Lessons from Softbank's Hard Knocks

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The late 1990s were a heady time for Tokyo-based Softbank Corp. and its CEO Masayoshi Son – as they were for many venture capital firms betting big on the Internet. Softbank's market capitalization had soared to a staggering $200 billion, and the company's Internet portfolio, which included hundreds of millions invested in U.S. startups, had showed $15 billion in gains, much of it from its huge positions in the Japanese versions of Yahoo and E*Trade.

The company lost $448 million in the last six months of 2001 and is expected to announce further losses in the quarter ended March 31. Market capitalization has fallen to below $30 billion, and those unrealized gains have shriveled by more than half. Despite a rebound since mid-February, the stock price is off by nearly 50% in the past 12 months. The company carries $4 billion in debt, and Merrill Lynch analyst Mina Koide warned last month that Softbank has enough cash to carry it for only the next couple of years. It must turn things around to regain access to vitally needed capital.

To a great degree, Softbank's misfortunes mirror those of the whole venture capital industry, which threw money into money-losing startups when the tech sector sparkled with glamour. Since the mid-1990s, Softbank invested in some 600 tech firms. But the decline of Softbank is not just an object lesson in bubble investing. It may also offer pointers to the way out. "What happened with Softbank is just a manifestation of the overall trend in the industry," says Raphael H. Amit, professor of entrepreneurship and management at Wharton and director of the Wharton E-Business Initiative.

But Softbank is not plodding along as usual. It is stripping away troubled holdings and focusing on making marginal holdings profitable. Analysts have cheered stories – so far unconfirmed by Softbank – that the company will raise cash by selling its profitable holdings in Japan's Aozora Bank. Late last year. it announced it would raise cash by trimming its positions in Yahoo, E*Trade, CNET Networks.

"What Softbank has done in many ways is admirable," Amit says. While some other venture capital firms are battling with limited partners who want their money back, Softbank voluntarily returned more than $200 million to its European investors. "They basically decided the European fund was a money loser. Softbank was proactive and didn't mess around and went ahead and returned the money." Not only has that allowed the company to avoid a divisive internal battle, it should boost its credibility when it thinks the time is right to seek new funding.

In the meantime, Amit believes the company has correctly changed its focus. "Today, the trick is to manage their portfolio of companies," he says. "The skills that venture capitalists have to show today are very different from what they had to show two or three years ago."

Back then, institutional investors were eager to throw money at dot-coms and other tech startups in the hope of making a quick killing when the companies were taken public. But, stung by the failure of many young companies, the public market is now reluctant to buy shares in risky, profitless newcomers.

That is reflected in the steep decline of initial public offerings of VC-funded firms. For the quarter ended March 31, there were only 13 such IPOs in the U.S., compared to 31 in the year-earlier period and 112 in the first quarter of 2000, according to the National Venture Capital Association. The average size of the recent quarter's offerings was the largest ever, $599.5 million, indicating that companies must now be more mature before they are taken public. "The silver lining in this cloud is that valuations seem to have stabilized and that venture-backed companies that have recently gone public are performing well," NVCA president Mark Heesen noted in reporting the numbers.

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The shrinking numbers of IPOs are nonetheless a problem. Typically, the limited partners who fund venture-backed firms use IPO proceeds to fund the next round of startups. The value of companies which went public in the most recent quarter was a scant $2.4 billion, compared to $46.3 billion in the first quarter of 2000. That means the limited partners still have lots of money tied up – or lost – in VC firms that haven’t gone public, choking off the flow of money to new ventures. "While it looks like it’s breathing, there are no sure signs of life in the IPO market yet, at least not enough yet to provide venture capitalists with much needed liquidity," says Jesse Reyes, vice president of Venture Economics, an information provider for the industry.

This doesn’t necessarily mean that innovation is coming to a standstill, says Wharton marketing professor and deputy dean David Schmittlein. The people who launch startups usually come from other companies, universities or government. To some extent, Schmittlein says, these people will promote new ideas within their existing organizations. But, he adds, these established institutions often operate more conservatively than startups do – else many entrepreneurs wouldn’t step out on their own. "There will simply not be as much high-risk innovation in the society at large as there would be otherwise," he says.

For the moment, Schmittlein argues, the pendulum has swung a bit too far to the conservative side in correcting for the VC industry’s excesses of the late 1990s. "In a lot of business settings, we tend to fight the last war," he says. The lesson of the 1990s was that companies that do not have provable earnings are risky. "For a few years, that will clearly be a focus," he adds.

"I think there’s a vast disillusionment with the post-dot-com environment, coupled with a retreat to conservative thinking following 9/11," adds Wharton management professor Ian MacMillan, who is also the director of Wharton’s Sol C. Snider Entrepreneurial Research Center. "Most of the VCs have kind of hunkered down to wait for things to turn around."

Over the next few years, the successful VC firms are likely to be those that can manage their existing portfolios of young companies well enough to take them public and allow investors to cash out. "The attention that you need to give your portfolio is a lot more serious when the outlook is bleaker," he says. MacMillan points out that venture capital has always had boom-bust cycles, recalling the electronics and biotech bubbles of the 1960s and 1980s. After a bubble bursts, it often takes years for the industry to rekindle its enthusiasm for risk.

"It’s hard to find high-multiple investments in any market at the moment because everything’s pretty slow and turgid," MacMillan says. But he says the market will probably embrace Internet-related companies again, eventually. "I think the real action is going to be firms which are going to be able to help established players and established industries really exploit what the Internet can really do," he says.

To a large degree, this is what Softbank appears to be attempting, as it focuses on making a go of its big investment in Yahoo! BB – the broadband Internet service in Japan. The public’s desire for fast Internet service is proven. And hopes many of its other Internet-related companies can benefit by offering their customers lightening-fast service.

There’s no guarantee Softbank can turn itself around, but Amit believes it is possible. "I think a lot of people will look at them and will see how they managed their portfolio and will see how they got themselves out of the bind that they are in now," he says. Periods of crisis are common, he adds. "That’s the venture capital business. You raise the next fund based on the track record of the last fund."

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