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BusinessWeek

JULY 24, 2000 / A PUBLICATION OF THE MCGRAW-HILL COMPANIES

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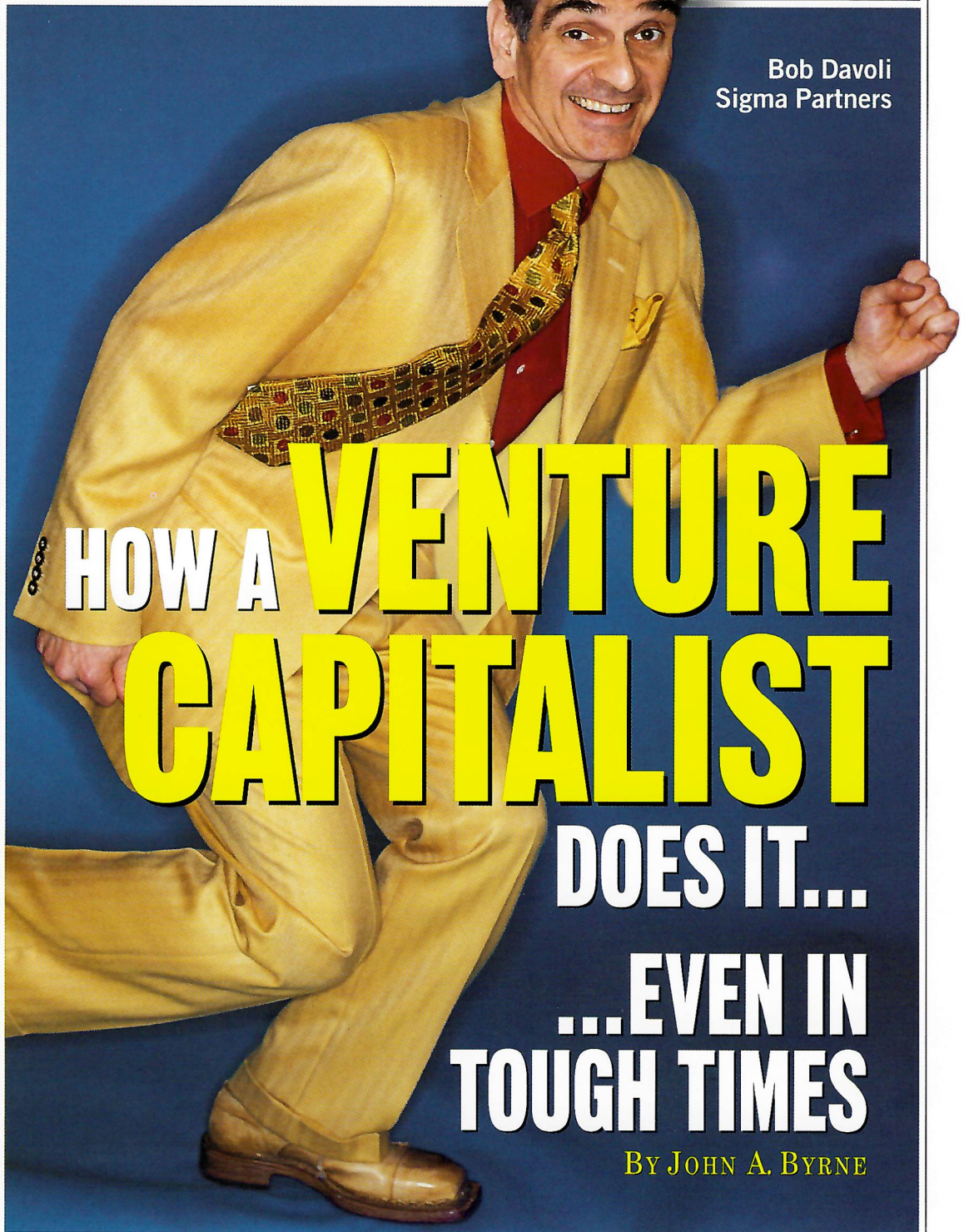


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The marketing of Harry Potter



Bob Davoli
Sigma Partners

HOW A VENTURE CAPITALIST DOES IT...

...EVEN IN TOUGH TIMES

By JOHN A. BYRNE



HOWA

WAG

DOES IT

Cover Story

Bob Davoli is a hands-on investor, and so far he hasn't picked a loser. Can he keep it up?

BY JOHN A. BYRNE

It is a bright yet chilly April day in New England, and venture capitalist Robert E. Davoli is behind the wheel of his slate-gray BMW 540i. Dressed in a dark-blue suit with purple pin-stripes, Davoli is flying down the Massachusetts Turnpike at 75 mph to get to a board of directors meeting in Natick, Mass.

For Davoli, 52, it is a jittery time. Many of the once high-flying stars of the so-called New Economy have lost one-half to two-thirds of their market capitalization. The market for initial public offerings has all but dried up. That puts Davoli, with five red-hot technology companies itching to go public, at ground zero of the tech-stock massacre. Edocs Inc., the company in Natick, produces software for Internet billing. The others boast appellations that just weeks earlier would have quickened the pulse of any investor. There's Excelergy, Servicesoft, Context Integration, and StorageNetworks, which some analysts believe could be one of the year's biggest IPOs. The market decline has exacted a huge price from Davoli. If these five companies had made their debut a month earlier, they would have fetched a combined mar-

ket value between \$7 billion and \$11 billion.

The biggest uncertainty on this spring day is StorageNetworks, which lost \$23.9 million on sales of \$3.9 million last year. With investors suddenly queasy about funding money-losing startups, the data-storage utility has been forced to lower its latest proposed offering price to below its last-round valuation of \$2 billion. "This has been ugly," says Davoli. "Really ugly."

Ah, the life of a venture capitalist in the year 2000. Until things turned less rosy, people like Davoli had been the kingmakers of the New Economy. By providing early cash for new ideas, they had helped to power one of the most extraordinary flowerings of innovation in U.S. history. With unabashed hyperbole, Stanford University law professor Joseph A. Grundfest compares today's venture capitalists to the Medicis who funded the artists of the Renaissance.

A Leonardo da Vinci has yet to emerge from Silicon Valley. Still, the cash that venture capitalists have poured into technology startups has wrought dramatic changes in the past decade. Venture cash, which tends to be far more tolerant of risk than cash tapped in traditional capital markets, has giv-

Scenes from the Life of a VC

How Bob Davoli attacks his day



◀ SWEAT EQUITY

Davoli heads to the basement of his Belmont (Mass.) home every morning for an hour-long workout

▼ FOREVER YOUNG?

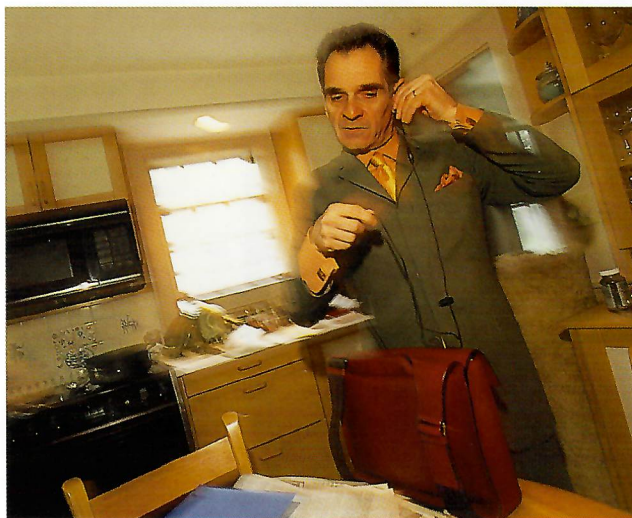
Davoli, a war protester in the '60s, has a photo of Bob Dylan and Allen Ginsberg in his office

en birth to many of the icons of the New Economy, from America Online and Cisco Systems to eBay and Yahoo!

These days, the VC business has become more competitive than ever. The mammoth wealth created by technology companies less than a decade old has created an explosion in venture capital. Hundreds of new VC firms have raised billions in new venture funds—despite hefty charges that can reach as high as 30% of returns. Last year, venture capitalists built war chests worth some \$46.5 billion, up from \$27.9 billion in 1998. Until April, when technology stocks went into a free fall, it seemed nearly impossible to lose money.

For a glimpse inside the world of venture capital, BUSINESS WEEK spent several days following Davoli to board meetings and partner sessions on both coasts. A partner and chief rainmaker at Sigma Partners, a venture fund with offices in Boston and Menlo Park, Calif., he has been at the center of the VC gold rush. Although half the size of higher-profile players such as Kleiner Perkins Caufield & Byers or Benchmark Capital, few venture funds can beat Sigma's record. Since 1984, when a nerdy engineer and a corporate lawyer formed Sigma in Menlo Park, the firm has regularly outperformed its rivals, throwing off annual returns that have been more than triple the industry median. Its 1997 fund has posted returns approaching a gluttonous 370% a year, vs. the 57% annual median.

HOT BAT. Davoli's contribution to that record has been extraordinary. The \$45.5 million he has invested in the past five years has generated more than \$2 billion in returns to Sigma investors. A former chief executive of two startups himself, he is hyperaggressive and superinvolved in the companies he backs. He has sold companies to Microsoft, Hewlett-Packard, and E.piphany. By last spring, three of his companies had gone public, including software maker Vignette Corp., which yielded a return of \$628.3 million to Sigma on an investment of \$3.2 million. "Normally in the investment business, if you swing for the fences, you get a lot of strikeouts," says Anthony Hoberman, an Alliance Capital Management senior vice-president with a stake in Sigma. "Davoli gets



▲ CELL-PHONE TAG

The deals begin before Davoli leaves the house

home runs without the strikeouts. It's remarkable."

The question, of course, is whether Davoli can keep that record intact. For most of his tenure at Sigma, the market for tech stocks seemed to move in one direction only: up. For Davoli, an aggressive investor willing to take huge risks, the conditions were perfect. But suddenly, he and his VC colleagues are finding that it is harder than ever to cash out of venture investments. With many startups running out of cash, big losses and write-offs seem inevitable. "I have never seen an extended bear market as a venture capitalist," says Davoli candidly. "I don't know what it's like."

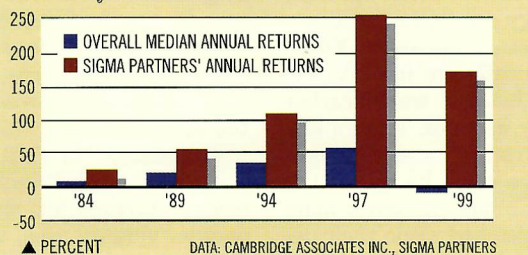
But he doesn't intend to get sucker-punched finding out. The role of his partners at Sigma, who tend to be more conservative and better-versed in the nuts and bolts of computer hardware, is more important than ever. They act as a powerful brake on the impetuous Davoli, forcing him to drill deep into the details of potential deals.

And Davoli has shown a keen sense of the market. Late last year, fearing a market rout, he urged all of his IPO-bound companies to raise cash—just in case a market crash delayed their ability to go public.



HOW SIGMA STACKS UP

Sigma partners has been outperforming the industry since its first fund launched in 1984



PHOTOGRAPHS BY PORTER GIFFORD; CHART BY ERIC HOFFMANN/VIEW



◀ MONEY TALKS

Critiquing proposals in the Boston office; Davoli meets with five entrepreneurs a week

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▲ FAST PACE

As the day's end approaches, Davoli hits the streets to make yet another meeting

deals than ever before, the valuations of many companies have remained stubbornly high, forcing Sigma to be even more disciplined. Since early May, it has lost five deals to rival vcs who paid 30% to 125% more than Sigma's best offer for their

stakes. Davoli believes a shakeout is inevitable, but he says that Sigma has made money in good times and bad—dating back to long before the Net frenzy took hold.

In venture capital today, there are two kinds of money: smart and dumb. Davoli trades in the former, which means that he brings a lot more than cash to a deal. He brings a Palm Pilot crammed with essential contacts and a brain filled with real-world operating experience. Sigma's imprimatur also lends a halo of invincibility to every deal, providing entrepreneurs with "branded capital." These days, it's no longer enough just to get financing; a successful venture needs the right kind of financing. Cash from a top-tier firm has magnetic



Context Integration Inc., for example, which builds business-to-business commerce sites, raised \$12 million in January, even though it hoped to go public four months later. At their current burn rates, all five ventures have enough cash to get them through the end of the year or into the first quarter of 2001 without having to tap private or public equity markets.

Oddly, the tech-stock crash failed to correct one big problem created by the mania that preceded it: Cash has continued to pour into venture funds. With more venture money chasing

DAVOLI'S GREATEST HITS

Nothing but home runs—so far

COMPANY	DESCRIPTION	INVESTMENT MILLIONS	TOTAL RETURNS MILLIONS
STORAGENETWORKS	Data-storage utility company. Went public on June 30	\$12.4	\$706.3*
VIGNETTE	Leading maker of online content management software. Went public in 1999	3.2	628.3
TRADEX TECHNOLOGIES	Internet B2B market maker. Acquired by Ariba in March	4.0	343.1
OCTANE SOFTWARE	Internet relationship software firm. Merged with E.piphany in May	9.0	176.6
ISS GROUP	Internet security software company. Went public in 1998	2.9	90.6
VERSATA	E-business software firm. Went public in March	8.6	72.2*

*BASED ON CURRENT VALUATIONS

DATA: SIGMA PARTNERS, BUSINESS WEEK



properties, attracting talent, customers, partners, and investors. "Today, it's what you get after the check that counts," says Tim Guleri, former CEO of Octane Software Inc., a Davoli company recently acquired by software maker E.piphany Inc.

BOBBY GUITAR

For years, Davoli dreamed of becoming a folk and blues musician

With his experience and connections, Davoli is a throwback to the 1960s, the good old days of venture capital, when pioneers Arthur Rock and Thomas J. Perkins assumed hands-on roles in guiding companies. Many of today's instant venture capitalists are more passive, sometimes lacking the background to add much knowhow to a young management team. Davoli, who sits on 15 company boards, serves as an entrepreneur's personal consultant, headhunter, sounding board, and crying towel. "Bob is able to draw upon his operating experience to

help his CEOs," says Ted E. Schlein, a general partner at Kleiner Perkins. "That is one

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of the most valuable things a venture capitalist can do."

Not everyone applauds Davoli's demanding, sometimes heavy-handed style, which detractors say can encourage managers to take unreasonable risks. "To VCs with a portfolio of companies, a home run is more important than four singles," says one executive whom Davoli helped to oust. "For a CEO trying to make rational business decisions, the single may make more sense. In the go-go era, Bob is an extreme example of a VC who always wants the home run."

Davoli makes his board meeting with minutes to spare. Soon after taking Exit 15 on the Mass Pike, he cruises into the parking lot behind edocs' headquarters office building. With his silver-streaked black hair and his deep-set dark eyes, Davoli looks like the movie director Martin Scorsese. He is short and thin, yet solid from his daily workouts and vegetarian diet. On this day, he's in a hurry, partly because he and his wife, Eileen, major Democratic campaign contributors, are to have dinner with Vice-President Al Gore in Boston, and partly because he is always all motion and energy—"five-foot-six of exposed nerve endings," as one friend puts it.

FLASHY ATTIRE. "Hey, Gianni Versace," laughs James Moran, a co-founder of edocs who serves as head of sales and marketing, when he sees Davoli. The comment is a reference to his flashy attire. Davoli, who has an entire room in his home crammed with three-button suits in a palette that ranges

from fluorescent blue to lime green, dresses to be noticed as much as to express his individualism. It's safe to say he looks like no one else in venture capitalism.

In a windowless conference room on the second floor, Kevin E. Laracey, edocs' 35-year-old CEO, calls the meeting to order. After the seven directors run through a range of issues, from stock options to employee head counts, the talk inevitably turns to its forthcoming IPO. Four weeks earlier, on Mar. 24, edocs filed its S-1 registration statement. To move forward, however, edocs must put a proposed offering price on its shares and respond to the Securities & Exchange Commission's comments. Laracey seems wary of going public in a crashed marketplace.

Davoli, however, wants the management team to plow ahead, answering the SEC queries and preparing for an offering. If the process is put on hold, he reasons, edocs will be left at the end of a long queue of IPO wannabes once the market stabilizes. And time, in this case, really is money. As an inside investor, Sigma can't cash out its investment until at least six months after the company goes public.

Davoli leaves no doubt about where he stands. "We need to manage the investment bankers," he says. "When a sales guy tells us he can't get customers to buy, we fire him. We

ROBERT E. DAVOLI

BORN 1948, Syracuse, N.Y.

EDUCATION BA in history, Ricker College, 1970; course work in computer science, Northeastern University, 1979-81.

CAREER Jobs included short-order cook, folk and blues musician, babysitter, and substitute teacher. Landed first software job at age 32. Ran two companies. Joined Sigma Partners as venture capitalist in 1995.

QUIRKS Wardrobe includes neon-colored suits. Has not owned a television set for 25 years.

PERSONAL IDOLS Novelist Graham Greene, comedian Lenny Bruce, blues guitarist Mississippi John Hurt.

BIGGEST DISAPPOINTMENT Not making it big as a musician.

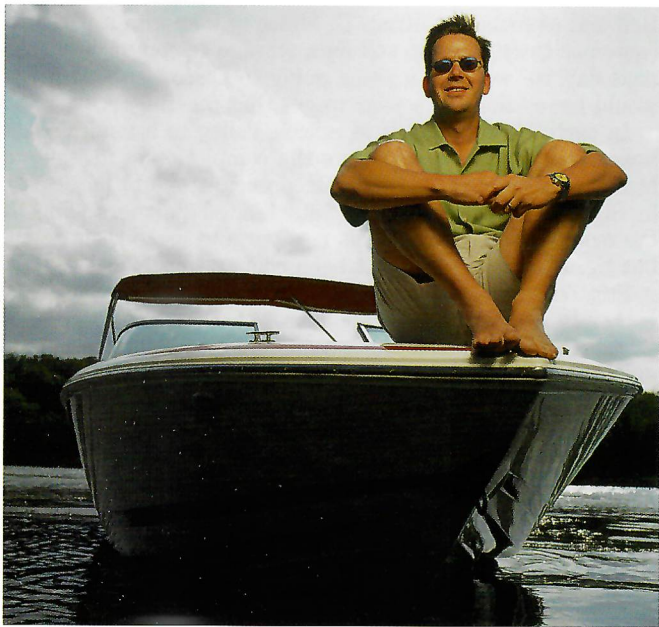
ON CAPITALISM "Capitalism is a perversion. We have the highest crime rate in the world. We have people living in the streets, and no one gives a s__."

PERSONAL WEALTH Has set up a charitable foundation for the arts, the disenfranchised, and women's right to abortion. Plans to leave much of his estimated \$250 million fortune to the foundation.

FAMILY Married for 16 years to Eileen L. McDonagh, a Northeastern University professor. Two stepsons, Robert and Edward, from McDonagh's earlier marriage.

have to keep the pressure on." Laracey polls the other outside directors. All agree with Davoli. "O.K.," Laracey says. "We hear that loud and clear." By the time the four-hour meeting ends, edocs has agreed to respond to the SEC's remarks—the last step before putting a price on its shares and taking a show on the road for investors.

Laracey knows he has to take Davoli seriously. Every chief executive who accepts money from him understands that Davoli will be extremely involved in management and that he has little patience for CEOs who fail to measure up or persistently ignore his advice. "What do venture guys es-



“It’s not always easy... If you’re not doing the things to achieve the bigger objective, he is going to be all over you”

— GREG PETERS, CEO, Vignette Corp.

northern Maine commune. His early choices, not to mention a longish ponytail, hardly pleased his conservative father, who ran an industrial-supply business in Syracuse, N.Y., and referred to his son as a “hippie bum.”

For a time, Davoli seemed intent on proving his dad right. Through the 1970s, after graduating from Ricker College in Maine with a history degree, he clung to his life’s dream of becoming a folk and blues musician, barely supporting himself as a short-order cook in Boston. In 1976, Davoli responded to a classified ad in the weekly Boston Phoenix for a babysitter. Eileen L. McDonagh, a political science professor at Northeastern University, had recently separated from her husband and needed someone to care for her two sons, ages 4 and 6.

From the first meeting, she was impressed by the connection Davoli struck with her children. “Bob was an extraordinary babysitter,” she laughs. “He was compassionate and warm. I’d sit on the porch and marvel at the energy he showed playing with the kids in the backyard.” Six months after hiring him, McDonagh invited Davoli for a stroll around Walden Pond. Three years later, he moved into her modest wood-frame home in Belmont, Mass., where they still reside. They married in 1984.

“SOMETHING HAD TO GIVE.” By the late 1970s, Davoli was substitute teaching in Boston’s public schools for \$40 a day. “Something had to give,” he recalls. “I literally said, ‘Software sells a ton. It can’t be that hard.’” So he began taking computer courses at night and on the weekends at Northeastern. Finally, in 1981, at the age of 32, Davoli landed a job as a systems analyst for engineering outfit Stone & Webster. Four years later, he launched his own startup, SQL Solutions, a database consulting firm.

Anxious to succeed and ever intense, Davoli proved a terrifying boss. “Bob can be a ruthless character,” says Robert

mentally do?” he asks out loud. “They hire and fire CEOs.”

Davoli has done plenty of both. In his five years as a VC, he figures he has fired six of about two dozen chief executives. After one founder-CEO missed his earnings, Davoli quickly mobilized the board against him. “We’ve got two announcements printed here,” Davoli recalls telling him. “One says that you decided to move up as chairman and take a more strategic role in the company. The other says you’re fired. You decide which one you want.”

The story is classic Davoli. “If he believes in something, he will push you very hard,” says Naren Bakshi, former CEO of software maker Versata Inc. He says Davoli once opposed an outside search to replace a key executive. “He called and lobbied every board member against it,” recalls Bakshi.

Most say that Davoli adds so much value in and out of the boardroom that any difficulties he creates are well worth it. His experience gives him the kind of resolve a young, unseasoned entrepreneur may lack. Last year, when Tradex Technologies Inc. got a \$1.1 billion takeover offer from software supplier Ariba Inc., 30-year-old CEO Daniel S. Aegerter was eager to accept. Davoli insisted on holding out for \$1.9 billion—and eventually got it. Sigma’s return on its \$4 million investment: nearly \$350 million. “He helped us get a better deal,” concedes Aegerter. “Bob is mostly right, occasionally very wrong, but never in doubt. The dark side is that he is very opinionated and so powerful a personality that there was no one else on the board to balance him.”

In a business mostly populated by bland, Republican Ivy Leaguers, Davoli stands out as an unlikely banker for capitalist dreams. A product of the 1960s counterculture, he marched in protest against the Vietnam War, drove a psychedelic Volkswagen van to Woodstock in 1969, and lived in a

“Bob is mostly right, occasionally very wrong, but never in doubt... He is very opinionated and so powerful a personality that there was no one else on the board to balance him”

—DANIEL AEGERTER, Former CEO, Tradex Technologies



(TOP TO BOTTOM) WYATT McSPADEN; ANN STATES/SABA

Loughan, senior vice-president for sales at Octane Software Inc., who worked with Davoli in the early 1990s. Loughan recalls one incident in which Davoli "got three inches from my nose and berated me for making excuses about why something couldn't be done."

But his intimidating style brought results. Davoli scored his first big hit in 1990 when he sold his 100-employee company to database provider Sybase Inc. for stock and \$1.75 million in

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cash, just enough to officially make him a millionaire after taxes. He hung around for two years before he got fired after a disagreement over the company's direction, but he walked away with some \$25 million after selling his stock. In 1993, he was recruited to head Epoch Systems, a client-server software company. Epoch was later acquired by EMC Corp., netting him an additional \$7 million.

Soon after, in 1995, an invitation arrived to join Sigma from a firm partner who sat on Epoch's board. Davoli, tired of the intensity of running companies, gave it a try. "When you are a CEO," he says, "you're on 24 hours a day. You have hundreds or thousands of people who rely on you. I didn't have the energy for that anymore."

His first Sigma investment was in Vermeer Technologies Inc., a pioneer in Web-publishing software. After helping to recruit a new chief, Davoli engineered a sale to Microsoft Corp. for \$130 million in early 1996. Davoli, who put \$500,000 of his money into Vermeer, reaped a \$20 million windfall.

But finding the next Vermeer has gotten harder. In an average week, roughly 50 potential deals come into the Boston office alone. Of these, Davoli will meet with only five of the entrepreneurs. Every deal is viewed through five lenses: the people, the technology, the competition, the market size, and the business model. Nothing is more important than people, however, because often a startup will change its market or even its products as it evolves. Davoli looks for people who have high levels of energy, are willing to work around the clock, and are still hungry for success. "I need the guy who has made just a couple of million," he says. "Then, he's a racehorse, champing at the bit."

TALENT SCOUT. Once invested, Davoli rolls up his sleeves, ready to do whatever it takes to make the company a success. "I don't spend time reading the trade magazines or the analyst reports," he says. "I don't do breakfast. I believe in doing a good job on the boards." CEOs will tell you that Davoli is the most active and accessible director they have. "It's not always easy," says Vignette CEO Greg Peters. "If you're not doing the things to achieve the bigger objective, he is going to be all over you." And for the hapless CEO, there's no escaping him. Davoli's cell phone is on 15 hours a day. He returns every call, often within minutes.

Davoli's role at StorageNetworks shows the difference a smart, well-connected venture capitalist can make. Early on, he made a phone call to Cisco Systems Inc.'s chief information officer to set up a crucial meeting that allowed CEO Peter W.

Bell and co-founder William D. Miller to test with a potential customer their plans to sell data storage to companies. "The next day we were on a plane going to Cisco," says Bell. "It would have taken us a year to get that meeting."

In early May, Davoli is in Silicon Valley to attend his last board session at Octane before the completion of its sale, to hear a series of pitches from entrepreneurs, and to participate in Sigma's annual meeting of its limited partners. This is the month when all five of his IPOs were to make their debut, but the stock market hasn't been cooperating.

Still, on May 11, Sigma's five partners are upbeat when they gather in a spacious room on the top floor of San Francisco's Clift Hotel. Before the fund's investors arrive for the annual meeting, the partners review the portfolio's investments and debate potential commitments.

Typically, they meet every Monday afternoon via videoconference. Every investment made by Sigma must be approved by all the partners, each of whom has \$20 million of his own money tied up in the fund. So a single veto torpedoes a deal.

Last year, for example, Davoli argued in favor of investing in WebMethods Inc., but his partners insisted that he line up another VC to share the risk. Unable to get one, Sigma decided to pass, but Davoli later kicked in \$250,000 of his own money. When WebMethods went public in February, the company's market cap hit \$11 billion, making his investment worth nearly \$20 million.

From the start of the meeting, Davoli is campaigning for approval to invest \$10 million in LavaStorm Inc., a Waltham (Mass.) software developer. He thinks the company's valuation should be about \$80 million. His partners aren't so sure. "Are we considering the fact that the public markets may not bail out our venture deals?" asks Lawrence G. Finch, a partner who has run three high-tech companies. "There's little tolerance for unprofitable companies now."

Finch's concerns resonate a month later when LavaStorm rejects Davoli's offer in favor of another VC that coughs up the same \$10 million in return for less equity. "A top-tier firm doesn't have to overpay for a deal," he maintains. But the game is clearly getting harder. Four of his

five IPO-bound companies have put off their offerings until the fall. Still, Davoli's streak hasn't ended yet. In April of 1999, he persuaded StorageNetworks' founders and board members to reject an unsolicited \$250 million offer for the fledgling enterprise. When Storage finally went public on June 30, its stock tripled from an offering price of \$27 to over \$90 per share. The company's market cap is now \$9.6 billion—\$9.3 billion more than the board would have sold the company for only 14 months earlier—and Sigma's \$12.4 million stake is worth \$706 million.

It's a sweet deal, but Davoli has always had his eye on more than profits. "Look, I'm really a failure," he says. "I wanted to be a musician or a writer. I just didn't make it. But what I'm good at is what I ran away from: making money. I got a nose for it. That's the damn truth." Now, if he can just keep failing as well over the next five years as he has over the past five.



TOGETHERNESS

Davoli met his wife, Eileen McDonagh, after responding to her ad for a babysitter