



## ***VC's in the Sweet Spot - An interview with Stuart Ellman of RRE***

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Q: Briefly explain your background and how you came to start RRE Ventures?

~ Early on I worked at Dillon Reed and that ended after 2 years when I got into Harvard Business School. During the first summer at HBS, I wanted to do something different for the summer, and while I was at Dillon Read I had some bankruptcy and restructuring exposure. In fact, I worked for a long time on the first public leveraged buyout, a company called Formica, which interestingly enough made - Formica. It was an interesting and complex deal and I knew I wanted to stay in private equity.

Q: When did you first try to get into venture capital?

~ For a summer job during business school I applied to all the venture capital firms and private equity firms and came up with a big donut in terms of job opportunities. However, I was pretty heavily recruited on the banking side, and so I decided I would try Morgan Stanley, but instead of doing investment banking again, I decided to try capital markets. I sat on the debt capital markets desk, which was interesting. It's very different sitting on a trading floor creating structured products. But I realized that sitting on a trading floor was not really my personality; it's not what I wanted to do long term. So I went back to business school.

I was close to one of my professors at HBS, Bob Eckels, and he was looking to start a business with the former head of Morgan Stanley Capital Partners and they pulled me aside to see if I'd be interested in joining as the junior guy. Needless to say, it took me about 3 seconds before I responded yes. The idea was to raise a private equity fund and invest it in primarily family-run businesses while also offering financial, strategic and organizational help through both the banker and professors' real expertise. So I got out of business school and was driving up to Greenwich, Connecticut everyday. It was a great experience, starting this company with nothing but a sheet of paper and a phone and a desk - you really learn a lot

about how to start things. We went out to market to raise a \$200mm fund but after 2 years it was a pretty tough market. It was difficult to raise money and we were unable to get the fund raised. I failed . . . with a capital F.

Q: After hitting this dead end, what were your options and what were you thinking?

~ 2 years later and I still could have gone back into banking, I had a good banking background and I done well before and at Harvard, having tutored Accounting and Finance. They would have docked me a year, and you can come back and be a banker. So now instead of \$50K in debt I had more debt and was married and had an apartment in NY. I decided to take a chance again and start another company. It was probably the biggest swing I took in my life because if I failed at that I wouldn't have been able to jump on the other ship. My best friend from business school was Jim Robinson IV, and he was at H&Q on the venture side. As I was a general financier, Jim was really technology focused, having been a tech banker a J.P. Morgan before going to business school. We were both very entrepreneurial and our skills were very complimentary. So while he was in San Francisco, I was in NY, and we would be on the phone every night from midnight to 2 in the morning trying to figure out business plans to do. Finally we said lets get together and start a firm, and it was about that time that Jim's father left American Express. Jim Robinson III, (former CEO of American Express) had loved technology and was making investments with his own money on little silicon alley companies. One of his investments became ScreamingMedia. . . an interesting company. So we decided to come together the three of us and be a New York-based venture firm.

Q: So what was the premise of RRE? And describe the early years?

~ We were investing in companies that sold to or partnered with the Fortune 500 or their global counterparts, utilizing Jim Robinson III's relationships to help small companies get access when they otherwise couldn't on their own. The first years were tough; we didn't raise a fund at first. We did four deals...deal by deal...scraped them together. Back in 1994-95, venture wasn't the hot thing - it was something most people hadn't really heard of. What we found was that we really were able to help these companies, by getting them to the CEO or CFO level suites at lots of large companies to either make sales or create partnerships.

Q: Having started your own venture capital firm, do you suggest others to follow in your footsteps or try and work at established VC firms?

~ **If you really want to be a venture capitalist you've just got to get in the game.** You either get in the game through joining a big firm or a small firm and it really is risk reward. If you can get a job at Warburg Pincus, take it, although it's really tough to do. Cary Davis, a partner at Warburg, was in my business school class. I think they interviewed 500 people and they choose him. He is incredibly talented and that's great. Venture capital is very difficult to get into - unlike banking and consulting where new people are hired every year, venture spots only open up when new funds are raised or when someone specifically leaves an existing fund. You saw a huge explosion of the number of funds and a lot of people came into the industry in '99. And now you are seeing a huge decrease in the number of funds, so when VCs are looking to hire new people, they have a choice of hiring lots of people with VC experience versus taking on someone new who doesn't. Now it's even more difficult to get into. I remember in business school there were probably about 200 people who wanted venture and there were three that got jobs.

Q: Any suggestions for those looking to find a job in Venture Capital?

~ Getting a job in venture capital is a little like being a venture capitalist, because as a VC you have to find and ferret out the best deals. Find them wherever you can. Find them and get yourself into them, because the best deals are always the hardest to get into. That is a bit like getting a job in venture capital. You have to find where it is and that's either by meeting everyone under the sun, and doing a lot of research and getting meetings, then you have to be top of mind when they decide to hire somebody

Q: What do you look for in other team members?

~ The primary skill set to be successful in this business is good judgment. And I think it is hard to tell whether you have good judgment or not until after you've been in the business. What I want is someone with a real drive to become a venture capitalist. I want someone to tell me that "I am going to become a venture capitalist" and if I can't get a job as a venture capitalist then I'm going to start a company or be an entrepreneur, be successful at that and then become a venture capitalist. If you say, "well if I don't get a job in this, then I'm going to go to banking or consulting" - you don't have the drive. This is a tough industry and it's not going to be easy for the next couple of years. You have to have a real fire in your belly. You have to research and say these are the spaces that are interesting to me and these are the companies within them that I'm interested in looking at. A lot of venture capital is force of will. . .you have to force your will on things to make them happen. I want someone with the force of will to become a venture capitalist.

Q: Going back to RRE, explain the early years and how you are dealing with today's environment?

~ We raised our first fund in 1996, and in retrospect '96 was a fabulous time to raise a venture fund - it was the right side of the trajectory. Silicon Alley had not really developed yet so Jim and I started spending 2-3 weeks a month on the West Coast. There was a real opportunity, as most of the West Coast firms had a couple hundred million dollar funds max. So they would do the series "A" and they were looking for someone to do the series "C" and "D." So we did a lot of series B and C and really helped the companies. Fortunately a lot of those companies went public quickly afterwards and got snapped up. Maybe because it

was our first fund, we were believed we should take profits off the table. So while others decided to let them ride - we ended up getting in and doing 5 or 7x your money in a year.

Q: When did the second fund get raised?

~ We raised our second fund in 1999, and I think everyone who has a '99 fund has a difficult time with it. It was like the **perfect storm** of bad things to happen. In terms of all the industries, B2B, B2C, B2G, Optical, Enterprise Software, they all basically went to zero in a short period of time. And the worst place to be was later stage, because you were being priced up to the pre-IPO market. We were fortunate though, in 1999 we looked and we were doing all these B and C rounds at valuations of between \$20 and 50mm and then in '99 people all of sudden had raised these large funds themselves and didn't want to share their deals and the price had gone up from say \$30-40mm to \$150-200mm. We looked around and said that's crazy - it doesn't make sense. For a while we were missing the boat. We turned down WebMD in the first round and a bunch of other ones that went up significantly from there. But we said we have to stick to what we believe in. So we focused in '99 on the New York metro area doing business software and business infrastructure. Slightly earlier stage turned out to be exactly the right thing to do. We didn't get caught up in the Internet frenzy and late stage high pricing companies that just went out of business. Not to say the '99 has been easy or great. Its hard. You have to really work your companies, but I think we'll end up a well performing fund for its vintage year.

Q: And 2002? What was it like raising a fund in this environment?

~ We raised our most recent fund in 2002, which was a really difficult thing to do. We were lucky because almost all of our existing Limiteds came back. However, this time, as compared to 1999, the fundraising environment was hard, even existing Limiteds wanted to cut the number of L.P. relationships they had. The result is that they took a hard look at each and every single fund they were in, to figure out what they should be in and what they shouldn't be in. We raised \$225mm in both '99 and '02. The difference was that in '99 it was an incredibly small fund and in '02 we were the third largest technology fund raised. It was a difficult market environment because the world was back-lashing, we were fundraising right through September 11, the markets were crashing, tech was in a depression, and people were pessimistic with what was going on in the world. On the other hand, because we got it raised, we think this is a phenomenal opportunity to make investments. In '99 any company good or bad was getting funded at huge valuations – even in '01 and '02 - till now. Any company whether it's good or bad is being funded at wash out round. There is pricing arbitrage, we believe the market will come back to normalcy. There's not going to be a bubble, but it will come back to a point where good companies, good products with good customers and growing revenues will have value and create public marketplaces. So whether it's a company with \$75 million in revenue going public at \$150 million, that's different than a '99 company with zero revenues going public at a billion dollars or an '02 company with \$100mm in rev trading less than cash. We think there's a place for market normalcy to develop sometime in the next 3-5 years.

Q: Has RRE changed its investing process given the current market environment?

~ There is a supply /demand imbalance on the part of the investors whereby we can sit around and wait for what we perceive as the perfect deal. You can really wait for a company with great management, product, great market, you can do due diligence on these guys for 4-6 months and really watch them as they develop to see if they are hitting their numbers. Before there was so much competition for deals and companies would go public if you didn't fund them anyway. Basically, you had to put in your money or lose the deal; now the dynamic has changed. We think that the people that have the confidence to tread in these uncertain waters will reap greater than market returns for taking that risk. It is a game of patience - the market is not going to turn quickly. We've been in a recession for 3 years and we think the market will return to normalcy sometime in the next 3-5yr period. This implies that in the end we would have been in an 8 yr recession, which was one of the longest since the great depression.

Q: What is the vision for RRE in terms of Capital Under Management and Personnel?

~ We're are looking to stay where we are. We can learn from the experience of others - we saw a lot of firms go from \$2-300 million dollar funds up to a billion dollars and back to \$200 million. We like the sweet spot. We've selectively added people. Ken Ross on the West Coast is a 30 year Silicon Valley entrepreneur. We added Rich McGinn who was the CEO of Lucent. I'll even go on record as to say I think he is going to be one of the most talented venture capitalists the world has seen. He is an extraordinarily talented human being who has great knowledge and experience in the communications sector. We don't want the \$7-800 million dollar funds, where we have to start putting to work \$25-40 million. We don't want to have to compete with the guys laying out large amounts of cash. We think there's a very profitable area in making \$5-7 million dollar investments, leading series B and C rounds in companies, helping them grow and helping them access the Fortune 500. If I look forward 5-10 years, I would say we have two more partners and we are on fund VI, and it's a \$400mm fund. I don't see us becoming an asset management company.

Q: What is the most important skill set a person can have? Operating experience, Engineering, or Transactional experience?

~ Choosing someone and choosing a company is like dating. . .you know it when you see it. Would have it been better if I was an electrical engineer at Caltech instead of an economics major at Wesleyan? Yeah sure. I've co-founded a number of companies, and a number of companies we've invested in. That has given me operational experience, but everything helps. All three of those help, including deal experience. **But none of them make or break a great venture capitalist, in the end it really is your drive and your judgment.**