Saved to Savior

Stuck with soured investments, Zero Stage Capital recasts itself as a venture turnaround firm

by Vyvyan Tenorio

It would have been a safe bet that **Zero Stage Capital** would share the fate of many of its bubble-era portfolio companies that faded gently into oblivion. From its beginnings in the early '80s, the firm was the quintessential early-stage investor, staking technology and life sciences companies in the Northeast from its Cambridge, Mass., headquarters. But with investments such as Mothernature.com Inc., Hotsocket Inc. and ToySmart.com Inc. evaporating in the meltdown, one of its funds in receivership and another fund in trouble, the future looked murky.

But now Zero Stage is staging a comeback. In the salvage operations that followed the downturn, Zero Stage's management realized there were profits to be made in adversity. That discovery formed the basis for its relaunch as a venture buyout firm.

Zero Stage's transition came almost by accident. In its portfolio was a promising company, OuterLink Corp., a Concord, Mass.-based global fleet tracking and communications provider, that needed help. Rather than give up, the firm reinvested in a recapitalization in 2001 so OuterLink could reorient to a new set of customers. A year and a half later, OuterLink merged with a public company for a 4.3 times return on the recap investment.

A few such workouts later, Zero Stage formally underwent a makeover, ousting four of its executives and bringing in three replacements. Taking a page from the strategy that has worked for ailing portfolio companies, it targeted a new market. For its second act, the firm plans to acquire distressed venture assets at a discount and execute quick turnarounds. In addition to reviving companies from its own funds, it hopes to take on stagnant businesses from other venture funds' portfolios.

If Zero Stage was all too typical of early-stage firms during the boom, its transformation from venture capitalist to vulture capitalist is perhaps unique. Most failed VCs with bubble-era funds that are tapped out have little chance of raising another fund and simply go through the motions of helping surviving investments. By recasting itself as a savior of orphaned startups, Zero Stage hopes to save itself from extinction.

"There are a lot of these funds that are effectively the walking dead," says Michael Littenberg, a partner at New York law firm **Schulte Roth & Zabel LLP**. "But it's relatively rare to be able to switch focus from a venture to a buyout because you need to have the relevant skills set to look at companies differently and deal with issues differently."

Zero Stage had a very conventional VC pedigree. It was founded in 1981 by Paul Kelley, a former executive of Ciba-Geigy Corp. and **Gillette Co.**, and entrepreneur Gordon Baty. Over 20 years, Zero Stage raised seven funds with a total of $450 million, the last three of which were backed with federal government money under the Small Business Administration's Small Business Investment Companies program, which matched private capital with federal dollars.

Overall, Zero Stage's track record was solid. Its family of funds boasted a cumulative 18% IRR, or a 2.3 times return multiple collectively. The maiden fund posted a 15% internal rate of return after backing a handful of hit companies, including a small modem maker, Octocom Systems Inc., which **Cisco Systems Inc.** later absorbed. Fund V, a $50 million fund invested in the mid-'90s, had the best performance so far, with a 52.9% IRR as of Dec. 31, 2003, from investments that included stakes in 24/7 Media Inc. (now named **24/7 Real Media Inc.**), About.com Inc., **Evergreen Solar Inc.**, Kinetix Pharmaceuticals Inc. and Kana Communications Inc. (now **Kana Software Inc.**).

But Zero Stage's $150 million sixth fund, raised in 1998, was a different story. It invested in a slew of e-commerce and technology startups in 1999 and 2000 that went bust, and it is now one of 23 SBIC venture funds under SBA receivership. According to court papers, the SBA invested a total of $93.2 million. Zero Stage managing general partner Edwin Wang says the fund has maybe three portfolio companies left and has a negative 15.5% IRR.

In 2001, with value in the fund evaporating quickly, founder Kelley drafted his son, Matthew, to help rationalize the foundering portfolio. The younger Kelley had worked as an analyst and associate at Zero Stage in the early '90s and later founded **MB Capital**, a Boston private equity boutique that managed $20 million from regional banks.

They focused particularly on OuterLink, which had burned through $26 million in VC money and was on the verge of being written off. At the time it had $3 million in sales and $4.3 million in losses. The Kelleys tapped Shanghai-born Van Chu, a seasoned entrepreneur who had run Zero Stage's successful Octocom Systems in the 1990s, to see if OuterLink could be revived. Chu, a director of OuterLink, stepped up as CEO in 2002.

Later that year, Chu set about trying to raise distressed financing from Edwin Wang, a friend and former **Credit Suisse First Boston** investment banker who had raised a $150 million Asian private equity fund at CSFB. Later Wang went on to head Chicago-based **SCM Investment Management Corp.**, before joining San Mateo, Calif.- and New York-based **Cross Pacific Technology Partners**, where he led late-stage technology financings.

Wang became interested in OuterLink, but as a financial adviser, not an investor. He thought there might be ways to shift focus from transportation applications to the defense and homeland security markets, which would allow the company to recoup some of its investors' losses. All it needed was a small, incremental investment from Zero Stage and co-investor **ChevronTexaco Technology Ventures** of Houston, which together threw in $2.4 million.

Under the elder Kelley's guidance, shortly after Sept. 11, 2001, OuterLink began to pitch its location tracking and satellite communications technology to the markets. Soon Wang found a bigger company, South St. Paul, Minn.-based **Digital Angel Corp.**—a publicly traded global tracking technology provider—to merge with OuterLink. That merger, completed in November 2003, yielded a 4.3 times return on the investment in the recap by Zero Stage's Fund VII. (Funds V and VI, which invested earlier, wrote off a total of $11.35 million on OuterLink.)

A similar recasting also helped resuscitate **LiveWave Inc.**, a Newport, R.I., developer of wireless software to operate underwater cameras for oceanographers. Zero Stage's Fund VI had invested about $5 million in 1999, when the company was targeting the broadcast media. By 2002, that industry had retrenched and the company redirected its digital video surveillance for use in security applications, with a $1.5 million injection from Fund VII.

The strategy worked. LiveWave's technology was used for the Democratic and Republican national conventions last year, executives say. The company is now a target of an acquisition that could translate to a 5 times return.

Zero Stage also restructured **Aprilis Inc.**, a Maynard, Mass., developer of holographic technology that had hoped to tap the enterprise storage market. The company, which spun out from **Polaroid Corp.** in 1999, had taken in $23 million from VCs, including $5.7 million from Zero Stage's Fund VII. Executives slashed the burn rate on the enterprise storage side while developing holographic storage capability for biometric identification and authentication applications. According to fund managers, the Federal Bureau of Investigation later used its technology in upgrading the standard for its automated fingerprint identification system. The company, which was recapitalized with a $1.4 million infusion from Zero Stage, is also the subject of an acquisition, says Wang. If successful, Zero Stage expects to realize a 1.8 times return on its recap investment.

Fund VII has now invested in a dozen restructurings and consolidations. It was showing a negative 5.4% IRR about 18 months ago, but is now in the black, with 14 remaining portfolio companies out of a total 26, says Wang.

According to Wang, the strategic changes at its companies have resulted in about $500 million in enterprise value added or monetized.

Last year Wang, who had continued to be CEO of Cross Pacific, joined Zero Stage full time as the third managing general partner, alongside the Kelleys. To help develop strategy, strengthen corporate governance and assist in marketing, Wang last year recruited former California state treasurer Matthew Fong, whom he knew when Fong was a trustee of the **California Public Employees Retirement System** and the **California State Teachers' Retirement System**. An engineer and lawyer by training, Fong had recently retired from the U.S. Air Force Reserve as an adviser on finance and budget matters. He also founded San Francisco private equity consulting firm **Strategic Advisory Group**, advising funds on capital formation. Fong came on board as a general partner.

Along the way, four principals who were veterans of the earlier era—Stan Fung, Bic Stevens, Ben Bronstein and Frank Pinto—agreed to leave.

The idea of restructuring technology companies that have lost their shine isn't

Matthew Kelley (left), Wang

novel. This has been the purview of technology buyout firms on the West Coast such as **Golden Gate Capital, Silver Lake Partners, Gores Technology Group LLC** and **Platinum Equity LLC**. On a smaller scale, venture buyout boutiques such as **Vector Capital, Shah Capital Partners** and **Garnett & Helfrich Capital** all claim a similar mission.

But Zero Stage targets much smaller, microcap businesses. "Even in the current environment, where there's so much capital chasing the **SunGard [Data Systems Inc.]** deals, or **Toys "R" Us [Inc.]** or Sears-Kmart, there's a lot of neglect and abandonment," Wang says. "In the IT, communications and life sciences sectors that were so popular during the boom, there are a lot of underserved, ignored and otherwise forgotten companies."

There are more than 5,400 venture-backed private companies, of which only 980 are profitable, according to industry tracking firm **VentureOne**. "We think a smaller subset [of the profitable companies] is our sweet spot," says Wang.

The reinvented firm will look at funding or acquiring later-stage growth companies as platforms for consolidation. It will focus on companies with $25 million to $50 million in revenues, but whose businesses appear to be stalled.

"We're not looking for spoilage," Wang says. "We're looking for companies that may be attractive diamonds in the rough that may be attractive to bigger companies."

Now the firm hopes to raise an eighth fund, though the executives are mum about details, citing gag regulations. But Wang says the firm hopes to make later-stage investments that could be realized in 12 to 24 month cycles.


Fong

At least one existing LP gives the new direction the benefit of the doubt. "It was a very significant change in strategy and key principals, so clearly it was a yellow flag," says a long-standing, New England-based institutional backer who declined to be identified. "But once we sat down with them, I could understand why they wanted to do it. The timing was such that, with a lot of technology busts, their kind of approach was ripe."

The prospects for Fund VII are looking good now, the investor says. "They are optimistic that they could salvage many of the companies and get a pretty good return of maybe double digits."

If so, Zero Stage will have beat all odds and pulled off a turnaround even more remarkable than that of its portfolio companies. ■

JUNE 13, 2005 MONDAY PP. 32, 33, 34