

Executive and Investor Corner – DN Capital



DN Capital Overview: DN Capital helps technology companies bridge the Atlantic. We invest enterprise software companies and consumer-focused internet/digital media businesses. Most of our companies are European seeking to expand to North America, or North American companies with plans to expand to Europe. Our most recent fund is approximately \$70 million, raised at the end of 2007. Examples of our portfolio companies include Shazam, one of the top 5 applications on the iPhone, Endeca, regarded as the top private company in enterprise data navigation, and Sonico, one of the fastest growing social networks for the Hispanic market.

DN Capital Commentary (Steve Schlenker, Managing Partner):

1. *What would you change in the U.S. stimulus package to benefit your portfolio companies and technology companies?*

“Three of DN Capital’s companies are directly affected by the stimulus package – Lagan, which sells case management software to state and local government, Datanomic, which sells data quality software for compliance purposes to financial services firms and other institutions, and Endeca, which provides database search and analytics to a variety of customers including various three-letter acronym agencies.

In the case of Lagan, while \$144 billion of the \$787 billion of ARRA funds goes directly to State and Local fiscal relief, in practice only \$5.7 billion of this is directly related to IT spending (source: www.recovery.gov and www.input.com). Higher mandated IT spending budgets at the State level would ensure that more citizens were aware of the services now available due to the stimulus capital, as well as ensure that the capital is invested efficiently.

In the case of Endeca there are multiple changes where Endeca could assist. Just as one example, funding to build a nationwide directories of property title would reduce transaction costs for homebuyers rather than paying for title searches, which would be as effective as a direct subsidy; Endeca’s technology would be ideal to implement such a system.

In the case of Datanomic, there is \$2 billion of the \$787 billion allocated to the Office of the National Coordinator of Health IT, of which a portion is to build e-health records for all citizens by 2014 (which will naturally require the type of data quality software provided by Datanomic). It would be useful if this service was replicated within the ARRA for other social service records, vocational records etc, as well as within security services (using data quality can prevent normal citizens from showing up on terrorist watch lists) and within financial institutions (to ensure better tracking of derivative counterparties).

In general, like all government funding programs, there are plenty of things to be pleased with and plenty of things still on the wish list. Overall I think many initiatives will benefit not only the software companies in DN Capital’s portfolio but also companies in other VC’s portfolios, particularly in broadband, sensor technologies, and green tech.”

2. *What action is the U.S. Government taking that is most detrimental to your portfolio?*

“I am most concerned about changes to the top rate of capital gains tax, as this would provide a disincentive to many talented software executives to start technology companies and a direct disincentive to my existing senior managers. A better system would be some form of taper relief like the UK had for the late 1990s-early 2000s where the tax rate progressively gets lower for capital gains over 1-5 years.”

3. *Which key metrics do you require a Company to achieve before you get interested in an investment?*

“DN Capital has a “barbell” investment strategy meaning we invest our capital equally into companies at the seed/Series A level and in companies that have bootstrapped without any venture investment to about \$1 million in EBIT. In the first category, we are not structured as a firm to invest in science projects, so we require the company’s intellectual property to be at the point where it can go out to live customers. In the second category, our metrics include market size and growth rate, company growth rate relative to market, current margins and potential long-term margins, ratio of largest customer revenue to total revenue, completeness of management team and ability to grow internationally.”

4. *What are your concerns with the current market? Do you see any light at the end of the tunnel?*

“The biggest concern is that larger companies in the industries where DN Capital portfolio companies play begin using fear, uncertainty and doubt to try to hold market share. Venture backed companies on the whole are going into this market well funded, and DN Capital companies are no different, but it is often difficult to convince IT directors and CIOs of this fact. At the moment, most of our companies, particularly (a) our enterprise software companies and (b) those digital media companies in our portfolio either not dependent on the on-line advertising industry or small enough from a cost base seem to be doing well. As a firm, DN Capital believes this downturn will probably look like the 2001-2003 downturn, so we are likely to have another 12-18 months to go before seeing a meaningful turnaround.”

5. *What is your outlook for technology M&A?*

“M&A will remain strong, and we continue to see M&A interest for our existing portfolio companies. However, this is clearly not a seller’s market, so unless a company is either particularly well positioned to benefit from US stimulus funds or has a business model that directly benefits from the economic recession, multiples will be materially lower than they were in 2006/7 or where they are likely to be in 3-5 years, so many good companies not in those sectors will likely stay out of the market. The exception will be where funds are near the end of their life and have to sell, but I believe in those cases it is more likely the funds will sell their investment stakes to other funds rather than forcing portfolio companies to exit.”

6. *What lessons have you learned from past recessions that you have utilized in today’s economic environment?*

“Having started my direct investment career during the 1991-1992 buyout downturn and having worked through the 2001-2003 venture downturn, the first and foremost lesson is “this too shall pass.” Now is a great time to be thinking about strategy, because a company will not be penalized for 5% growth when their markets are flat to shrinking, and often there is little time for strategy when growth is 50-100%. This holds equally true for the VC firms as for the portfolio companies – it is a great time to evaluate whether there is an alignment between your investments and your team’s strengths, and either to augment your team or to redirect in which sectors you are seeking new investments. For consumer companies, it is a great time to position yourself relative to more expensive options – spending \$15 a month for a year on virtual assets in video games is not expensive when compared to spending \$500 for a single ski weekend. For enterprise companies, now is the time to mine your existing customers for follow-on revenue, because it is harder than ever to win new accounts.”