



ALLEGIS CAPITAL QUARTERLY

REDUCING THE RISK OF VENTURE INVESTING

By Richard L. Brandt

BOB ACKERMAN, MANAGING DIRECTOR AND FOUNDER of seed and early stage VC firm Allegis Capital, enjoys all the trappings of a highly successful venture capitalist. The San Francisco office where he spends much of his time (the firm's main office is in Palo Alto) enjoys a picture window view of the sailboat-dotted bay, modern and ancient Asian art, and, incongruously, two business-style telephones hanging on the wall.

The phones are mementos of his time as an entrepreneur, products of Infogear Technology Corp., a firm Ackerman founded in the mid-1990s and later sold to Cisco Systems. Ackerman can boast that these are, literally, the original iPhones. The devices, complete with Web browsers and touch screens, were designed to connect to the Internet. Ackerman dubbed them "iPhones." (Cisco later threatened to sue Apple for usurping the trademarked name.)

The phones may be something of an historical curiosity, but that history is also a reminder of one of the things that makes Allegis different. Part of the firm's reputation rests on the fact that all but one of the general partners had corporate operating experience before becoming venture capitalists. Before Infogear, Ackerman was CEO of Unix supplier Unisoft. Jean-Louis Gassée, the newest member of the team, was a senior executive at Apple Computer, and later founder and CEO of Be Inc. John Funk, the one partner without

operating experience, has been in the venture business for over 20 years.

"We've been there," says Ackerman. "When we started Allegis we asked ourselves, 'What do we wish we'd had in a VC firm when we were entrepreneurs?' The answer was someone who could help entrepreneurs jump start their businesses, anticipate their problems, and increase their chances of success. We help our entrepreneurs play bigger than they are."

But that alone is not enough. On this sunny afternoon he's talking about the need to distinguish his firm from the plethora of *me too!* VC firms that fill Silicon Valley. Allegis may not be the first VC firm that leaps to mind when considering industry leaders, but it aspires to be.

"We've got to show we deserve to be a venture firm," asserts Ackerman. "The last thing we want to do is sit in an office in Silicon Valley and wait for all the same deals to come through the door and compete on price."

Ackerman believes that his firm has found that distinction. In an industry driven by seat-of-the-pants guesswork, big gambles, and the many failures and few hits that (eventually) make up the difference, Allegis has developed a disciplined methodology to reduce the risks of venture investing. Its goal is to ensure that most, if not all, of its investments succeed, using an approach that's designed to generate traditional VC returns even in recession years when IPOs are harder to float than a leaky canoe.

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The business of investing vs. the business of making money

It seems to work. The fund Allegis raised during the start of the technology recession in 2000 has reached more than a 20% internal rate of return. That matches the IRR of the overall seed and early stage VC industry over the last 20 years, according to Thomson Financial, and blows away the 3.1% return the industry has garnered in the last five years. Of the 18 companies in Allegis' 2000 fund, 14 are still active, and Ackerman expects a final return of two to three times the initial investment. In the meantime, many funds of that vintage are struggling just to break even.

The burst of the Internet bubble in 2000 provided the firm with the inspiration to hone their investment model. Although Allegis had closed a fund that year, the partners decided that the business had gotten too crazy to reinvest. There was too much inexperienced money floating around, valuations were outrageous, and recession loomed. The firm held off for five quarters before investing again (which it finally did in the fourth quarter of 2001).

Some of the firm's limited partners were unhappy with this cautious approach. One suggested that if no one was going to invest the money, perhaps the fund should be cut back. But one of the firm's most savvy limited investment partners (a "very private man" whom Ackerman will not name) was more sanguine. His response: "I don't pay you to invest; I pay you to make money for me. And I think you're on the right track."

"This was a defining moment for Allegis," says Ackerman. "We saw the clear delineation between the professional investor and the amateur. If the objective is to make money *consistently*, you've got to be prepared to step back from the market at times."

Ackerman criticizes venture firms that play the market in bad times the same way they do when IPOs are strong, firms whose sole aim is the sky-high valuation that makes news—and puts money in the VC's pocket through concomitantly dramatic investment fees—but that, ultimately, is unlikely to succeed. This style of investment fails to make money for the limited partners and kicks the entrepreneurs to the curb.

Allegis pays particularly close attention to its investments when the market is weak. As Ackerman notes, facetiously stating the obvious, *the good times take care of themselves*. And during these good times, Allegis has had funds with 70% and 100% IRRs. "But when the market is down 12%, it's cold comfort to say that the investment portfolio is only down ten. Fiscally, I'm a very conservative guy. I can't accept a down year. Failure is not an option."



By the numbers

The Allegis philosophy starts with a dedication to keeping fund sizes small and avoiding faddish investment trends. Ackerman derides billion dollar funds as impossible to manage properly. He recently turned down an offer ("a substantial amount of money"), from a fund manager who wanted Allegis to start a green technology fund. Someday, perhaps, but right now Ackerman sees too much money chasing too many "environmentally unimpeachable" deals. "We don't invest in a technology just because it's really *cool*."

By working with smaller funds, the firm's six partners can work harder on fewer deals. Each partner is limited to six board seats at any one time, an average of just 1.25 deals per partner per year. The firm, which has \$700 million under active management, invested \$39 million in 2007, up from about \$14 million in 2006. "Some large VC firms would rather just write off a \$5 million investment than spend the time to work through problems with a portfolio company's management", Ackerman asserts.

In order to reduce the VC cyclical­ity that ebbs and flows with the stock market, Allegis structures its investments in tough times to assume an exit strategy through acquisition. Before investing in a company, the partners look at the likely valuation in an acquisition, and then estimate how much capital is required to get to that level. If the numbers add up, you've got a deal. Then, if it looks like the firm can reach an IPO after all, even better. "But," notes Ackerman, "if you assume a big exit and it doesn't work out, there's nothing you can do. We generate returns on smaller exits... but we have *more* exits."

When Allegis makes a commitment, they work with the entrepreneurs to ensure the capital is used efficiently. For example, if a portfolio company continues to look like a likely acquisition target, there's no need to build an expensive (and pointless) sales and marketing organization—after the buyout, they'd be the first to go.

Another part of the strategy is to spread the risk, in good times and bad, by syndicating all deals. Many investors try to increase their investments in bad times, taking deals alone and filling the pipeline while valuations are low. The idea is that even though the risk is very high, the potential reward will be higher still when the market returns. "When the market was slowing down in 2000," says Ackerman, "other VCs did the same math we did and said, 'We're going to own 40% of a company. That's how we'll get our numbers.' It works only if you ignore how high the level of risk really is."

Off-balance sheet leverage

Finally, the firm takes the task of bringing in corporate limited partners very seriously. Allegis has more than 30 companies in its Active Corporate Partnering program, including A&E Television Networks, AT&T, Best Buy, Boeing, Comcast, Fujitsu, Honda, Motorola, Siemens, Sun Microsystems, Société Générale, and Telecom Italia. These partners were cho-

sen because they have a vested interest in the markets in which Allegis invests: network communications, enterprise IT, digital media, electronic commerce, and Internet infrastructure.

Allegis taps the corporate partners for more than just money. Each must be willing to help the firm understand markets, identify opportunities, and contribute due diligence. Allegis' partners spend time with the corporation's CIOs, talking with them about where their business is going in the next few years, what parts of their technology infrastructure are bro-

ken, and what needs they foresee. The corporate partners often become early customers of the firm's portfolio companies. "Let's face it, capital is a commodity," says Ackerman. He describes the firm's corporate limited partners as "off-

balance sheet leverage."

This process led Allegis to one of its biggest successes, an investment in corporate email security provider IronPort Systems, one of the companies from the 2000 fund. The CIOs Ackerman talked to during his year of non-investment said their email systems were horribly insecure. Too many services had been bought from too many startups and the systems were essentially held together with "rubber bands, bailing wire and glue." By late 2001, Allegis began looking for a startup that could provide a strong, fail-safe email system for enterprises.

Tom Gillis, an entrepreneur who had worked with Allegis before, approached the firm with just such a company, IronPort Systems. Gillis introduced CEO Scott Weiss to Allegis, and IronPort was launched in early 2002. Six of IronPort's first dozen customers were Allegis limited partners. IronPort became a huge success, and Cisco bought it in 2007 for \$830 million. Gillis praises Allegis for its help, especially in bringing in early customers.

Ackerman says he wants Allegis to be "the most entrepreneur-centric guys on the block." Still, he's willing to fire management if they can't cut it. Several of the portfolio companies offer testimonials that Al-

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legis provides real help, excellent introductions, and credible potential customers. One entrepreneur is working on his fifth company with the firm. “If you build a reputation for really working with entrepreneurs to build companies, the word gets around. Your former entrepreneurs return to you and new entrepreneurs seek you out.”

Desperately seeking Google

Allegis seems to have hit upon a formula that provides impressive returns in a terrible market. But what about that big hit that every venture capitalist covets?

The truly disruptive technology is the one that nobody sees coming. Interviewing media companies about their future would not have led to the creation of YouTube. Collecting feedback from retailers would never have generated the idea for eBay.

Ackerman acknowledges that the disruptive ideas don't come from serial entrepreneurs, but from inspired newcomers, “the people who aren't jaded by experience.” When it's pointed out that Allegis doesn't have such a company in its portfolio, he smiles and says, “Well, not yet. But how many venture firms *do*

have those kinds of companies in their portfolios? Not many. It takes years to build up a firm. We're not just looking for one big hit so we can take our money and get out. We're building for the long term.” (Allegis was founded in 1996.)

He insists that the firm's structured approach to investing doesn't discourage the partners from taking on a far-left-field entrepreneur with an unexpected new idea. “You can make the argument that a less disciplined approach to investing creates a much larger beta in your portfolio, so you're more reliant on the high beta company to make up for the losses. We're trying to narrow that band but still preserve the upside.”

Ackerman has a plaque in his car that proclaims *Fate favors the prepared mind*. So how do you recognize a disruptive technology? “You have to have a prepared mind. I'd rather be smart than lucky.”

When luck and the firm's reputation favor Allegis and a starry-eyed entrepreneur walks through the door with a wild, disruptive idea, Ackerman and Allegis will be ready. “And,” he adds, “willing to invest.” ■

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ANOTHER \$1B YEAR FOR ALLEGIS CAPITAL

2007 WAS A GOOD YEAR FOR OUR PROFESSION. According to Dow Jones VentureSource, 2007 VC liquidity events reached \$52.9 billion, the highest total since 2000, that year of dubious fame. During the year, the Casandras foretold another bubble, and we know now they were right, but it's a decidedly un-tech mortgage shell game that besets the economy.

Regrettably, Allegis didn't own 100% of our 2007 exits, but we owned enough. From our portfolio, we “lost” IronPort and LGC Wireless as well as IdeaForest and Size. IronPort, founded in 2000, was sold to Cisco for more than \$800 million, a patient shepherding that paid off with an impressive liquidity event. The exits bring our total over the past three years to more than \$2.2B.

Several of our portfolio companies took follow-up rounds in 2007: Apprion, Autonomic Networks (formerly Vernier), Collinear, ClariPhy, IMVU, QSecure, Rosum, Staccato, and Wavemaker (formerly ActiveGrid).

In the past year, Allegis made a number of seed investments in the Web 2.0, video, and social entertainment fields. A seed round is ideal for such development—but with no guarantee that we'll move to a full-fledged Series A round. For perspective, a seed investment means \$500K or less and a Series A round runs from \$3M to \$5M or more, which is always syndicated, or shared with a co-investor. Why dilute the investment when seed becomes serious? We believe that another set of eyes helps to guard against the most expensive disease in our profession:

Infatuation, falling in love with the idea, pursuing what has become our dream instead of staying in the more helpful position of a friendly but greedy cynic. Among the new investments:

- Inertia Beverage is a high-tech solution to the low-tech maze of crazy post-prohibition regulations governing the distribution of wine inside and across state borders in a market where consumer taste gravitates towards higher quality wines. (www.inertiabev.com)
- Allegiance is a Web 2.0 provider of customer and employee retention solutions. (www.allegiance.com)
- Symplified is a compliance and identity management SaaS platform. (www.symplified.com)
- PureWave Networks supplies Wimax wireless DSL picostations employing beam-forming antennae. (www.purewavenetworks.com)
- Ribbit, our final investment in 2007, is a VOIP switching and protocol normalization platform that enables telephony for Web-based applications. (www.ribbit.com)

There are common threads in these investments. First, we like the market as it is or as we think it will develop, and we value the entrepreneur (a serial founder in one case), but the product or business model needs development. Also, these companies target infrastructures as opposed to consumers. They provide building blocks that other companies can use to put together a business-to-business (B2B) or a business-to-consumer (B2C) enterprise. Although we understand the upside of potential B2C opportunities, we prefer investing in technology rather than in end-user seduction. We think we know how to build a technology company; we fear the unbounded expense associated with consumer marketing.

Another thread is “Valuation Discipline.” We like single digit investment, below the \$10M Series A pre-money valuation. Put metaphorically, we like air above our heads, not under our feet. Some of us have raised money for companies during their early days and have seen the pitfalls of overly-ambitious initial valuations. Subsequent rounds become difficult if the valuation shows an exaggerated uptick. Valuation discipline at the first round makes it much easier to attract new investors at a later stage.

Not everything worked. For example, we had to give up on a company after it raised more than \$300M over its 11 years existence. We’re a seed and early stage company and we have to get out, one way or the other, when valuations become stratospheric. This is no longer the company-building early stage game we specialize in. By concentrating on early stage investment, we avoid protracted IP litigation (think NTP vs. RIM) and Last Man Standing duopoly that can become costly if, as in Windows Mobile vs. Nokia, a well-financed interloper (Google’s Android) suddenly redraws the map. As one observer of the VC scene has remarked, when we fail it means we’re doing our job. We take risks, we push the envelope, we finance innovation as opposed to more of the same.

Are there things we’d like to have done differently? Did we miss the obvious opportunity? Some have asked, for example, if we could have gotten a better return for our investors had we waited for an IPO window for the IronPort exit. Events such as the striking VMWare IPO (quickly exceeding \$40B in market cap, and then down to \$29B in a nearly-as-quick correction) can lead one to wonder. But let’s consider that VMWare is a pure software play with much less friction than a combined hardware/software solution such as IronPort. In the case of IronPort, Cisco provides the leverage of its muscular sales and support infrastructure, such leverage being the reason for the nice multiple of sales (the exact terms are not public) reflected in the exit price. We’ll never know other than observing that, in today’s down market, an IPO would be questionable – and the economic outlook might also depress the multiple of revenue in the transaction price.

With this in mind, we feel that 2007 has been a solid year on the in and the out, on the over \$1B of exits and the investments we made. ■

A THOUSAND PRESENTATIONS LATER

By Jean-Louis Gassée, General Partner

A LITTLE MORE THAN FOUR YEARS AGO, I WROTE “THE DANCE OF THE SEVEN FOILS.” Tips from a sinner, seven droplets of the Essence of Early Stage that were intended to instill deal fever into the blasé VC. A thou-

with a combination of French and Cupertino hauteur. Putting thought into pointed symbolism, I buy two four-foot-tall ceramic pigs in an antique shop near Bordeaux. Dressed in Belle Époque costume, one a butcher, the other a cattle merchant, I dub them Victor and Charles: V and C. Subtle. They're on my



sand presentations later, I want to dismiss the adults and speak, frankly, to the entrepreneur.

My credentials: I've been on both sides of the PowerPoint. I recall my horrified reaction, at a time far to far back in memory, when it was suggested to me by an otherwise respected comrade and benefactor that I commit the ultimate entrepreneurial apostasy and give in to the Dark Side: Become One Of Us. Would I, then, pluck out my offensive orbs and stare blind and numb at the four-letter acronyms, hockey-stick charts, and spreadsheet follies, to say nothing of the buzzword bingo locutions, the paradigm shifts, the strategic fits, the peelings of the onion? I am an *entrepreneur*, I do not sleep in a lead-lined coffin.

Full of Apple modesty, I view venture investors

desk today, and when an entrepreneur gives me the lip about what VCs are really like I suggest they tell it to Victor and Charles. If only they could speak...

I still poke fun at my adopted profession, of course; I marvel at its...rich complexity. But with a few drops of humility I try not to forget what it's like to be sitting at the low table with watered-down wine. A thousand presentations in a still excitable mind, a few observations beyond the canonical Seven Slides, addressed to you, the entrepreneur.

#1 Watch the clock

Nearly all overview presentations go beyond the scheduled hour. Not because of interruptions but be-

cause the entrepreneur simply goes on and on and on. Yes, you have ideas and, more important, passions, and, certainly, some ideas and theories can't be felt in a mere twenty minutes. But the honest truth: Yours isn't one of those. Keep it short. Shut up at the end of a twenty minute overview—extremely hard to do but very profitable. If no question, objection, examination, or request for clarification emerges from your audience, you have your answer: *No*.

Twenty confident minutes in front of a cynical and healthily confrontational—and experienced—in-vestor is all you need, and it's about all we're going to tolerate. Another forty isn't going to draw us back in.

I learned this the hard way. In 1991 I present a well-scripted adumbration of the Next Big Thing to a small group of sympathetic victims. For three hours, in four acts, with a cast that includes the VP of Marketing, the CFO, and, humbly, the founding CEO, we demonstrate the superiority, the sheer righteousness of our vision...and there wasn't an open eye by the time we were done.

Eight years later it's time for the next round. An authentically humbled CEO takes to the road with a laptop, a single cohort (the VP of Sales, but only to keep me honest, which is admitting a lot more than I should) and, most important, a twenty minute distillation. It was the Right Thing and for this I thank our bankers who convinced me that a thoughtful reduction from Grand Opera to a short but stirring cantata was the form that best fit the Road Show.

#2 Ask questions

You've had your twenty minutes and, unfortunately, there are no shouts of *Bravo* from the claue. What should you do? You could beg your leave and go on to the next meeting, or go home and think about what didn't work and fine-tune. Or, better yet, you ask a question: "So what's not to like?" And ask it

twice. You have to ask twice because the first time you'll probably just get a polite answer. "No, it's great, we love what you do, you're clearly taking the right approach and have assembled the right players, and no doubt we'll kick ourselves in the morning...but... it's not our sector/it's not our type of investment/we're already invested in the space/we're simply not the right firm for such...innovative innovation."

Fight the impulse to dig deeper into your market research—it's not going to do you any good. You lost, and nobody won. Instead, admit that you understand that it's not us, it's you, and respectfully mark the politesse for the dodge that it is. And then ask again. For all that we entrepreneurs—sorry—I mean for as

much as *you*, the entrepreneur, know that yours is a higher calling than that of the VC, you have sitting before you an invaluable resource. The VC who has just rejected you is the doe-eyed chippie who can tell you how to win the favor of her slightly younger and much prettier sister who has an even more enviable address on Sandhill Road Ask about

her favorite perfume. Suggest possible reasons why you've been given a pass and watch the body language: Are my credentials a little too thin? Is there no market? Do you think the technology is weak? You may or may not get usable feedback, but you'll almost certainly get an answer—VCs like to express their opinions as much as anyone. But if you stick to the twenty minute rule, you afford yourself the time to plumb this resource without infringing on lunch.

#3 Don't tell us everything

The VC wants to hear as little as possible. Don't leave anything in your back pocket, but don't cover the entire canvas with details that distract from the main point. You're insecure and agitated—we expect this in a founder—and you want to make sure that we see the full picture. We want a concise and well-presented

Twenty minutes in front of a cynical and healthily confrontational investor is all you need. We want a concise and well-presented overview so we can decide if we want to pursue. When we ask a question, resist the temptation to answer with a lengthy parade of *everything*.

overview, organized into layers, so we can decide if we want to pursue. When we ask a question, resist the temptation to answer with a lengthy parade of *everything*. Don't use the question as an excuse to return to material that you've already covered, or that you'll get to presently.

#4 Talk, don't click

During the overview, present three slides, not seven, or twelve, or fifty. One slide for each of the Essential Ingredients: Founder, Technology, and Market. If you have only three slides, you're guaranteed to make it through your entire presentation and our interruptions—interested, engaged, skeptical but ready to be swayed—won't be answered with a fumble forward to slide #14. Of course, you have another 150 slides to show us if our questions are earnest and we seem authentically engaged. By the way, you should welcome our interruptions. It means we're interested. We may be irritated because we perceive you as way too sure of yourself but we wonder if we could make your bravado work in our favor.

#5 What about the demo?

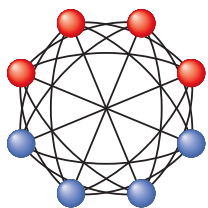
Among the many good theories, I'd choose to offer it after the difficult silence at the end of the Three Ingredients. If you've given your presentation in twenty minutes, then you have the rest of the hour for the demo and discussion.

#6 How do you get to Carnegie Hall?

I have little to add to all the wise things that have already been said about practice. Rehearse your presentation. Refine your performance with an audience of your colleagues, of course, but make sure that you also try your pitch on someone who's unlikely to understand anything about the subject matter, and who will be frank enough to share her thoughts. Your future mother-in-law, perhaps.

#7 ...

...Sorry, I'm out of time... ■



ALLEGIS
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Allegis Capital invests in early stage companies developing enabling technology and infrastructure to serve emerging information technology markets.

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