Left in the lurch

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Startups are finding that in hard times not all of their backers hang around. Here's what to do if they don't.

Illustration by Jonathan Barkat

Hubert Engelbrechten became CEO of Fremont (Calif.)-based semiconductor manufacturer GTronix in 2005, when the company was barely out of startup mode. He helped it raise $40 million in venture capital, including a $10 million round led by Palo Alto (Calif.)-based Jafco Ventures. Jafco partner Aaron Cheatham had been instrumental in persuading the firm to invest, believing the company had truly innovative technology and that it could do well in the Asian marketplace, where Jafco has strong connections. With that round of funding, Cheatham took a seat on GTronix' board and became a close adviser to the company. But in the fall of 2008, Cheatham dropped a bombshell: Jafco had become disenchanted with the mature, capital-intensive semiconductor industry, and Cheatham himself would be leaving the firm. That left Engelbrechten with an empty board seat and a financial backer having second thoughts, just as he was starting to raise his fourth round of financing—crucial to getting GTronix through the recession.

While you might think the compensation structure of venture firms would tie their principals to the firm pretty much for life, such exits are becoming more common. In 2008, nearly 16% of principals left their venture capital firms, according to the National Venture Capital Assn., and those remaining had about 10% less money per partner to manage. A survey by Deloitte Touche Tohmatsu earlier this year found that 41% of firms plan to invest less, while 21% are changing the sectors they invest in. As a result, Mark Heesen, president of the NVCA, says: "I expect that you'll continue to see a decline both in the number of VC professionals and the number of VC firms in 2009."

There are other, more ominous factors at work as well. Each partner at a firm is responsible for bringing in new deals and for helping his or her companies grow. The firm takes a share of the profits when the company is sold or goes public, with the person who "discovered" the company often garnering a slightly larger share. A partner whose companies aren't doing well cuts into his colleagues' profits and hurts the firm's track record. Now, with more economic pressure on VCs and their portfolio companies, firms are quicker to cut loose a colleague who brings in problematic deals. Partners are fleeing to other firms or other kinds of work if it becomes apparent their firm won't be able to raise its next fund and will have to wind down. And VC firms raised only $1.7 billion in the second quarter of 2009—the smallest amount since

2003. "Quite a few of my clients have been told that a firm is no longer investing in their sector, so the partners who focus on it are leaving," says Josh Nathanson, a partner with Cleveland recruiter ON Search Partners, which specializes in startups.

For entrepreneurs, such unexpected exits raise unnerving questions about the possibility of a new board member, access to the venture firm's network, and the willingness of the VCs to commit to follow-on financing. In the case of GTronix, Cheatham would be handing over his board seat to another Jafco partner, one who might be less familiar with the industry and the company and far less vested in its success.

While the relationship between an entrepreneur and his or her investors can be fraught during the best of times, CEOs at this crossroads need not sit by idly—and nervously—awaiting their fate. Here's how to manage a difficult situation and prevent it from undermining your business.

Signs of a turnover

If you're getting nervous about your board, stay alert for some common signals that turnover is coming. If your VC firm isn't making new investments in your sector, the partners may be cooling on it—and on the particular partner whose specialty it is. "If the VC on your board isn't making new investments, or if a lot of his investments aren't doing well," he's most likely headed for the door, says Michael Braun, CEO of San Jose (Calif.) software company Intacct, who has been involved in the tech industry for 38 years as an entrepreneur and a VC. "If he doesn't want to update his partners about you without excessive preparation, that could signal he's no longer very powerful at the firm," says Braun.

If that's the writing on your office wall, look for opportunities to connect with other partners at the firm. That will make it easier for you to cultivate a new advocate should you need to do so. Attend the networking evenings and conferences that the firm holds for its portfolio companies. Let the other partners know you're happy to share your expertise with their portfolio companies, and make it your business to stay updated about the progress of those companies. Put regular business updates into e-mail (even if you've just had a phone conversation), making it easier for your director to pass it along to his partners. If you haven't been invited to present your business to the firm in the past year, make a point of suggesting you do so.

At the same time, stay on top of your relationships with the rest of the board so you can count on their support should a seat become open. Finally, dust off and update your business plan, and start networking with other VCs in case you need to find new investors.

Finding an advocate

Maintaining good relationships makes it more likely that you'll be invited—or that you'll be able to invite yourself—to the meeting where the firm's principals choose your new director.

Peter Van Deventer, co-founder and CEO of SynapSense, a 40-person company in Folsom, Calif., that makes wireless sensors to track energy use in data centers, credits reliable, ongoing communications with his investors for a smooth transition when American River Ventures co-founder Corley Phillips retired and needed to give up his board seat this spring. While a retirement can often mean an easier and less stressful transition, these days some partners are stepping aside sooner than they otherwise might. Either way, a retirement can create the same uncertainties as other untimely VC exits and needs to be managed the same way.

Van Deventer used to be an executive at Intel, and a former Intel colleague, Cheryl Beninga, had joined American River Ventures two years before Phillips announced his intention to retire.

As soon as Van Deventer knew Phillips was likely to leave, he invited Beninga to be an observer on his board. That strengthened his relationship with her and helped broaden his connections within the venture firm.

This April, Van Deventer was invited to meet with the firm to discuss who his next director would be. He says the partners gave him a "strong voice" in the choice of a new director. To no one's surprise, Van Deventer suggested and got his former co-worker, someone he knew he could trust to understand his business and advocate for him as well as Phillips had.

Be proactive

From the moment you suspect that change is on the horizon until you've got your VC firm and your new director squarely on your side, you need to be proactive about addressing directors' concerns. Says Christine Comaford, an angel investor, entrepreneur, and former VC: "The partners might be putting out a lot of fires. So they stick someone on your board who isn't a good fit and don't pay the attention they should to what he's doing. Meanwhile, the guy is scared that the companies he's involved with will fail, so he micromanages the CEO and gets too nervous anytime something goes wrong."

In this situation, she says, a good CEO is relentless, but calm and polite, about acknowledging the new director's questions and concerns and demonstrating why they aren't significant—if that's the case—or have already been addressed. But you can't be too adversarial. "VCs talk, and if anyone ever asks this investor how you are to work with, you don't want this person saying you were difficult," says Comaford. If it becomes clear your company would be better off if the VC firm could sell its stake and bow out, see if another executive or an outside director can back you in raising the tough issues. That will help the firm acknowledge that it's got a real problem on its hands, not merely an intransigent CEO who needs to be replaced. In the best-case scenario, you might get your other directors to push the troublesome one out, either by buying up his firm's stock or bringing in a sizable new investor to dilute the firm's stake and, therefore, his influence.

Knowing when to sell

In Engelbrechten's case, after his close adviser Cheatham left Jafco, "I knew we would need more funding to get us through the downturn, and now that was unresolved," he says. "My priority was making sure the firm was still committed," he explains, so he would know he wouldn't have to scramble for new investors in a stalled financial market.

Engelbrechten invited his new director, Nick Sturiale, to the company's offices for a business briefing and tour and arranged for him to attend his first board meeting while Cheatham was still there. That way, Sturiale could witness Cheatham's enthusiasm for the company and his support for the CEO. Sturiale was new to Jafco but, fortunately, had some experience in the semiconductor arena. "We had to do some educating as to what we were doing and why it was a good thing, but his having a little bit of a semiconductor background made it easier," Engelbrechten says.

In the first quarter of 2009, Jafco came through for GTronix, leading a fourth round of funding for $7 million. With three rounds of funding already under the firm's belt, it would have been painful for Jafco to cut its losses. And GTronix was starting to bring in revenue, making further investments less risky than if sales had still been some quarters away.

But there are other outcomes. When Cheatham left Jafco, it wasn't only GTronix that was left hanging. Quellan, another one of Cheatham's semiconductor companies, was acquired in August by Intersil, a publicly traded semiconductor manufacturer. That created a much earlier exit than Cheatham had anticipated. "I thought there would be additional [venture] financing, but it's too hard to build an independent company in sectors that are capital-intensive," says Cheatham. Given the circumstances, he doesn't think it was a bad result: "This way the firm got something of a return."

Quellan CEO Tony Stelliga characterizes the sale as "a tough call." Says Stelliga: "You're at a point where your technology risks are behind you, you have good prospects, customers, and market momentum." On the other hand, "There's not much going on in the IPO market, so your exit is less certain and you have an offer on the table. But that's what happens with startups."

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