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PERSPECTIVES

Getting R.E.A.L. in Later Stage, Venture-Backed Companies

Our perspectives feature the viewpoints of our subject matter experts on current topics and emerging trends.

INTRODUCTION

Often later stage, venture-backed companies ("late-stage start-ups") seek advice as they find themselves languishing in the neverland between being heavy on intellectual property (IP) assets and light on commercial products or services. They are at a point in their evolution where the concept is proven and customers are demonstrably interested, but the ability to commercialize the product or service hasn't yet matured. Typically, we are contacted by an investor or board member who has become fatigued by management's assertions that ultimate success is "just around the corner," only to see the company repeatedly fail to achieve important milestones. The board of directors and capital sources have begun to lose confidence in management and want to get ***R.E.A.L.*** about the company's status and prospects.

Venture-backed companies are founded – and funded – on unbridled optimism. However, founders are often scientists or engineers, not business professionals, and as the company progresses from the development stage (investing in product) into the commercialization stage (investing in growth), the profound difference in the two skillsets becomes apparent.

In this article, we discuss how leading, managing, and operating a business with a focus on growth and development but with profits and cash flow is far different than driving interesting research and development (R&D) and engineering activities; and how a company should deal with these challenges as they evolve.

Founders often find themselves adrift attempting to foster and control activities that have little to do with their base of experience. Despite this skill gap, founders will demand to remain "in charge" through each stage of corporate development, and this disconnect can become the root cause of missed targets, broken promises, and if not corrected, collapse. *"Four out of five entrepreneurs are forced to step down from the CEO post. Most are shocked when investors insist they relinquish control."*[1] The clash can be jarring for everyone involved. Investors and board members want management to rise above under-achievement and dysfunction and achieve promised goals. On the other hand, management is faced with product development or commercialization difficulties they perceive will require additional time and money. As investors balk at continuing demand for additional funding, it can appear to company founders and management that investors' expectations have become irrational and that the board is insensitive to evolving realities. In fact, because resources have been refreshed in funding rounds B, C, and D – effectively upon request – a belief that new funds will always be available, despite the failure to deliver concrete results, exerts a strong influence on management's perception of reality. *However, several sources estimate that 30% to 50% of venture capital backed entities fail due to an unwillingness to continue funding*).[2]

The two opposing positions often create deep divisions. The board becomes more vocal as their frustration increases because it is not positioned to discern whether founders and management have presented accurate operating results and achievable financial forecasts. Founders are frustrated because they can feel their world becoming threatened and their character and credibility being questioned – often for the first time.

There's a Real Problem

Getting R.E.A.L. starts with ***Realizing*** there is a problem. While this seems like an obvious step, confronting reality can be difficult – particularly in venture-backed businesses wallowing in optimism. For instance, our firm was engaged by a company that had hired an extensive management team and leased a large amount of high-end office space and information technology. These long-term commitments to growth were made before the company's products were sufficiently tested and proven – putting the cart in front of the proverbial horse. When product development experienced delays, senior management found themselves defending poor decisions and living in denial. Simply put, they hadn't delivered what they promised, and the money had dried up. In this case, they had become victims of confirmation bias, grasping at assertions that supported their viewpoint and justified past decisions. They ignored adverse indicators that contradicted what everyone wanted to hear. Their judgment had become clouded, and they resisted the need to ***Realize*** – to admit to themselves and others – that there was a serious problem.

[1] Wasserman, Noam, "The Founders Dilemma," www.hbr.org, Harvard Business Review, February 2008. https://hbr.org/2008/02/the-founders-dilemma.
[2] Kotashev, Kyril. "Startup Failure Rate: How Many Startups Fail and Why In 2023?", www.failory.com, December 2022. https://www.failory.com/blog/startup-failure-rate

What are the signals that can inform a constituent's pessimistic view? A consistent inability to achieve financial forecasts, a lack of repeat customers, delays in product introductions, an increasing cadence of customer disputes, failure to achieve regulatory approval: All may indicate problems with R&D, product development, engineering processes, or even leadership. If such problems are becoming more frequent, investors, founders, board members, and management must coalesce, get ***Real*** about the facts, and develop an effective response or risk losing their investment.

Examining the Problem

Once a brave soul has voiced a concern, the next step is to objectively ***Examine*** the situation to determine the nature and extent of the problem. Constituents must be aware that the context described above can also serve to impose obstacles to an objective approach to the ***Examination***. Such obstacles can cause delays that consume critical liquidity – the company's lifeblood. This is the stage where the involvement of an independent third party provides significant value by objectively ***Examining*** the problem – we may also use the word assessment here – without the constraints of relationships or responsibility for past decisions. The need to thoroughly and impartially ***Examine*** the circumstances that are inhibiting success can't be overstated. These impediments must be defined, understood, and inventoried.

The process must take place against the backdrop that the original, expected outcome may now be impossible to achieve. This may prove contrary to the thinking of founding management, and leadership of the organization – especially the founder(s) and board of directors – must be open-minded to the possibility of a broken business model and senior management's inability to see it or accept it. It is important to be mindful that even board members may be part of the company's culture of optimism since they may have invested in the company and be loath to admit the potential for a large cash loss. The process of ***Examining*** and assessing must result in a deeper, detailed understanding of exactly why and how the company has failed to reach established targets so that accurate intervention can occur.

Adapting the Organization

Once the board and senior management have realized that a problem exists and understood its nature, the process of ***Adapting*** previous efforts to address the root causes of prior failures is the next step. This ***Adaptation*** takes the form of an updated operating plan incorporating the costs and outcomes of the specific tactics necessary to effect requisite change. The nature of these projects will be defined by the root cause of the problem. Is the problem driven by shortcomings in the product or by failure to successfully commercialize a solid product?

In the best case, existing management may be retained. However, this will be determined by their willingness and ability to accept hard truths and to manage through challenges – despite past decisions and existing relationships. This phase requires close collaboration between all functions of the business – leadership, R&D, operations, finance, and sales and marketing. An independent Interim chief restructuring officer, (CRO), chief operating officer (COO), and / or chief financial officer (CFO) may be required to augment the team either from a credibility perspective or to fill skill gaps. For example, our firm was retained as interim COO and interim CFO by a client experiencing unmet performance expectations. Our roles were to manage liquidity, finalize an external audit, and organize R&D and engineering efforts under a newly created Project Management Office to focus efforts and resources on a well-defined series of operational projects, tasks, and solutions.

The development and execution of an effective operational plan is the bridge between the current context of failure and ***Adapting*** the organization to a credible path of success that delivers (i) the original outcome or (ii) an acceptable, though reduced, version of it or Option (iii) development of alternatives that may return the original expectations but in a different form. *Option (ii) should not be disposed of lightly, as an estimated 30% to 40% of all venture-backed companies never return cash to investors. Some say this number is closer to 70%.*[3] The operational plan should be paired with a detailed financial budget that illustrates the investment required to complete the specific projects necessary to remediate the situation.

[3] Gage, Deborah. "The Venture Capital Secret – 75% of Startups Fail", www.scalefinance.com, www.wsj.com, September 20 2012. https://www.wsj.com/articles/SB10000872396390443720204578004980476429190.https://scalefinance.com/the-venture-capital-secret-75-of-startups-fail. Article content from interviews with Shikhar Ghosh, Professor of Management Practice of Business Administration, Harvard Business School.
Main, Kelly, "65% of VC-backed Startups Fail Because They Didn't Ask These 2 Questions", Inc.com.
65 Percent of VC-backed Startups Fail Because They Don't Ask These 2 Questions | Inc.com

The plan should be within the scope of the original business concept, be understandable, and describe the correct balance between optimism around possibilities and conservatism around the likelihood of execution that will hold up to intense scrutiny and criticism from investors and lenders. Being overly optimistic in this stage is not advised as credibility may be irretrievably eroded, almost ensuring the failure of the company. *And always remember the time-honored truth – results are delivered by effective operational execution – not financial analysis.*[4]

Criticality of Effective Leadership

To execute the operational plan properly, effective ***Leadership*** is the key to success. Though effective leadership is not a unique need of venture-backed companies, the particular characteristics of such companies place a premium on the quality of leadership as the business evolves and attempts to successfully commercialize an advanced product. Progressing from a concept to an effective development organization and thence to a marketing, sales, distribution, and support business can place outsized demands on the leadership team. ***Leadership*** must discern when it is not up to the task and seek support and assistance.

When targets aren't met and constituents become impatient or unhappy, these demands begin to multiply exponentially. Only the best leadership teams survive this critical juncture – and they do it by being mercilessly self-assessing and accepting responsibility for promises made and not kept. Leadership must also demonstrate a thoughtful balance between optimism and realism, high energy and thoughtful restraint, and frugality versus a need to make necessary investments.

Once a high-quality recovery plan is designed and quantified, the ability to communicate the plan and resulting capital requirement to all constituents – investors, lenders, employees, and the board – is a core component of effective ***Leadership***. A board of directors and senior management team is well-advised to seek whatever advice and additional skillsets are necessary to lead, and to constantly monitor the recovery process to ensure that this capability is present, active, and effective. This can be done through additional training, staff augmentation, or members of the board taking a more hands-on approach to the business.

CONCLUSION

Getting ***R.E.A.L.*** in later-stage venture companies requires a willingness and ability on the part of all constituents to ***Realize*** that a problem exists that must be thoroughly ***Examined***. The company must then ***Adapt*** its approach in the form of a new operational plan and budget, making a break from past ineffectual approaches and practices, and moving forward in a new context where the board and senior management ***Lead*** by example. By choosing to intervene in situations where targets remain unmet, all constituents will increase the likelihood of realizing returns on their investments. If leadership fails in responding to challenges by choosing to ***resist*** acknowledging a new reality, attempting to ***elude*** responsibility, ***accusing*** others of failures, and ***litigating*** with former partners, all parties can expect the worst outcome.

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Bayard B. Hollingsworth is a Managing Director with J.S. Held which he joined in October of 2023 as part of J.S. Held's acquisition of Phoenix Management Services. He has more than 25 years of experience managing and advising clients in complex situations. Bayard's professional background has been focused on advising closely held, private, and family-owned entities ranging from $5 million to $2 billion in revenue. His expertise and knowledge span a wide range of industries including manufacturing, distribution, agribusiness, transportation, food and beverage, business services, and consumer products. Bayard is a Certified Turnaround Professional (CTP) with extensive experience in the areas of interim executive leadership, serving in roles ranging from CRO, CEO, COO and CFO. In addition to turnaround and restructuring, he is often retained by investors as part of the Phoenix investor services team

[4] Hoque, Faisal, "Why Most Venture-Backed Companies Fail", www.fastcompany.com, December 10, 2012, https://www.fastcompany.com/3003827/why-most-venture-backed-companies-fail. Article content from interviews with Shikhar Ghosh, Professor of Management Practice of Business Administration, Harvard Business School.

in support of portfolio companies experiencing varying degrees of challenges. He is a registered investment banking professional with experience in sourcing and executing M&A, refinancing, and other special situation investment banking opportunities.

Bayard can be reached at
Bayard.Hollingsworth@jsheld.com or +1 770 608 7314.