Bridging the Valley of Death

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Topic #1

My Lessons Learned in Financing the Valley of Death
Topic #2

The Valley of Death

A Market Failure Requiring Intervention?

Or the Rational Behavior of Investors to Risk?
Topic #3

Influencing Investor’s Behavior to the Valley of Death

Deal Flow Funds to ‘Scale Up,’ Do More Faster
My 1st Fund

- Seed/Early Stage Tech, SMEs in Valley of Death
- State of Michigan Major Investor
- Goal: Make $ & Advance Economic Development
- Structure: Royalties in Perpetuity, No Cap
- Royalty Investment in a Tech, a Product (Design)

USA (1986)
The Michigan Product Dev. Fund ($4MM)

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Oops!
Lesson #1

Royalty structures are great for early & fast cash returns

Terrific to finance medium growth & family-held SMEs

But

Not so good: Investment in a single platform-SMEs obsolete products

Results? Terrible when SMEs replace one product with another = no (or little) ROI

USA (1986)
The Michigan Product Dev. Fund ($4MM)

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Lesson #2

Structure investment to market needs satisfied, not platform or product design

Circumvents risks of product replacement, obsolescence

- Gives investor multiple cash streams from multiple products
- Emulates equity w/o the disadvantages of equity

USA (1986)
The Michigan Product Dev. Fund ($4MM)

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Lesson #3

Cash payments can become onerous for the investee with royalty payments for multiple products.

Happens when SME hits the & must reinvest cash to capture new growth.

What to Do?

When cash payments become too much for the investee company, sell the royalty claim for equity.

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Some Results

- $700k investment in Applied Intelligent Systems Inc., $500K in royalty returns, years 1 & 2. Sold royalty claim for equity, 10%, exit @ $120MM

- $700k investment in Neogen. Little royalty ROI, but later, Wow, IPO. 2010 valuation $750MM

- All on a $4MM fund. Lucky!

- Demonstrated new uses-royalty financing, creative & flexible
What Happened Then

- Development finance institutions & corporations seeking creativity in financing
- Engaged IVI & me as advisor &/or fund manager
- Create VC funds, new schemes to finance underserved markets, underfinanced entrepreneurs, access new markets & countries
- Mobilized new $ >$500MM
And We Financed Entrepreneurs
Around the World

Canada (1992)
C$100MM-Canadian Bus. Dev. Bank

USA (1986)
The Michigan Product Dev. Fund ($4MM)

Europe (1992/94)
Tech Fund, $10MM-EU, $5MM Financière St Dominique, Paris

Russia (1992)
CIS Hi Technology Partnership Initiative: Shell Oil & IVI

Russia (2005)
Shell Tech Ventures

Russia (1997)
HP LP, $30MM-EBRD & USAID

Africa (1993/96)
E. Africa $5MM, Sub-Saharan, $280MM, South Africa, $30MM, IFC/World Bank

Kazakhstan (2011)
$85MM Tech Commercialization Project
Investing Through a Variety of Funds, Structures & Strategies

**Canada**
- Venture Lending

**USA**
- Royalty + Equity

**Kazakhstan**
- Grants: Proof-of-Concept thru 1st Sale

**W. Europe**
- Technology Performance
- Finance & Royalty

**E. Europe, Slovakia & Croatia**
- Grants & VC

**Russia**
- Venture & Private Equity

**Africa**
- Venture Lending, Fund-of-Funds & Private Equity

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To Make $ & an Economic Development Impact
What I Learned in North American, International & Emerging Market VC

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We Investors Embrace the Valley of Death
The Valley of Death: It’s not a Market Failure, but the Rational Behavior of Investors to Risk
Because

Only the strong survive.

the Valley of Death

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So What’s the Problem?
What is the Valley of Death?

“A phrase that refers to the period of time from when a startup firm receives an initial investment to when it begins generating revenues.

In the valley of death, additional financing is usually scarce, leaving the firm vulnerable to cash flow requirements.

Traversing it requires an intelligent blend of public and private sector investment.”
What’s Odd About that Definition?
It Incorporates the Perspective of
& their Companies

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Finance Institutions & Gov’t Too

Inter-American Development Bank

USAID

International Finance Corporation

EUROPEAN COMMISSION

The World Bank

European Bank for Reconstruction and Development
But Not Perspectives of Investors

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And Not Why We Do What We Do

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Especially Our Behavior to Risk & Risk Taking

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So How Influence Investor Behavior?

- to Valley of Death
- to Seed & Early Stage Tech
Let’s Start Discussion in an Unlikely Place
Valley Investors ‘Buy’ Opportunity & Potential
And They Willingly Finance Failure

It won't work out
Financing the Future & Failure: not the Valley’s Greatest Attribute
It’s Attitude to Risk Is: Silicon Valley vs. World

Velocity of VC in Silicon Valley

Attitude to Risk Impacts Risk Taking

Accept Ambiguity & Lack of Certainty

Risk Taking Attracts Best Entrepreneurs with the Craziest (& Riskiest) Ideas

Private Equity 2-6-2 DISTRIBUTION OF RETURNS RULE
But Cultural Attitudes to Risk Are Very Different in Emerging Markets
Investors ‘Buy’ Risk They Know & Understand

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Risks in Deals Like:

- Real Estate/Construction
- Food & Beverage
- Retailing
- Mfging
- Consumer Products
- Telecom

Even in Greenfield Projects, Markets & Customers Are Guaranteed

Results are Assured if Execution is Successful
But Risks in the Valley of Death, Especially in Tech
Are Too Much for Investors in the Developing World

Does the Market Exist?

Will Tech Work?

Do Customers ‘Get It’?

Will They Pay?
Why this Fear?

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There Are So Many Friction Points in Execution, Emerging Markets
That Even the Big Guys Trip!
So Investors ‘Buy’ Growth with Certainty, not Potential
Where the Risks Are in Execution, & the Risks of Capturing Opportunity are Zero
And That’s The Reason Why (for example)
“Croatia is a Country of Savers, not Investors”

‘Capital Preservation’

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But Not Just Investors & the Culture in Croatia

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But Most of Us Investing in Emerging Markets
Yet What is the Typical Response to the Valley of Death?

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Create ‘Yozma’ Fund of Fund Clones

• Gov’t Initiate & Invest 49% as the Lead Investor
  • Gov’t $ Subordinated to Private $
  • Encourage Investment & More Risk Taking
With Economic Incentives Given to Invest

- Preferential Returns
- Subsidize Mgt. Fees
- Take 1st Losses
- Cap IRR

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Yet with Few Exceptions, Investors Don’t Behave as Intended
One Example

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Gov’t ‘Economic Cooperative Fund’ Initiative

• PPP* ≈ $184MM
• Match $ for $, 1 to 1
• Five Winning Funds
• Target Deal Size $250k-$10MM

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*PPP=Public/Private Partnership
Gov’t Hopes & Desires

• Some $ ‘Trickle-Down’ to Tech

• To SMEs in the Valley of Death

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Yet How Did Funds Behave?

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Oops! Invest in Growth, Not Potential

- Expansion Stage
- Finance the Risks of Execution
- Not the Risks of Mkt & Opportunity
- Exit in 2-3 Years

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Tech?

“Too Much Work”

“Too Little Reward”

“Do Customers Exist?”

“Will Customers Come?”

“Will Customers Pay?”

“When Pay & Amount?”

“Too Long to See Results”
Investor Behavior to Gov’t Expectations not an Isolated Example in Croatia
Russian Gov’t ‘Yozma’ Initiative

- PPP* Seeded with ≈$1B
- Mandate a Tech Focus
- Commit ≈$50MM/fund
- Match $ for $, 1 to 1
- Seven Winning Funds
- Target Deal Size $250k-$10MM

*PPP=Public/Private Partnership
Russian Gov’t Expectations

• Support SMEs in the Valley of Death
• Create an Early Stage VC Industry in Russia
• Invest in Technology
So How Did Funds Behave?
Oops! Technology Yes (Obligatory), But:

• Growth Financing, Expansion Stage

• Few $ for SMEs in the Valley of Death, Seed & Early Stage
So What was Response of to Fund Behavior?
Create New Funds?#@!!

- **Self Managed**, Gov’t Seed Fund & 2\(^{nd}\), a Bio Fund
- Not a PPP* at the Fund Level, but Deal-by-Deal with Private Investors
- Slower to Impact the ‘Ecosystem’ at the Country Level
- Increases Cost to Taxpayers

*PPP=Public/Private Partnership
But They Didn’t Impact Investors’ DNA to Risk
What are the Risks of the Valley of Death Again?
Risks That Scare Investors in the Developing World

Does the Market Exist?

Will Tech Work?

Do Customers ‘Get It’?

Will They Pay?
Can’t Blame Governments of Croatia & Russia for Behavior of Investors
We See this Mismatch, Investor Behavior to Expectations in Country-After-Country
Emerging Market Investors Behave Rationally to Risk

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Where the Risks Are in Execution, & the Risks of Capturing Opportunity are Zero
Emerging Market Investors ‘Buy’ the Risks in Execution, Not Opportunity

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Since Execution Risks are So Numerous to Trip Us Up

Opportunity Must be Assured
So How Impact the DNA of Investors?
Where the proof is in the pudding...
Tipping Point for Russian Tech in 2010
A Groupon Clone, localized for the Russian Market

1. Feb 2010, raise ≈$10k, programming, staff of three.

2. May 2010, raise $50k, market launch, staff of eight.

3. July 2010, raised $100k-for sales & mkting

4. August 2010, acquired by
What Happened Next?

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A Small Sample of Recent Russian Transactions—Clones of US Models

Business Models Where the Opportunity is Assured
Since September 2010, a Tsunami of E-Commerce Clones

• Last Count, 30+ Seed Deals Transacted
• 15+ Early Stage SMEs
• Total $ Committed > $150MM
• Deal Size, $250k-$55MM
And It’s Happening Not Just in Russia
Recent Transactions, 2011

- eBay buys gitti.gidiyoo Valuation ≈ $215MM
- Naspers buys 70% markafoni Valuation ≈ $200MM
- KPCB Invests $26MM in trendyol.com
- Intel capital Invests in nokta grupanya!
- hummingbird Invests $15MM in peak games
Russia & Turkey Not Isolated Examples
But Likely (& Unlikely) Places Throughout the Emerging World
Ok, Big Deal. What’s So Game-Changing About These Deals?
Deals that Circumvent the Risks of Opportunity Leapfrog the Valley

- Low Investment to Copy & Localize Technology Platform-Launch ($00,000-$000,000)
- Revenues Earned 2-3 Months after Launch, Some in the $ Millions
- No Profits but Exponential Revenue Growth
- 3-6 Months, Concept to Launch
And They Impact Investors’ DNA to Risk

- Int’l Investors Typically Lead: Show the Way Forward Since They Invested in US Biz Models
- Domestic Investors Follow, then Lead Since Opportunity Risks are Minimal
- Execution Risks Remain, Risks that Domestic Investors Willingly ‘Buy’
Deals Typically Centered Around:

• A Single Technology
• A Single Product
• A Single Service
• A Single Idea
VC Funds Organized to Finance this Emerging Trend Began in 2008

• Finance Entrepreneurs & SMEs Executing to a Single Tech, Product or Service Idea

• I Call Them ‘Deal Flow’ Funds
1st Movers in 2008

Total Investment = $70MM

iFund™ 14 SMEs funded  Over 6000 plans received

The BlackBerry Partners Fund™ 12 SMEs funded

82 developers funded

Organized Around a Single Platform: Tech, Product, Service or Idea

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Examples: Deals Done by 1st Movers in 2008
Recent (2011) ‘Ecosystem’ Deal
Flow Funds to Finance Platforms

AppUp(SM) Developer Accelerator

$300 million Ultrabook fund
$100 million AppUpSM Fund

Microsoft, TechStars to Fund Start-ups through Kinect Accelerator Program

On Friday, Microsoft declared a new program specifically designed for helping ten developers or start-ups to launch businesses for various products related to Kinect. Kinect is a controller capable of...
Deal Flow Funds Create a ‘Cambrian’ Explosion

• New Ideas & More Business Models
• More Entrepreneurship
• Increase # & Velocity of Deals Circulating in the Market
And They Create

- Opportunities for the Young
- Rapid Deployment
- + Youth ‘Get’ Tech & Business Models
We Can Be Smarter & More Creative to Deal Flow Funds

• Themes Broader than Just E-Commerce
People own their digital assets with New SMEs enabling users to access them anytime, anywhere.

Start-ups that will make human-computer interaction seem silly when we look back in 20 years.

Start-ups disrupting global online mkts with mobile & user driven distribution.

Source: Foundry Group
A Theme With Explosive Growth

• Computers Talk to One Another with the Amount & Velocity of Computer-to-Computer Interaction Increasing Exponentially

• This Communication Needs Layers of Software ‘Glue’ to Bind One to the Other

• A Horizontal Market with Hyper-Growth that SMEs will Exploit
But Deal Flow Funds Can Do Much, Much More

Brand Camp

The Idea Factory

We need to increase throughput and efficiency.

But what if it's time for a whole new way of thinking?

Sorry, creativity slows down the line.

© 2009 Inspired by Seth Godin and Tribes

TomFishburne.com
To Generate & Refine More Ideas
For GameChanging Solutions

Thereby Generating:
• New Knowledge Creation
• More Entrepreneurship
  • More SMEs
• More Economic Growth
  • & More Wealth
So What Kind of Problems & Needs Exist for New VC PPPs*— to Leapfrog the Valley of Death?

*PPP=Public/Private Partnership
Every Country Has National Priorities in Need of Solutions
Let's Take the Natural Gas Shtokman Project as 1st Example

Reserves Lie Inside the Arctic, 555km from the Coast of Russia, in 350m of Water
It Contains Breathtaking Wealth

• Gas Reserves = 3.2 Trillion cubic meters + 31MM tons of condensate, spread over an area of 1,400m²

• Exploiting Reserves, Environmentally Safe & Economically Requires New Technology That Does Not Now Exist
Who Will Innovate Needed Technology, Technical Solutions?

• The Russians or the Foreigners? Somebody Will

  • Russians—Capture More Value & Advance Economic Development
  
  • Or Let Foreigners Innovate to Advance Knowledge Creation & Exports for Their Benefit
What Are Examples of Challenges in Shtokman Project, in Need of New Technology?
Challenges #1

Design, Build & Operate the 1st Floating Platform for Pack Ice

- Ice, 3m Thick, Uneven Ridges
- Able to Withstand Impact of Icebergs Weighing 1-2 Million Tons, Drift at 0.25m/second & 1.2m Drift Ice Moving 1m/second
Challenges #2

Transport Gas Over an Uneven Seabed 565 km from Production to Receiving

• Operate to -45°C
All Accomplished Reliably, Environmentally Safe & Economically Over the Entire Supply Chain
How Develop Needed Ideas & New Technology for the Shtokman Project?
Shtokman Fund

Finance Creation of New Technologies & Technical Solutions

• Focus & Channel Russian Scientific & Engineering Talent to Specific Needs to Specific Problems

• Oil/Gas as a Fund Too Broad & Too Horizontal to Catalyze Ideas
Tech Solutions Not Russia Limited

- More Exploration in Hostile Environments—Extreme Cold, Deep & Far Off-Shore
- New Tech for Export, a Small But Substantial Success for Russia in the Global Community
Improved Logistics a National Priority

• Historically a Tourist Hub
• A Fantastic Asset to Build On & Up
Deal Flow Possibilities for Storage, Transportation & Distribution

- Tech for Multiple Supply Chains & Feeder Networks
- Innovation Even in Buildings, Storage Facilities, their Design, Use & Application
What Innovation is Possible in the Design of Brick & Mortar Assets?
Take a Look at This
Magic Happens:

• When Marry Innovative Thinkers
• Architecture + Engineering + Entrepreneurial Talent
It’s Not Just for Parking:
• Dining
• Shopping
• Yoga Classes

But
And Wedding Receptions Too!

Mr. and Mrs. Joy Elizabeth and Timothy Edward Johnson invite you to celebrate the marriage of their daughter

Nina Elizabeth to
Daniel Lester

son of Mr. and Mrs. Cheryl Ann and Richard Lester Milewski

on Saturday, the twenty-second of January
Two thousand and eleven
at six o’clock in the evening

1111 Lincoln Road, Seventh Floor
Miami Beach, Florida

Cocktails, dinner and dancing to immediately follow

Black tie attire
Logistics Hub in Storage, Transportation & Distribution

• New Solutions in More Than Just Physical Facilities

• New Ideas Needed to Organize & Manage Operations Too
The Nest

Like Technology to Make Buildings & Homes Work More Efficiently & Effectively

The ‘iPod’ of Thermostats ‘Learns’ Through Behavioral Algorithms

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Croatian Logistics Fund

Yes Some Solutions Will Be Improvements to Known Tech

• New Innovation Results as Experience Grows

• Familiarity Leads to New Ideas & Business Models
Raw Material Deal Flow Fund? Why Not?

Strengths in a Region

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What’s in Your Head?

Ideas—Deal Flow Funds?

• Ideas—Diaspora/Mentor Funds

• Ideas—Proof-of-Concept & Cash Flow Funds?

• Create More VC, Investment?

• Let’s Discuss. Call Me
My Country Experience, Direct Investment & Advisory

Let’s begin with advisory projects, then explore new VC initiatives

Country risk class:
- 0
- 1
- 2
- 3
- 4
- 5
- 6
- 7
- Closed
- Unclassified

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Valley of Death not a Market Failure, but the Rational Behavior of Investors to Risk
Why It Works

• Increases the # & Velocity of Seed & Early Stage SMEs

• Deals that Better Match Investor’s DNA to Risk

• Thereby Making the Valley of Death Less Scary for Investment

• Develops Experience
Re-Think Interventions in Venture Capital to Make An Impact

Follow the Herd **Cautiously**
We’ve Run Out of Time

Two Subjects to Discuss Next Time

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Failure is Accepted & Yes Glorified Here
Failure is the Unpardonable Sin in Emerging Markets
How Pay for the Cost of Failure? Who Pays? Subject Not Discussed. We Will
And Subject #2
Valley Investors ‘Buy’ Opportunity & Potential
We ‘Buy’ Risk, then Opportunity

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Let’s Mentor, Train Entrepreneurs to ‘Sell’ Risk, then Opportunity
To Match Investors DNA to Risk

And Create the Spark Points for Investment
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Credits—Resources for You

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Programs to Scale Up Innovation, VC & Entrepreneurship

1. Part I, ‘Scaling Up Entrepreneurship’

2. Part II, ‘Path to Commercialization’

3. ‘More Edisons Needed, Not Einsteins’


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