, or have experienced management. Different VCs have different thresholds which reflect their expertise and their comfort levels in taking on the risks inherent in early stage venture capital.

The question then becomes, "How do you recognize a great opportunity when you see one?" The answer often lies in the strength of the Value Proposition.

The Value Proposition

Fundamentally, the creation and sustainability of a new company lies in the strength of its value proposition, for its product or service, for its target customers, in the particular application at which it is focused. The size of the opportunity then relates to willingness of the customers to pay, and the size of the market, adjusted for dilution by invasive competition and alternative substitution. Below is a useful exercise, which was adapted from Geoffrey Moore in his book, entitled "Crossing The Chasm", which endeavors to simplify and complete the relevant aspects of the Value Proposition.

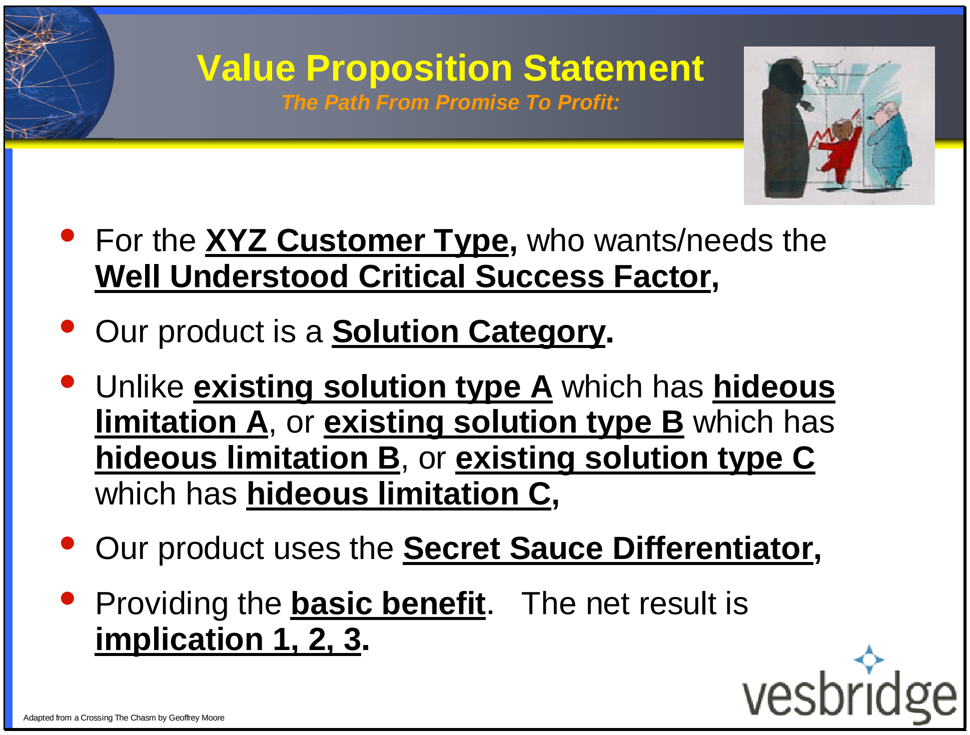

Figure 1. Value Proposition Statement

Again, this is not intended to imply that this is the answer, and if you can fill it in, you are a winner. It instead forces the issue of identifying the buying customer target, who has a need/desire, and establishes the solution category. It also forces acknowledgement of the competition, either direct or indirect, and the gap of the difference in terms of net benefits to the buyers. One then has to assess the sustainability of the competitive advantage, in the presence of the relevant competitive environment, such as patents, unique know how, channel lockups, or other irreplicable key elements.

Once a strong Value Proposition has been clarified and established, the attention turns to execution, and the inherently bumpy and risky road to building a company.

Company Building

The process of building a company is obviously quite involved and multifaceted, and a thorough description is beyond the scope of this text. But the role of an active VC who is adding substantial value to the creation of the enterprise is graphically depicted below in Figure 2.

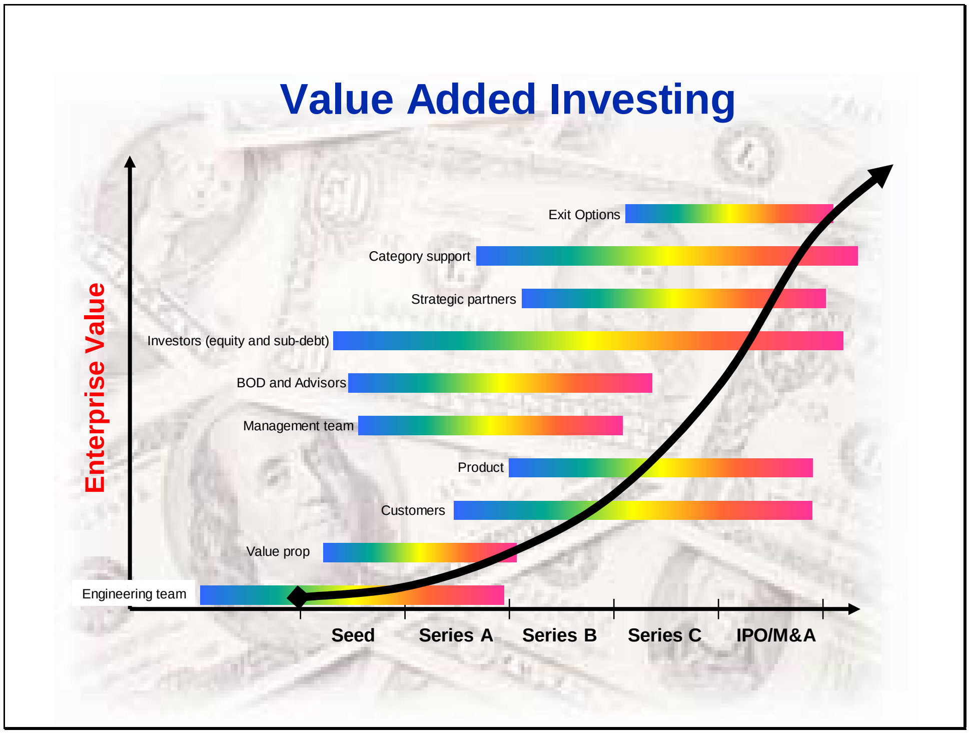

Figure 2. Value Added Investing

This chart shows the various dimensions of active VC involvement in the company building process over the course of the life cycle of the company, with shading in the bars for each activity indicating the level of completion or readiness that the company may be at for that element at that point in time. Early stage venture capital often requires an active involvement in all of these aspects of the company's development, whereas later stage VC investing does not typically require as much expertise or operational engagement.

One of the key roles in company building that VCs do play in all stages of venture investments is helping to establish and accomplish its financing strategy.

Financing Strategies

Building the appropriate investor syndicate is increasingly a critical element of success in venture capital. This is because the funding is typically done progressively based on the achievements of milestones. After an initial small Seed or Series A investment, the idea feasibility is tested, and if sufficiently successful, more capital is invested to move to the next significant milestone, and so on until the company is cash flow positive and exits through an IPO or an M&A transaction. Ideally, at each successive round of investment, the combination of the work performed and milestones achieved increases the valuation of the company, and decreases the risk of the investment. This is depicted visually in the Figure 3 below, which was adapted from a presentation given by Vinod Khosla of Kliener Perkins Caufield & Byers.

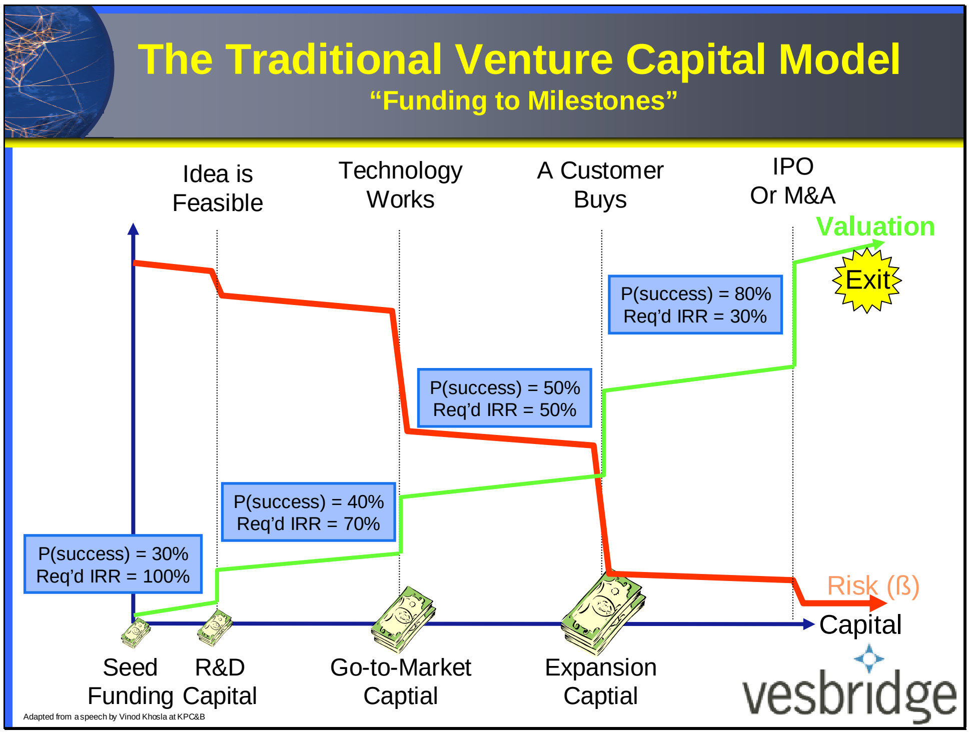

Figure 3. Traditional Venture Funding Life Cycle

Presumably, those that do not achieve the milestones do not get the next round of financing, which decreases the amount of capital at risk on a project that does not work out. Occasionally, however, conditions change and/or milestones are not reached before the round's money runs out, even though the company still has demonstrated potential in the eyes of some of its investors. The problems arise when a part of the investor syndicate withdraws their support.

This has in recent years led to a sudden and dramatic increase in risk in the company that it may not be able to assemble the needed financing to support it, which could lead to imminent collapse. This dramatic risk increase then leads to a dramatically lower valuation of the company, *if* it is able to secure financing. This is a phenomenon known as a Down Round or a "Zero Pre" deal, referring to the general realization that the pre-money valuation of the deal would be near zero, excluding new management incentive options. This is depicted below in Figure 4, and is typically accompanied by a recapitalization of the company's ownership structure.

Some of these recaps are able to restructure and still have a successful exit, while others languish amid the issues that caused the lack of milestone achievement in the first place. VCs who invest into recaps need to have the same type of deep sector expertise and operational experience as early stage VC investors in order to sort out the former, and avoid the latter.

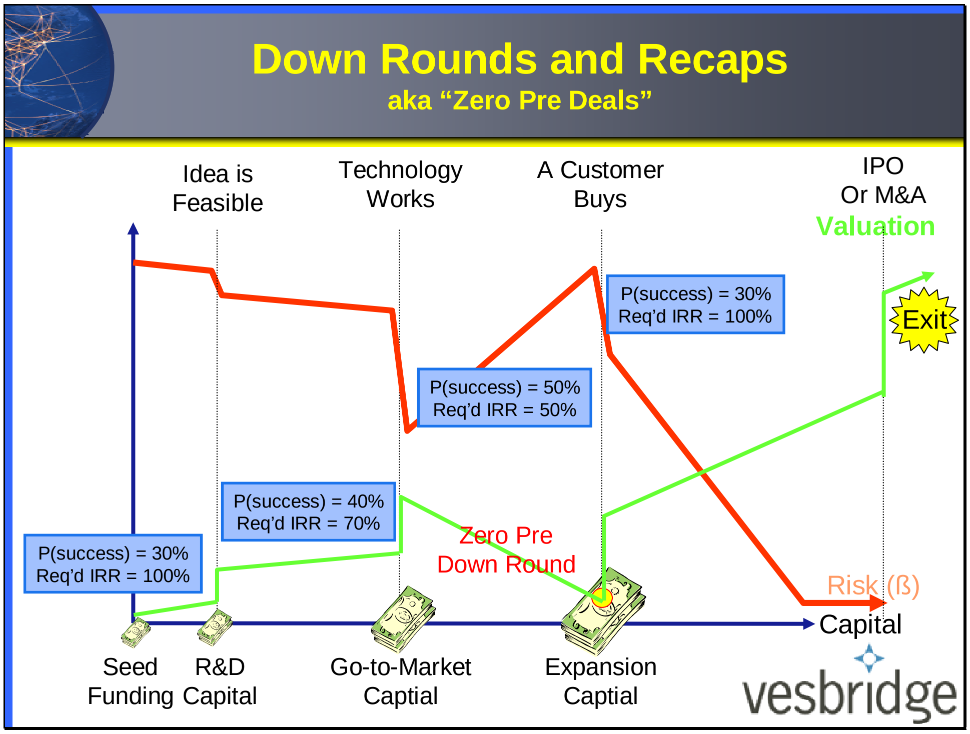

Figure 4. Down Rounds and Recaps

This financing risk issue is why, ideally, the investor syndicate is broad enough to have enough money around the table to support the company as it grows without unreasonably taxing any one investor, but the syndicate partners need to be of like minds, and in constant communications with one another, so as to avoid a dramatic difference in objectives.

Exit Scenarios

The ultimate objective for a venture investment is the exit out of the investment with more than was put in, hopefully significant multiples more. While an IPO and a long term industry growth engine is generally the target, a sale to willing buyer who pays the desired price is often the preferred alternative. This is because if the VC investor is holding a significant percentage of the shares of a company, even after the 6 month lock period after an IPO, selling its shares in a concentrated timeframe could actually flood the market and depress the price, based on a sudden supply of shares. So they would have to feather them out over time, which delays the return to its limited partner investors.

A desirable combination is of course to have a company go public, trade up in value significantly due to public growth, and then be acquired at a premium by a much larger entity, whose stock is so liquid anyone can get out at any time without tanking the stock.

Recycling

Recycling is the concept that comes about with the recognition that the most reliable source of entrepreneurs is previously successful entrepreneurs who come back in with a new company and are planning to do it again, hopefully at an even bigger level the next time. This concept is shown below in Figure 5, and is the Holy Grail of Venture Capital.

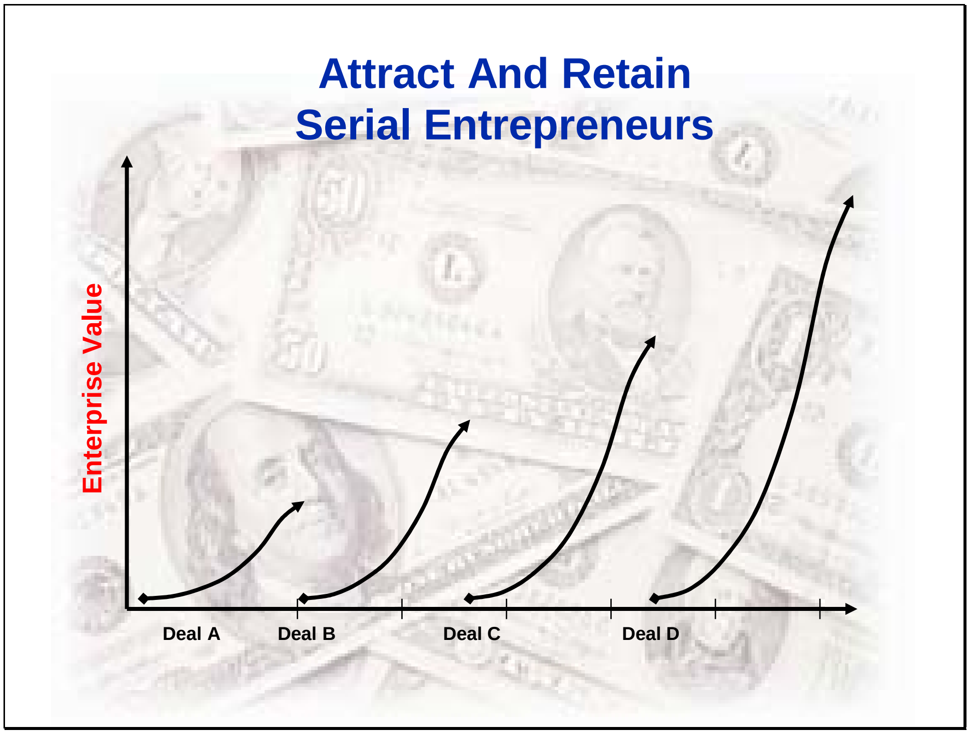

Figure 5.

Summary

Success in telecommunications investing depends on investing in and with intelligent people. The days of a single venture capitalist being the only investor in a company are over. Now, increasing the number of smart, connected people supporting a company is increasing the probability of success. Telecommunications and Wireless investing in particular is rich with opportunities for entrepreneurs and venture capitalists alike creating the new "Second Derivative" opportunities, followed by "Third Derivatives" and so on. While there are no guarantees in venture capital, creating and aligning with the best teams on the best concepts is the surest way to success.