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Is 'New Paradigm' Really So New?

While Traditional Rules Still Apply, E-Business Factors Do Need to Be Understood

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WHAT A DIFFERENCE a year makes. The year 1999 saw the peak of technology stock fever. The NASDAQ hit 5,000. Technology stocks increased in value at eye-poppingly astronomical rates. The market's appetite for initial public offerings of technology companies seemed insatiable. Venture capital firms could multiply their money many times over in the course of 18 months.

Then came April 2000. The market stopped rocketing upward, and instead began meandering this way and that. As of today, the equities markets as a whole are basically flat for the year. Those who dispense venture capital have become much more selective. The market for IPOs has slowed to a trickle, if that. The financial community and the investing public have taken off their rose-colored glasses and donned instead green eye shades.

This means that the magic — or, more accurately, perceived magic — of the dot-com boom has worn off, and the realities of business have set in. It is now apparent that the rules of economics apply to Internet companies just as surely and inexorably as they apply to bricks, mortar, smokestacks and metal. And there is no law that exempts companies built on bits and bytes from the forces that affect all industries: consolidation, elimination of excess capacity, insistence on efficiency and capacity to deal with an ever-changing marketplace.

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One has only to read recent newspaper articles to see the symptoms of retrenchment:

- Priceline.com has just closed its gasoline and groceries services.
- Some analysts have raised the once-unmentionable possibility that Amazon.com's business model might not be viable over the long run.
- Web sites have now popped up that are dedicated solely to tracking the woes of high-tech companies. F*ckedcompany.com and Dotcomfailures.com chronicle, day by day, an ongoing stream of layoffs, cutbacks and retrenchments.
- The NASDAQ index is now floundering near its low for the year.

What Is New in All This?

Is this litany of bad news really something new? Or are the same forces that magnified the dot-com boom now magnifying the dot-com bumps in the road? After all, a huge percentage of all start-up companies of all kinds fails, and always has. What is different about this latest crop of new ventures?

It would appear that the main difference is the amount of attention the strugglers are getting. Never before have so many start-up companies gone public so early in their corporate life cycles, with such spectacular run-ups in value. That has subjected these companies to unprecedented public scrutiny unusually early. And just as the hype fed the run-up of their share prices on the upswing, it feeds their every dip on the downswing.

Perception is often at odds with reality, though. Historically, ventures with sustainable business models, well-planned financing and sound exit strategies have had a good chance to succeed. Dot-com businesses are no different in principle: businesses that spend more than they take in will fail if they do not have adequate sources of cash. Irrational business plans will lead to failure. The differences are really in the details. Once those differences are understood, the way to deal with

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them, preferably at the planning stage, becomes much clearer.

First, the heavy use of equity financing, whether from the public markets in IPOs or the private venture capital markets, or both, so early in these companies' life cycles affects the interplay of relationships among sources of funds and users of funds. Control of the company is in the hands of whoever has a blocking position, or — as is the case when a company is financed with convertible debt, options or convertible preferred — a potential blocking position. This is unlike analog businesses which typically rely for their cash flow on asset-based or cash flow-based bank lines of credit (and, of course, on internally generated cash). Because the prototypical equity investor is often less risk-averse than the typical banker, he may be willing to "pull the plug" more quickly rather than find a way to restructure, particularly if he views his equity as worthless or nearly worthless, and this is just one of many e-business ventures he is invested in.

Second, the nature of e-businesses sometimes makes it difficult to restructure or even to capture — and thus exploit or sell — the value of the business. Often, the true value of an on-line business is not so much in its balance sheet assets as in the fact that others use it — the network factor. Having traffic that comes to a Web site is an asset that in some ways is similar to a customer list, but considerably more fragile and much more difficult to value. Networks of users are very evanescent. If an e-business has financial difficulty — for example, if its funding is not enough to cover its needs past a level of growth that it has now surpassed — it may find itself unable to continue providing the services or features that drew traffic to its site in the first place. If that happens, its entire value as a business can evaporate if there is no mechanism or plan in place to preserve this value, whether with new funds or otherwise.

It may be useful to have an early warning system that, upon occurrence of certain triggers, will forestall or delay bankruptcy by spurring management changes, activating equity conversions or rejiggering the board.

Third, many of the entrepreneurs of e-commerce businesses are younger people with lots of good ideas, technical ability and enthusiasm but not as much business skill as might be desirable. As a result, the basic infrastructure of building a business can often be neglected while the proprietors attend to the flashier and more alluring aspects of putting up a Web site and flogging the idea on the airwaves, to investors, and elsewhere. In fact, many of these young entrepreneurs may never have even given a thought to planning for the long-term needs of a business.

As the Market Tightens

These factors have a number of consequences. First, special burdens will often fall on equity investors, venture capitalists, angel fund managers and other sources of "adult supervision" that invest in, but do not typically operate, start-up ventures. With the death of boundless optimism comes the need for a more gimlet-eyed view of electronic businesses. There are still opportunities, but the chances of many-fold returns within 18-month periods are rapidly vanishing. Consequently, the need for sound management fundamentals is increasingly making itself felt acutely in the e-commerce field.

Second, the heavy use of equity financing will often skew normal "workout" issues. In most workouts, the basic constituencies that have to be addressed are trade creditors, bank lenders, bondholders and equity. But with the financing of so many e-commerce startups skewed so heavily toward equity, the cast of players will usually be different, or at least weighted differently. Banks and other secured debtholders often will not be holding the cards, usually because often there is no secured debt.

A third factor that alters the normal calculus somewhat is the nature of e-businesses. Their tangible assets usually are minimal: there is usually no property, plant and equipment, and little in the way of other hard assets. Basically, the business is — besides rapidly depreciating desks, telephones and computers, and perhaps some receivables — a collection of various forms of intangibles and intellectual property: patents, trademarks, copyrights, licenses of patents, trademarks and copyrights, customer lists (or rosters of "registered members"), domain names and accounts

receivable. Valuable? Sure. But how can anyone know what they are worth? And how can finances be restructured if there is no easy and predictive way to measure the underlying values?

How to Weather the Storm

The best advice for weathering the storm is to be prepared for it. Investors and others with a stake in the business's future should be sure that the following issues, at least, are addressed.

1. Is a plan in place to provide additional funding down the road if it becomes necessary? Before planning to raise the next round of financing, the business first must ask whether it raised enough in the preceding round to avoid disaster. Planning to pay only for the next three months of costs, without some plan for how to deal with the three months after that, can be a recipe for disaster, given the ethereal nature of e-commerce assets.

2. It is advisable to inventory and track the company's assets. Which licenses does it own? Are they assignable? Are there change-of-control clauses? Is any of the company's technology dependent on a non-assignable license of someone else's technology? Which patents does it own or has it applied for? Which copyrights? Which domain names? Is the company in compliance with all terms? What are the licenses and intellectual property worth? How are they to be valued?

3. How are the investors planning to realize on their investment? Is a plan in place for the investors to measure at what point the investment can be deemed a success? What criteria will measure when it is worth supporting the no-longer-fledgling with additional funds? When should the plug be pulled? Is there an intermediate exit strategy if the plug has to be pulled before the desired IPO?

4. What sort of capital structure will protect the investors' interests? Options are commonly used, but sometimes preferred stock will be useful. Other times convertible debt will be the best financing vehicle. In the absence of senior, secured loans, will the company's debtholders control the company's destiny? Sometimes it can turn out that debtholders will be able to dictate the future even if they were the last dollars in — with a smaller amount of convertible debt compared to the cumulative equity dollars that others previously invested — simply because they hold debt.

5. The investors, or the company's professional advisors, might want to keep and regularly update a list of potential acquirors for the business. Such a list will be useful when and if a liquidity crisis, or other difficulty, buffets the company. Knowing what the potential market is for the company is a very large step toward being able to preserve the value of the business in a rational way without being overwhelmed, when and if a crisis arises.

6. The bankruptcy process requires court supervision and places much of the company's operations in a fishbowl, which can be detrimental to the ongoing functioning of a business that, like most e-commerce businesses, requires flexibility, nimbleness and speed. It also can result in little or no value flowing to the equity holders. So staying out of bankruptcy often is the preferable avenue for both preserving a business's value and protecting investors' stakes. It may be useful to have an early warning system that, upon occurrence of certain triggers, will forestall or delay bankruptcy by spurring management changes, activating equity conversions or rejiggerin the board. Often what is needed is a new sets of eyes to examine the business and set the keel of the company aright, and the corporate structure can be set up to provide just that sort of backup.

Conclusion

Very little of this is new. The particular issues that high-technology start-ups face are not phenomena that first arose in the year 2000. It is important, however, to be attuned to how the old issues and solutions combine in the new high-tech arena. As with so much else, proper planning by knowledgeable business lawyers can forestall business problems before they occur.

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