USA TODAY

New tech start-ups can rise from the economy's ashes

By Jon Swartz, USA TODAY

SAN FRANCISCO — It's boom — and bust — for Silicon Valley companies these days. Literally. Facing their worst economic climate since the dot-com bust in the early 2000s, high-tech companies are treating 2009 with dread — but also with a tinge of optimism if they act smartly.

Already, a few established companies with ample cash reserves are bolstering war chests that will help them snap up innovative start-ups. Cisco Systems has $29.5 billion in cash reserves and last week sold $4 billion more in bonds. Despite 5,000 layoffs, Microsoft plans to do some strategic hiring to fill new jobs supporting Internet search. And that well could involve acquisitions to pick up talented workers.

Companies are looking to improve efficiencies with cutting-edge technology. Intel says it will spend $7 billion over the next two years to build advanced manufacturing facilities in the U.S. The plants would produce faster, smaller chips that consume less energy.

"If we want to see a return of American prosperity, we have no other choice than to invest in creating the future, not merely preserving the past," says Intel CEO Paul Otellini.

Still, as the recession wears on, tech analysts say consolidation is likely to remake some tech sectors. More layoffs could be on the way as companies alter strategies. Droves of start-ups, such as data-management provider Attune Systems, have pulled the plug on operations, while others have sold at fire-sale prices.

But from the ashes, dazzling new start-ups could arise. Previous recessions have coincided with the emergence of companies such as Cisco (during the 1987 crash) and Facebook and MySpace (shortly after the dot-com crash).

"A good forest fire cleans out the prairie," says renowned venture capitalist Steve Jurvetson. Start-ups unburdened by debt or history and cash-rich big companies "thrive on disruption," he says.

Cautionary times

The wrenching changes underscore an even faster-moving business cycle in tech and reflect the uncertainty of the months ahead. Cutbacks amid corrosive revenue at bellwethers Microsoft, Intel and

Hewlett-Packard portend rocky times for the industry, regardless of the billions they have in cash reserves.

Reduced business-tech spending squeezed Cisco's quarterly financial results and threatens to drive down current quarterly revenue 15% to 20%. That has forced the networking company to cut discretionary spending by $1 billion this fiscal year and invest in growing areas such as home networking and home entertainment systems.

"It's comparable to the (dot-com bust in the early 2000s), but this climate affects all industries," says Cisco CFO Frank Calderoni. Cisco plans to de-emphasize some businesses that will result in restructuring costs, including 1,500 to 2,000 job cuts.

Change is nothing new to the networking company, which has redefined itself through hard times in 1993 (acquisitions and switching devices) and 1997 (investments in Asia).

"Most successful high-tech companies transition into other opportunities" during trying economic times, says Cisco CEO John Chambers. "You need to focus on new markets and be willing to take good business risks."

This is especially crucial as IT spending wanes. Indeed, only 30% of tech CFOs expect increased revenue this year, according to a survey by BDO Seidman, a tax and consulting firm.

That's ominous for consumer-focused companies such as Sony and PC-related businesses, both of which will falter as penny-pinching businesses and consumers eschew purchases, says Charles King, principal of Pund-IT.

The market value of consumer electronics companies plunged 49% last year. For hardware and semiconductor companies, it dived 48%. The Dow Jones industrial average, by comparison, declined 34% last year, says Dave Sovie, a partner at consulting firm Oliver Wyman.

Peeking into the crystal ball

Signs of the listless economy are everywhere in Silicon Valley. Traffic is lighter because more people are out of work, and those still with jobs are taking public transportation to save money on gas. Restaurants such as Buck's — an upscale breakfast joint tucked away in the hills of Silicon Valley, where movers and shakers go for $11 waffles with hopes of putting together the next great deal — aren't as busy. Foreclosures are up. Demand for commercial real estate has plummeted.

"This is as bad as we've ever seen," says Russell Hancock, CEO of Joint Venture: Silicon Valley Network. Its annual report on the economic state of the Valley, released today, reveals that for the first time since 2003, Silicon Valley's per-capita income declined.

Total venture-capital investment in Silicon Valley dropped 8% last year, to $8.3 billion, the report said.

What Jurvetson and others foresee are seismic shifts in tech this year and beyond:

•The IPO market is all but dead. The market for initial public offerings is badly flagging. Just 43 IPOs were completed in 2008, down from 272 in 2007, making it the worst year since 1978, says Renaissance Capital. Just two were in Silicon Valley: Visa and computer-security firm ArcSight.

All is not dire, however.

Mark Heesen, president of the National Venture Capital Association, says early-stage investing was stable, at $6.8 billion in 2008. But he predicts it will be higher in 2009 as VCs make smaller bets — $250,000 to $500,000 — on start-ups in Internet-related services and medical devices.

Web 2.0 firm iWidgets is a case in point. An online service that makes it easy for media companies such as CBS to incorporate their content on social networks, it landed $4 million in early-stage funding from VC firm Opus Capital.

Oodle, an online service where budget-conscious people can post classified ads and search for deals, last week got an additional $5.6 million in funding from three investors.

•The rich get richer (or, cash is king). Cash-rich tech giants such as Cisco, Microsoft and Oracle are in prime position to pluck firms with specialized technology.

"I don't see any reason why we won't stay on course," says Dan'l Lewin, vice president for Microsoft's Strategic and Emerging Business Development group.

Microsoft has averaged 20 acquisitions annually the past three years, he notes. It has purchased companies running the gamut from security to search algorithms to mobile technologies.

For many smaller firms that are running out of cash or no long harbor thoughts of going public, an acquisition offers the ideal exit strategy.

"It's a good time to be an entrepreneur and an investor," says Ray Rothrock, managing general partner at venerable VC firm Venrock. "It's time to buy."

•Some start-ups will thrive. While leviathans such as Cisco, Microsoft and Yahoo attempt to reshape parts of their businesses, the faltering economy is creating a more level playing field for some upstart companies. (To be sure, many are coping with dwindling funds and slackening product demand that has stifled innovation or threatened their very existence.)

"Smaller companies are not as conservative as bigger ones," says Usama Fayyad, Yahoo's former data officer, who left the Internet icon in early September before the market crashed.

"They're aggressively hiring good, available talent and investing in new technology," Fayyad says. "Larger companies are overly sensitized to market numbers and share prices."

Since mid-October, Fayyad has purchased a couple of small companies in the search-engine marketing and optimization markets, and a data-mining firm.

In the fledgling online video market, Blinkx is not only building an audience and advertising roster, it is expanding.

The 3-year-old company, which just redesigned its site, added 20 employees last year — to 65. "This is the best time to make your mark and create momentum," says Blinkx CEO Suranga Chandratillake. "We have pressed forward while others have cut back."

•Cost-saving tech services are in demand. Tech firms with services that help corporations reduce operational costs, such as videoconferencing and clean tech, are in vogue. Cisco, for example, says it will save $400 million this year in travel expenses through its use of videoconferencing.

Computer-security firm Imperva, which monitors the digital traffic in and out of a company's database to prevent breaches, landed a contract with SuccessFactors, a software service for human resources departments, last week. Imperva's customers include 62 of the Fortune 1,000 — half of which joined in the last year.

Many, such as Wetpaint, a service that lets people easily create websites, are landing deals with big boys such as Fox and T-Mobile that either don't have the internal staff to handle the work or can't afford to pay larger companies for the service.

"Our projects are five- and six-figure contracts," says Wetpaint CEO Ben Elowitz. "We're affordable to big companies, who farm out the project to us."

But those are exceptions against the backdrop of a gasping economy, caution tech analysts.

The coming months just might be the worst for tech, says Trip Chowdhry, an analyst at Global Equities Research. He anticipates more layoffs, bankruptcies, consolidation, slackening online advertising sales and a dramatic drop in software licensing and subscription revenue.

Many vendors also were overly optimistic about their fourth-quarter revenue, and the dollar has weakened overseas, warns Andrew Bartels, an analyst at Forrester Research.

"It will be surprising if companies do not lay off people," says Mark Mahaney, an analyst at Citi Investment Research. "It shows how difficult conditions have become."

'Time to start a new crop'

Still, there are opportunities for enterprising venture capitalists and entrepreneurs to prosper during such hard times. Who knows? One of them could end up being the next Cisco or Facebook.

"Time to start a new crop," says Dixon Doll, co-founder of VC firm DCM.

"This is the biggest challenge of our lifetime," Cisco's Chambers says. "The question is, do we take the opportunity and come out significantly better? I think our country, and the tech industry, will."

Contributing: Matt Krantz in Los Angeles