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COMMENTARY

Dot coms or dot bombs?

Pace of Internet spinoffs likely to accelerate in 2001

The last days of 2000 saw technology-sector stocks take another hit. Newspapers in technology hotspots, such as Southern California's *Digital Coast*, carried reports of major layoffs at local Internet companies. This month, even once high-flyer, eToys (based in Santa Monica) announced layoffs of about 70 per cent of its staff and the closure of two warehouses.

Companies in Silicon Valley have also not been spared the pain. Many quietly closed their doors by late summer. According to *Fortune* magazine, by fall, the number of dot-com companies that had gone under during 2000 stood at 89. The valuations of others dropped by as much as 80 per cent in the last quarter of 2000. What can we expect during 2001?

Venture capital funding will be harder to get this year than in previous years. Although there is still plenty of money out there for investing, the crash of many "dot-com" companies, and the stock market's rough ride in 2000, have had an effect on the venture capital community. Many venture capital firms will be less willing to fund

high-risk "business concepts" than they were in early 2000.

This doesn't mean new businesses won't get funded, but rather that the bar will be raised. A catchy domain name coupled with a weak business



Bits and Bytes

By Alan Gahtan

plan packed with trendy buzz words (such as "first mover advantage") alone will no longer qualify.

A premium will be placed on experienced management teams. Innovative ideas are important but aren't very useful without an ability to execute. New money will also be more focused on companies that have validated their business plans — those that have lined up customers. Being profitable, or at least a clear path to early profitability, will also be an important criteria.

The business plans of many Internet startups rely on successive rounds of new financing — at regular intervals and at successively higher valuations — in their path to their ultimate destination, the ini-

tial public offering (IPO). The recent drop in valuations will mean serious problems for many of their owners.

A common term in many venture capital financing agreements can create a drastic loss of equity for common share owners if the valuation in a subsequent round of financing is lower than that upon which a previous round was based.

Consequently, venture capitalists will also be increasingly looking for opportunities in their existing portfolio of companies. In some cases, advancing even a small amount of additional cash at a lower valuation can result in a major squeeze out of existing common shareholders.

The drop in valuation also creates another significant problem — employee retention. Employee compensation in Internet startups is usually heavily based upon stock options which typically vest over several years.

A significant drop in valuation makes many of those options practically worthless. Consequently, many employees will be considering their other alternatives — a return to more stable employment or launching their own business.

Do these difficulties mean the end of the "dot-com" phenomena? Not necessarily. Even those businesses that fail will typically have provided a useful learning experience for the next crop of entrepreneurs.

Consequently, the pace of Internet spinoffs is expected to accelerate in 2001. However, the successful startups of 2001 will need to:

- focus on more substantive businesses (such as infrastructure technology);
- have the ability to self-finance a greater proportion of their cash flow needs;
- attract a management team which includes veterans who have previous experience launching startup companies;
- be based upon a business model which does not rely on running losses for several years; and
- consider non-venture capital sources of financing (such as greater reliance on owner financing, joint ventures with suppliers, etc).

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