

Is it a Recession?

By Bart Schachter, Blueprint Ventures



We Venture Capitalists are an optimistic bunch. George Bush wouldn't say the word. Henry Paulson wouldn't say the word. But now that the Honorable Ben Bernanke has uttered the unspeakable R-word as it per-

tains to the *possible* current state of the economy, it may be time for VCs and institutional investor to figure out where to invest in this market.

Some of us have been there before. It was March 10, 2000 when the NASDAQ peaked at 5,132 before beginning a long slide which would end only in late 2002. It was well into 2002 before sound bites like "nuclear winter," and "catching a falling knife" started spreading like wildfire around Silicon Valley and tech circles in a "New York minute." For the first 18 months or more of that correction, the venture market certainly slowed down, but the assumption was that it would turn around quickly. The few smart ones--the soothsayers, those who saw it all coming--took their money off the tech table and moved instead into Nevada real estate. What better way to play the NASDAQ downturn than to invest in *real* property that you can feel and touch. But we digress.

This economic cycle, however, we know what is coming and how to play it. Clearly the market's buyers and sellers have gotten smarter about technology projects. Gone for the most part are the thousands of companies dependent on E*TRADE IPO investors to fund them to profitability. Gone also, for the most part, are the billion dollar build-outs dependent on late-stage equity or mezzanine financings before hitting pay dirt with a Henry Blodgett IPO or Yahoo acquisition.

Where Should VCs Invest?

The current market offers an interesting dilemma. On the one side, exit opportuni-

ties will clearly degrade in volume and valuation and investors will be rewarded for sticking (with good companies) through the upcoming down cycle. Managing cash, expenses, and exit timing will be key to survival through a delayed or constrained exit environment. The other question we should be asking is, "What type of venture deals can make money in the current environment?"

As most investors know, only buy-low, sell-high strategies work. Unfortunately for venture-class investors, it is hard to short the venture market (undoubtedly if there were a way to do it, someone would make a lot of money and many investors would buy it as a hedge). The venture environment of 2008 offers several buy-low strategies for investors keen on capturing value in this down market. Distressed debt comes to mind as a good strategy. Special situations and secondaries are also attractive. Corporate IP Spinouts offer yet a creative way to go long in the 2008 venture market.

Corporate IP Spinouts are pre-revenue or early-revenue projects that are spun out of high-tech corporations into new venture-backed start-ups. Technology projects with significant prior R&D get spun out from corporations whose strategic mandates have shifted for a variety of reasons. Those reasons include change in direction, change in focus, change in competitive landscape, and change in

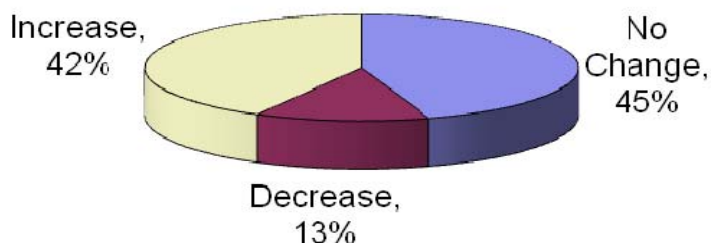
R&D priorities. For example, Mark Hurd of Hewlett-Packard recently announced plans to downsize the company's R&D efforts significantly and find homes for the orphan projects outside of HP via "Corporate IP Spinouts."

Why Now?

Down markets reflect a unique opportunity for private equity investors to leverage the perceived distress of prior investors. Prior investors could be late-stage investors, debt holders, or corporations. As the accompanying chart shows, distressed players have traditionally outperformed private equity and especially so during the last downturn. Why doesn't the aggregate venture market offer a similar buying opportunity (ie: why aren't pre-money valuations dropping dramatically on a Series A deal?) Simple: If traditional entrepreneurs had to drop the "price" of their deals to reflect the current environment, their pre-money valuation would be zero. This isn't a reflection on the merit of their ideas. It's simply a reflection on the difficulty of discounting an asset with no prior cash investment. No second-buyer distressed strategy can be applied here.

Corporate IP Spinouts actually offer early-stage venture investors a means to "buy low." A corporation who has invested \$30 million in R&D into a technology project and has chosen not to move forward with it will look to sell the asset for a steep

Changes to 2008 US R&D Budgets



Source: R&D Magazine, February 2008

discount. Given the scarcity of acquirers for pre-revenue or early-revenue projects, a venture investor can frequently negotiate attractive terms that value the company's prior R&D at pennies on the dollar. Blueprint recently invested in a Corporate IP Spinout where over \$60 million in prior R&D was invested in a project and this technology and IP were valued at less than \$0.03 on the dollar. These deals—akin to secondary investments, where holdings are valued at a fraction of the current NAV—allow venture investors to capture significant value as part of the spinout and build capital-efficient companies that require less equity investment going forward.

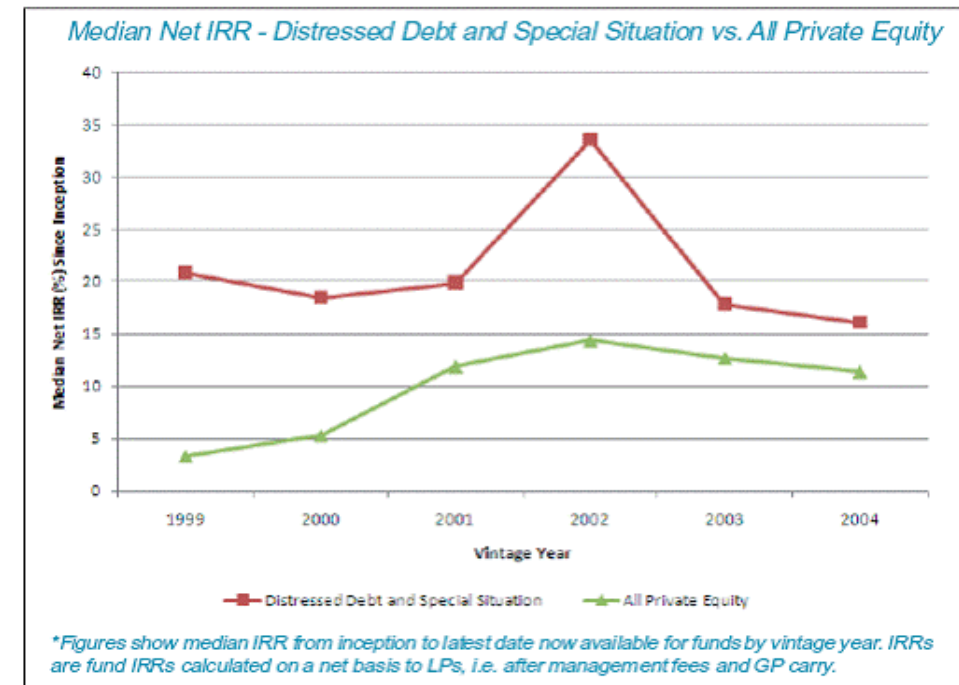
Contrast this with traditional early-stage start-ups, where valuations remain relatively stable in good times and bad. Let's take another example of a bootstrapped garage start-up that is seeking to raise a Series A financing. Simple start-up economics dictate that the founders and management team must retain sufficient equity (we consider 33% to be the absolute minimum threshold, though 50% team ownership is more prudent). Anything less than 33%, and the employees lose their financial incentive and the company is doomed to fail. If the start-up is raising a \$4 million Series A round, the valuation therefore cannot drop below \$2 million, regardless of the economic environment. This valuation floor doesn't exist for Corporate IP Spinouts.

Spinout Opportunities on the Rise

We have good reason to believe that Corporate IP Spinouts will accelerate in the upcoming economic downturn. Technology spinouts resulted in the past cycle as a reflection of the excesses of the bubble era, and we expect this trend to reoccur

If traditional entrepreneurs had to drop the "price" of their R&D, their pre-money valuation would be zero.

in the imminent downturn. More importantly, corporate R&D investment has actually *increased* steadily for the last few years as corporations are motivated by competitive pressure, higher corporate profitability, and steadily growing sales. This pattern is not at all abnormal. During the 1991-1992 downturn, the corporate mantra was to *increase* R&D spending because that would be the most logical ROI in the souring climate. Certainly sales, advertising, and discretionary spending would be of little use in an eco-



Source: Prequin, 2008

nomie climate with constrained consumer spending. Then, as now, the smartest move a company can make was to invest in innovation, invest in the future, and invest in non-revenue producing areas.

A growing number of limited partners are starting to think about Corporate IP Spinout opportunities in defining their asset allocation. In many institutional portfolios, funds focused on these opportunities belong as part of their distressed or special situation allocations given the unique deal circumstances and projected outperformance in a challenging economy. Cer-

can even write a two-page column about it but never utter the word!

Bart Schachter is a managing director with Blueprint Ventures, an investment firm that focuses on capital efficient technology start-ups and Corporate IP Spinouts. He may be reached at bart@blueprintventures.com.

tainly investing in one of HP's spinout innovations is tangibly different from investing in three guys in a Palo Alto garage.

As we move deeper into 2008, institutional investors and VCs alike need to look at themselves in the mirror and ask, "What new deals can I do today to best take advantage of the economic environment?" One thing is clear: invest appropriately but never use the R-word. You