



Options for Distressed Technology Companies: Turnaround, Sale or Liquidation

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Strategic Options for Technology Companies

In challenging times, many start-up companies consider their realistic economic options. Whereas an economic downturn has its impact on companies in all industries, the influence on early stage, venture-backed technology companies is unique, and the potential consequences on their strategies going forward differ from those for traditional turn-around management.

Technology Companies are Unique

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1. **Financing:** These companies are predominantly financed through equity, with very little debt financing. The equity is mostly provided in multiple series of preferred shares with unique rights.
2. **Development Stage:** Privately held technology companies are often at an early stage in their corporate development. Some may have reached the stage of generating third-party revenue; others may still be in the research stage.
3. **Workforce and Management:** Depending on the stage of development, the senior management and the workforce are usually only partially complete. Senior management often consists of founders, augmented with additional management hired as the company matures.
4. **Asset Base and Intellectual Property:** Technology companies are further characterized by their unique asset structure: they usually lack many of the tangible assets inherent in more mature businesses such as substantial amounts of property, plant and equipment, inventory, and receivables. Most of the value tied up in technology companies is represented by intangible assets such as rights, licenses, patents, software, relationships, partners, and customer lists. The intellectual capital represented by the workforce is substantial and not easily replicable.
5. **Financial Condition and Profitability:** Most early stage technology companies are not yet profitable and many do not have sufficient investment to reach break-even under their existing business plan. The companies that are profitable usually have not yet reached their expected sustainable long term profitability, but are still investing into corporate growth.

Look for Early Signals of Turnaround Assistance

The typical signal that turn-around assistance is needed is the looming brick wall resulting from running out of cash and the perception that even the completion of additional milestones will not lead to follow-on investments from current or new investors. The turn-around process must begin but it has to be divided into two distinct phases: the analysis phase and the implementation phase.

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Complete a Strategic Analysis and a Turnaround Game plan

Technology/Product

The company has made very specific assumptions about the feasibility and timing of a technical development. Deviations from these assumptions can block any strategy going forward (e.g., toxicity of a drug compound in human trials vs. animal trials), some can be mended (e.g., limitation of target indications), and others point more towards management issues (e.g., cost-overrun in software development projects).

The strategic analysis needs to take into account the different goals of the different stakeholders

The analysis will focus on the stage of the development, reasons for any development delays, and alternate monetization strategies.

Market

The company also made assumptions regarding the market size (both in the number of potential customers as well as in the pricing of the product), the current and potential competition, as well as certain market share and customer acceptance metrics.

The analysis will question all of these assumptions. It will also identify any other potential markets: whereas the initial risk-return assumption of the investor will likely have directed the company to the largest possible market, a turn-around scenario would also focus on smaller, profitable markets and markets that can be penetrated more quickly.

Management and Workforce

Both management and workforce have been selected for the specific development stage of the company. From the investor's perspective, this happened either directly by hiring the person or indirectly by investing in the company and thus buying into the existing management.

The analysis will include an evaluation of management and workforce, especially in light of the changed requirements of the company in its current state.

External Factors

There are a range of external factors that threaten the viability of an early-stage technology company. Of most immediate relevance is the possibility that the venture capital model for the company is broken: even with validated assumptions regarding technology and market and management hitting all relevant milestones, investors decide not to invest. It may be that investors are focused on a select few companies that currently provide a better risk-return ratio, or it might be simply that investors are constrained by their limited partner's retreat from venture capital.

Goal of the Turn-Around Strategy

Part of the analysis also needs to take into account the different goals of the different stakeholders, as well as the fiduciary duty that is owed to each of them. The goal of the turn-around process will be different and conflicting for the different stakeholders, such as creditors, equity holders, the board of directors, management and employees, as well as customers and suppliers.

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Depending on the situation, the company may implement its work-out plan in court (e.g., with a Chapter 11 bankruptcy filing) or in an out-of-court settlement. Out-of court work-outs are often faster, more cost effective, and more predictable, but will need the agreement of all affected parties.

If no turn-around strategy can be developed that keeps the company – or parts of it – as a going concern, the company will need to assess different liquidation scenarios, be it an Assignment for the Benefit of Creditors (“ABC”), a Chapter 7 bankruptcy filing, or an orderly corporate dissolution.

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Then Implement the Turnaround Strategy

The implementation of the strategy developed from the foregoing analysis can be divided into short-term and long-term plans. Short term measures consist mostly in immediate efforts to conserve cash and to provide enough time for the implementation of the longer-term strategy. These can include dramatic reduction in expenses, furloughs or reductions in force (“RIF”), reduction in inventory through aggressive sales, repositioning of facilities, and others.

The turnaround plan will usually consist of an operational and a financial restructuring plan.

The operational plan for a technology company will include a trade-off between short-term survival and long-term value creation; e.g., the company may forgo or reduce certain target markets, customers, and geographies, and limit product features and application areas in order to extend the runway.

Other aspects will include the renegotiation of contracts (e.g., with landlords or service providers), the monetization of intellectual property, and the sale of non-core assets. The company’s strategy and product portfolio needs to be reassessed in terms of the core element that should continue to be provided by the company as opposed to ancillary parts that should be outsourced or that can be provided by partners. Reductions in employee headcount need to be done early and decisively but keeping in mind that the value of the company is to a large extent represented by the team the company is able to retain. The ongoing motivation of key contributors must be assured. This holds true even in the event of liquidation: the proceeds that can be gained by liquidating intellectual property are usually much higher when it is accompanied by key personnel that can support and maintain it.

The financial restructuring usually includes a more or less aggressive restructuring of the balance sheet. The company may be able to leverage assets such as receivables, inventory, or property, plant and equipment for debt financing. If the company can show an attractive investment case given the altered strategy, investors might provide equity; the terms may be highly dilutive for non-participating current investors, leading to diverse implementations of “wash-out” scenarios or a complete restructuring.

External Advisors Can Make the Difference

External advisors play a significant role in both analysis as well as implementation of a turn-around or liquidation. They support the current management and the board of directors with their particular skill set and provide an independent viewpoint. They can come in as a Chief Restructuring Advisor, or can serve as a mentor to the current management and guide them through the process. They help the company to implement the unpopular decisions, lead contentious negotiations, and serve as a buffer for the different relationships – be it with employees, creditors, or investors. The existing management often has lost credibility with current creditors and investors that an independent advisor can help to restore. The turn-around team will need to regain trust by providing transparency and meeting expectations.

Experienced restructuring advisors are an essential ingredient to success---and get them engaged early on to help.

Additional financial analysis and valuation work is needed in the different phases of the restructuring: to analyze different scenarios for the different stakeholders, value the company as going concern or in liquidation.

Specific transaction support is needed to monetize non-core assets such as ancillary patents or software in a turn-around situation or to find a buyer for the company and its assets in a liquidation scenario. This may include acting as assignee in a liquidation involving an Assignment for the Benefit of Creditors.

After a successful sale of its assets, the wind-down operation will last for well over a year, ensuring that all creditors are satisfied, all filings are properly made, taxes are paid, and tax clearance certificates are obtained. These tasks are usually performed by external resources.

Conclusion

Many technology companies fail to realize the severity of the situation soon enough and make insufficient plans or changes, until the point at which the only possible option becomes the liquidation of the company. At the first sign of trouble, complete a thorough business analysis, forge a turnaround plan and implement it expeditiously. Seek qualified external advisors early on to assess the situation, provide counsel, and identify options that can keep the company as a going concern.