



Strategies for Surviving the Telecom Downturn

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Not so long ago, the Telecommunications Act of 1996 looked as though it would create enormous opportunities for venture capital-backed telecommunications startups that cater to competitive local exchange carriers (CLECs) and equipment vendors. The deregulation did indeed generate handsome returns. Then, as the telecommunications boom started faltering in mid-2000, many of these startups found themselves high and dry. Yet not all of these companies have failed. In fact, many have changed with the times and show promise.

These startups, such as Lumenare Networks and Glimmerglass Networks, which are both backed by **Onset Ventures**, have shifted 180 degrees and overhauled their product and sales force to target large corporations instead of telecommunications carriers. Others, such as Onset-financed CPlane Inc., are targeting Asia/Pacific telecommunications carriers, which are creating green field networks with relatively short sales cycles, partly because they have less legacy infrastructure than the former Baby Bells.

Startups have also become adept at sharply cutting costs, and they have replaced their boom era marketing-oriented management teams with hands-on operational experts, or they've made doubly sure their CEO was an operations expert from the start. Until 2001, the typical startup CEO was a charismatic marketing expert who had Wall Street savvy and who knew how to promote his company. That breed has largely vanished, replaced by people who know how to maximize the odds of building a viable company in what is still one of the most challenging information technology markets ever.

On the cost-cutting front, our communications startups and others have become experts in slashing monthly cash burn rates. Those still alive have already developed their products. Or they have largely replaced their domestic engineering development team with far less expensive engineers in India and other low-cost countries.

Streamlining

Startups have also negotiated much cheaper rents, laid off non-critical workers, implemented salary cuts and learned to focus employees on only the most essential tasks. Sunnyvale, Calif.-based Lumenare, for example, dismantled its 27-person U.S.-based engineering team and replaced it with a wholly owned Indian subsidiary more than 18

months ago. It also renegotiated its rent, cutting it by two-thirds. Similarly, Glimmerglass of Hayward, Calif., reduced its staff by 20%, and its mainstream engineers and product-marketing managers perform double duty by supplementing their core duties with product demonstrations on behalf of prospective customers.

Traditionally, communications startups sold their products mostly to corporations, not telecom carriers. The latter were mostly monopolistic Baby Bells with unusually long sales cycles of 24 months or more. Facing minimal competition, they were in no rush to spend more to improve their offerings. The Telecommunications Act of 1996 changed that by introducing competition. Almost overnight, the telecommunications startup marketplace emerged. CLECs became the target customer of choice. That was predictable, because they had a voracious appetite for emerging technologies that might give them a competitive edge. Unfortunately, in less than four years, the CLEC market began to collapse amid the telecommunications bust, threatening the survival of most telecommunications startups.

An analysis by **Onset Ventures** of venture funding numbers for communications startups is illustrative. Between 1990 and 1996, a startup focused on selling communication products to either the enterprise or a telecommunications customer normally required between \$30 million and \$38 million to achieve cash flow break even and become a viable M&A candidate.

From 1997 to 2001 that range grew to between \$75 million and \$85 million a reflection of higher rents, salaries and recruiting costs. During that same period, engineers typically earned \$120,000 or more annually, at least 20% more than their previous pay. In addition, a hot market meant that most had to be professionally recruited and frequently replaced, all at an additional cost of 30% of an engineer's annual salary.

Higher startup expenses were viable for a while because the average exit value of successful communications startups soared to roughly \$400 million between 1997 and 2001, up from \$100 million to \$175 million in the first six years of the 1990s. Now exit values have returned to where they were a decade ago. So once again, communications startups have to demonstrate they can break even on less than \$35 million in capital if they expect to get initial or subsequent venture funding.

Fuzzy Outlook

While we are finally seeing signs of an upturn in information technology spending, times unquestionably remain tough. That's partly why surviving startups remain so cost-conscious. Even the most adroit players aren't out of the woods yet. In July, telecom carrier gear supplier Lucent Technologies retreated from a prediction that it would turn profitable by the end of September. Lucent, which had been making this promise for more than a year, pushed back its projected return to the black by up to an additional year, even though it has cut billions of dollars by closing factories and eliminating nearly 70,000 jobs.

The good news is that communications capital expenditures by telecommunications carriers and corporations remain gigantic and are expected to continue to grow, at least marginally. So startups with the right strategy, products and business model can still fare well.

U.S. telecom carriers, for example, spent more than \$53 billion on capital equipment in 2002, according to Goldman Sachs. Asian telecom carriers spent even more, \$58 billion, and U.S. "enterprises" spent more than \$28 billion. Especially heartening is the projected growth in broadband subscribers. Goldman Sachs reported that the number of DSL subscribers worldwide will grow from 27.2 million in 2002 to 90.7 million in 2005, and the number of cable modem subscribers in the United States will double from 5 million to 10 million.

Three types of communications startups still have a good chance of success if they execute extremely well and maintain rigid expense discipline. Perhaps the most promising group are startups born in 2002, almost all of which intentionally targeted corporations from the start and never had to change course midstream.

But these companies face significant challenges. Most of the markets they are targeting - such as Wi-Fi 802.11 and mobile devices for employees - are not as big as gigabit Ethernet, which emerged in the mid-1990s and produced Foundry Networks, Extreme Networks and Alteon Systems, among other prominent public companies. Moreover, more venture capital is being invested today, creating more competition for each startup. In Silicon Valley alone, at least 50 Wi-Fi startups have been funded, about double the number of gigabit Ethernet startups in the mid-1990s.

A second group of startups one including Lumenare and Glimmerglass were forced to switch from targeting carriers to targeting enterprises. Lumenare initially focused on providing laboratory automation software for telecom carriers so they could more efficiently test new services and software before they were installed on networks.

Nailing Big Accounts

Now Lumenare has successfully begun selling its gear to big corporations, such as Brocade Communications, which are using its systems to quickly change configurations for various types of tests and schedule them in a more efficient batch-processing mode. Because corporations are smaller customers than telecom carriers, Lumenare needs more of them to succeed. Consequently, it's exploring new sales channels it can penetrate in partnership with companies in related lines of business. For example, it's currently negotiating with an application development life cycle (ADLC) software company that targets engineering groups.

Glimmerglass, whose initial charter was to sell optical switching subsystems to carriers, now targets manufacturing corporations that use a heavy mix of manufacturing and test equipment. Recent customers include Cisco and Intel. At a tenth of the cost per port of an electrical switch, corporations are finding that Glimmerglass's optical switches make a lot of sense in new manufacturing and test applications.

A third group of communications startups, such as CPlane in Sunnyvale, were created to target telecom carriers. And they remain true to that mission although they have to find new prospective customers to replace slow-moving U.S. carriers. CPlane makes enabling software for the provisioning of guaranteed, multi-class, end-to-end WAN services needed by carriers' enterprise customers across IP and MPLS networks. This includes the likes of Virtual Private Networks and Voice-Over IP. The company currently has trials underway with a half dozen significant Asia/Pacific carriers, including some of the dominant incumbents in China and Southeast Asia. The sales cycle of these carriers is a relatively short nine to 12 months.

In addition, CPlane this year sold its software to Schlumberger's Houston-based Dexa.Net Division, a specialized carrier that tends to the networking requirements of their major oil company customers such as Exxon/Mobil, Chevron and Phillips.

Prospects for these ONSET-backed communications startups and others following similar paths are more promising than casual observers might suspect. There is no guarantee, of course, that they will ultimately succeed. Yet they have a good chance, and that wouldn't have been said a year or so ago.

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