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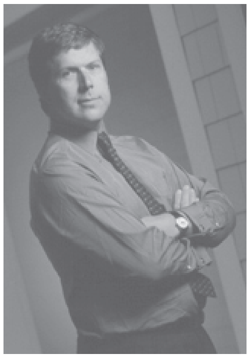
Why One Chance is Never Enough

by: Stuart Davidson, Labrador Ventures – December, 2005

It's often not just the first chance that creates our best investment opportunities. It's often the second, third and even fourth "half chances" that really help build truly great companies.



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Every company, every entrepreneur, every successful startup has a story. The story of why they first went into business and how they ultimately made that business work. Yet, every one of those stories usually has a twist – that the company started off in one direction and, invariably, ended up in another.

Early stage VCs know this. In fact, when investing in the earliest rounds, they count on it. We don't just give companies one chance. We give them a chance and a half.

Take Solaicx, a Santa Clara, California-based silicon wafer manufacturer serving the solar cell industry. Solaicx began life in a chicken coop, literally. The brainchild of Nick Gralenski, the company's first technology solution married one of Gralenski's inventions – a highly efficient chemical vapor deposition furnace (first assembled in said coop) – with unique "thick film" technology created at the Stanford Research Institute. A licensing agreement with SRI for its rapid epitaxial growth of silicon allowed Solaicx's founders to raise their first $500,000 in angel financing in January 2002.

There was just one problem: Solaicx's potential customers didn't care for its solution. Silicon sprayed onto substrates and then engineered into solar cell manufacturing was a technique that had been tried and dismissed. Solaicx's customers wanted a plug-and-play approach, a better cheaper silicon wafer that could match existing cell design.

With half its money gone Solaicx decided it would continue to address the same market, solar, by making silicon better/faster/cheaper, but that it needed a new approach to get to market faster while still using its domain expertise in high-efficiency furnaces. "We were still working for no salaries, so the burn was extremely low," says co-founder John Sedgwick. "We knew the SRI deal was a fundable deal, but didn't think it was sustainable for what the market was looking for. That was the hardest part – to let go of that giant crutch and to realize you're on your own again, but that second chance was what made all the difference."

Having morphed into a pure-play silicon wafer manufacturer, Solaicx took its first chance, cut it in half, and found the next solution, which would form the basis for its second chance at future success. This is what early stage investors should be looking for most in their entrepreneurs – the willingness and ability to find second and third chances, adapt them to market opportunities and be able to execute against them going forward. But investors must first be willing to sign on to such early stage investments with this "chance and a half" concept firmly in mind.

Parsing Risk

Like most other VCs, we break risk into three major components: management risk, technology risk and market adoption risk. With every financing, you have to keep looking at each of these risks and ask yourself: Are they rising or declining? If at any point the risks are on the rise, where must the company cut back, reposition itself or change in order to give itself that extra chance at success? It's a question we try and ask when there's at least half a tank of gas, if not more, of invested capital still left in the company.

Management risk is perhaps the easiest to solve (and often explains why VCs have such itchy trigger fingers when it comes to firing people.) Good management can adapt, change and save your bacon every time. Technology risk combines blending the "art" and "science" of venture capital, when you often have too little data to judge whether a technology solution will truly work. It's market adoption risk that's the hardest to fix, and it's this change

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that must be made at the earliest possible stages in order for investors to have a prayer of a "chance and a half."

"You can always shut the doors and give the money back, yet our investors always encouraged us to figure it out," says Scott Potter, Managing Partner with San Francisco Equity Partners and former CEO Quiver, a startup backed by Hummer Winblad. In fact, market risk was all Potter could think about back in 2001 and 2002 when Quiver – which developed a directory technology that has since been sold to Inktomi – didn't seem of much use to an Internet market in freefall. "We were going to be a B2C play and suddenly the world changed, so we swapped out the management team, took the company down to nine or 10 people and went to the board and asked for more time," Potter says.

Quiver felt it could still use its original algorithms to help create directories for corporate enterprise customers and their internal portals, and luckily still had enough of its original venture capital to carry it through a change in strategy. "For better or worse, your balance sheet helps make your decision, and as early stage managers we always felt that being honest with the board and giving them clear visibility would only help in the long run," says Potter. "And the good news is it all worked out. All the investors ended up making money on their investments."

Too Far Ahead of the Market

The mistake most early stage investors make, says Toni Schneider, vice president of Yahoo's Developer Network, "is trying to treat an early stage company like a later stage one, fabricating a story that says that certain things must happen in certain ways."

Schneider knows from experience that early stage companies *never* work like that. His previous company, Oddpost, a high-end Web-based email system, was supposed to offer technology that would set a higher bar for consumer email functionality. Unfortunately, companies like Yahoo and AOL didn't see it that way a few years ago. Good old-fashioned email was just fine for them. If this attitude meant that product risk was high for Oddpost, the risk of market adoption was suddenly through the roof.

In order to survive, Oddpost morphed into an email solution for the enterprise, selling itself into and through larger software offerings from the likes of Oracle. The strategy paid off for the company and offered an attractive future alternative path for its investors. Interestingly, however, Schneider's ability to swiftly adapt to a changing market allowed him to enjoy even more than a "chance and a half."

When Google came along with Gmail in 2004, increasing the robust functionality of Web-based email, companies like AOL, Yahoo and Microsoft were forced to improve their email offerings in much the way Oddpost had originally envisioned. Suddenly, the market adoption risk that first caused Schneider to change direction was now all but gone. Faced with a "buy it or build it" decision, Yahoo bought Oddpost in July 2004 to offer its users more robust email.

The "chance and a half" concept often has less to do with what's being sold than it does *how* it's being sold. After starting ExchangeWave, a San Francisco-based B2B Internet exchange in February 2000, it didn't take long for CEO Tim Albinson to realize exchanges were not sustainable. Understanding just how hard it would be to create critical mass among buyers and sellers for an excess inventory marketplace, Albinson saw a big hole for product supplier enablement and management software. That was "chance and a half" number one, and a decision that Albinson says he first had to resell to his angel investors.

Like Quiver and others, ExchangeWave (renamed Aravo) slimmed down by outsourcing engineering talent. It also shifted from a direct sales model to an indirect model, reaching into the enterprise software sales channel through valuable partnerships with IBM and Accenture. "If we hadn't gotten it right with that first half a chance when we became a software company, we'd be dead," says Albinson. "But if we didn't get it right again with that second chance and a half, where we switched to a channel strategy, we'd have been really dead all over again."

Early stage investors should take note of this, as it's often not just the first chance that creates our best investment opportunities. It's often the second, third and even fourth "half chances" that really help build truly great companies.

This is one in a series of monthly columns on seed and early stage investing that Labrador Ventures was selected to contribute to the *Venture Capital Journal.*

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