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The StoneWood Perspective

A STONEWOOD GROUP INC. BULLETIN

Never Ever Quit!!

An Interview with Castek Founders Fay and Yung Wu

Castek Software was founded in 1990 by siblings Yung and Fay Wu, along with a third partner who exited the business in 1999.

Initially funded with $60,000 in credit card debt, the partners nurtured the firm into a successful and profitable international enterprise software company, with revenues approaching $40mm, and double that in committed order backlog. The founders risked it all and raised $70mm over three major financing rounds in an effort to become the leading insurance software vendor in the market.

The ensuing product launch was overwhelmingly successful with over $72mm in orders in the first year alone. With staffing more than doubling to almost 400 employees, the company raced to deal with the enviable challenges of hyper-growth, when it was suddenly hit by the 'perfect storm' triggered as the impact of 9/11 pulled the rug out from under its customers in the insurance sector. The company went from winning 60% of the new deals in the US, to having no deals available to any vendors over the ensuing 24 months, in a vertical market which ground to an abrupt halt as insurers cancelled all capital spending and new IT investments. Over the next several years the firm reeled as it retrenched, halving its staff once, then again in a fight to stay alive.

StoneWood Group's Bob Hebert sat down with Yung and Fay Wu as they recounted their 18 year story of perseverance culminating in the successful sale of the firm into the Oracle group of companies in 2008.

Let's start with how you got started?

It was 1990 and we saw an opportunity in the marketplace. A lot of IT projects were late and grossly over-budget; we were convinced we could reengineer tools to reduce the time and cost of many of these projects while increasing the quality of the software in the process. We had the audacious ambition of developing the world's most efficient software factory. Why not?

We thought that our reputations for building systems would enable us to get that first shot to help someone and then we would be off to the races. We were young and each of us had credit cards, so why not? Curiously, the times were somewhat similar to today. The market was very soft and everyone was cost cutting. Capital budgets were being reduced left, right and centre. As a result, organizations were quite amenable to seemingly wildcat ideas and to companies that promised substantive improvements and savings over simply incremental ones.

Who was your first client and how did you leverage them?

The country's major airline carrier was contemplating a new fuel inventory management system. We approached them and offered to plan and prototype a system; and even construct the project architecture at our risk. We told them that after one month, if they liked what they saw, they could hire us, otherwise walk away without having risked a penny. We put our hearts and souls into that project, they loved what we did, hired us for the whole project, and we were off to the races. That project led to us landing projects at Confederation Life and the Bank of Canada, which led to projects at Zurich Insurance in Canada and then onwards to Zurich in UK and other parts of their worldwide operations.

They say that necessity is the mother of invention. We were undercapitalized yet had to be better, faster and cheaper than our competitors. We had to be creative and in time developed the component-based-development (CBD) methodology that really distinguished us. The market noticed, and by 1997 we had grown at a compound annual growth rate of 80% and were doing $20mm in sales per year with continuing profitability.

What were the biggest challenges of scaling the business during the period?

As with many services businesses, our biggest challenge was predictability of growth. The business was very lumpy, changing by dramatic step-ups rather than in a smooth curve. By pursuing big customers with big projects we learned fast how easily decision paths can change, be extended and even delayed. Meanwhile we had employees and assets that needed to be deployed in a predictable manner. It was always a challenge balancing the need for growth capital against cash and revenues.

Secondly, human resources were a big issue. As a smaller business we could not afford one-dimensional employees. While we needed superb technical people, we also needed business skills and experience. We needed those same people to be flexible in how they would be deployed. Such seasoned, multi-talented people are hard to find, grow, and even harder to keep, so we needed to instill a culture that would help us attract, motivate and retain such key people. And that is what we did. We invested a lot of time and money in becoming the “Employer of Choice” with one of our key strategies being the ‘Get-Keep-Grow’ program.

For example, we educated and cross-trained over 150 employees in a Master of Business Dynamics program (MBD). This was a multi-year program which brought together a number of North American high growth companies. It brought leading edge thinking from business gurus such as Jim Collins, Gary Hamel, Aubrey Daniels, Jack Stack and Seth Godin who taught our people a wealth of creative problem solving, strategic planning, business measurement, financial literacy, team and personal development skills. In addition to making us a better company, it proved to be a wonderful retention tool for the company as a whole. Even around the Y2K period, when resources were moving readily from company to company, our turnover rate remained less than 5% as our people ate up the opportunity to learn and grow and add to their personal skill sets.

All of that said, our people challenges continued to accelerate as our growth accelerated. During some periods we were growing so fast that we had 3-month new employees still integrating themselves into the company now involved in interviewing, hiring and training even newer employees, and it became even more challenging to maintain a common focus and remain cohesive.

How did the two of you keep ahead of the learning curve?

It was not easy, but we took it seriously. We looked for opportunities to put ourselves through our own personal “continuous improvement” processes by taking part in executive development programs offered by leading institutions such as MIT, joining the Young Entrepreneurs Organization (YEO) and Young Presidents Organization (YPO), all the while networking and participating in various industry groups and forums where we would compare notes with other like-minded entrepreneurs and successful business people. We made sure our senior team continued their education both in-house and externally and selectively added seasoned industry players along with consultants to advise us on designing and implementing programs and processes for a more complex organization. Concurrently, we worked hard to build a board of directors and advisors who brought wisdom, contacts, and valuable experience to the company.

At no point did we assume that we knew it all. In fact, we made enough mistakes to keep us humble. Like many young entrepreneurs we learned the hard way about hiring senior executives, what works and what does not work.

You then decided to become a product company. Can you explain the shift?

We were a profitable company from year one all the way through to our $20mm in sales in 1997. But the writing was on the wall. As we grew we undertook larger projects whose financing requirements expanded and became more sophisticated. We serviced multiple customers and the complexity of the overall business grew. We became increasingly concerned about our ability to continue to scale the business.

Because we had such a strong relationship with Zurich Insurance, we had built quite a library of building blocks and thought that we could readily assemble them and develop solutions that we could sell to multiple companies. We felt that we could build a core product with at least 65% of every solution pre-engineered and pass some of the savings onto our clients. We spent more and more time thinking we should be a product company.

What happened next?

We developed a plan and went out to raise money. We calculated that we needed $25mm to develop and launch the product over the next 18-24 months. We then knocked on a number of investor doors. They clearly liked our story as we were able to raise over $30mm bringing our total capital raised to approximately $70mm over three major financing rounds.

We then worked furiously to transform the company. We sold off and closed non-core pieces of the services business and aligned everything towards the future insurance enterprise software company we were determined to become. Aspects of the transition proceeded well while others did not. We clearly underestimated the length of time it would take us to finish the product. In fact it took us twice as long and cost twice as much as we had anticipated. We had to manage our investor expectations carefully, despite a few bumps along the way. As we got closer we ramped up our team to launch the product.

How did the market react?

It responded spectacularly. Everyone speaks of the proverbial hockey stick curve. Well we actually had it. We booked almost $73mm in orders by October 2000. It was redemptive as it validated our vision but it was also overwhelming. The accolades came in - we were selected one of Canada's 50 Best Managed Private Companies in 2000, and received Branham Group's award for best Product Launch of the Year in 2001 followed by the Best Transformation Company of the Year in 2002.

Did everything come together after that?

Of course not! We found ourselves trying to finish the product while meeting all of the market demand. We underestimated the degree of customization that our clients would require. We sold into large insurance companies who liked things their way and we learned fast that there was little we were going to sell off the shelf.

Implementing our solution proved to be another matter altogether. We had entered into partnership agreements with global partners such as PWC and IBM and we had to get them up to speed quickly. We were hiring so many people that we had new people training even newer people. We were running as fast as we could and it was quite a frenetic time.

Speaking of people, as we noted earlier we had invested a lot of time and effort into the Castek culture. This became very difficult to preserve when we were growing from 160 to 300 to 400 employees in a very short period of time.

In addition, with the exploding sales, came a huge spike in our working capital costs. Juggling all of those balls at the same time given the size and scale of each project was like nothing we had ever encountered. That said, we are convinced to this day that we would have figured it out had it not been for what came next.

What changed?

In essence all hell broke loose. First the tech bubble started to burst which affected everyone. In our instance that paled compared to the impact of 9/11 which profoundly affected our target market, the insurance sector. In the ensuing two years the insurance sector experienced a huge turndown. In fact, we went from winning 60% of all of the enterprise insurance deals to none in the next 24 months. To be clear, we did not lose them to someone else; there were simply no deals to be had. None! It was the perfect storm.

One of the big lessons for us in all of this is about risk management. There is a constant dynamic in startups about spreading your risks across multiple markets versus dominating a single market. We had abandoned several healthy vertical markets in favor of becoming the market leader in one very large sector, insurance. Even though 90% of our business came from only a few customers, they were significant customers and we spent a lot of time expanding that customer base. We never contemplated that it would all disappear at the same time. We should have. However, even in hindsight, we might have backed into the same trade-offs. There are likely a lot of startup companies today who put all of their eggs in the financial services marketplace only to ask themselves the same questions.

What did you do?

We were very fortunate that we had just completed our 'C' round of financing just prior to everything coming apart so we had a little time. That said, once we realized what was upon us, we reacted fast and over the next 12 months disassembled over 75% of the company over three rounds of cuts. It was an extraordinarily difficult time. We were extremely open with everyone and there were no surprises. Nevertheless, extremely difficult decisions had to be made and lives affected.

We had to extend our cash runway to survive, so we cut costs and scrambled and scrambled some more. By the time it was all over we were down to less than 40 people. We looked in every nook and cranny for ways to stay alive. For example, we realized at one point that we had significant tax losses and R&D credits that we could monetize. We did some fancy footwork to restructure the legal entity and move our IP assets into a newly created company so that we could monetize our tax credits. In the process we ended up with an interest in an oil and gas exploration company. This provided some cash to the shareholders and the company and got us through a difficult period. As an interesting sidebar, that oil company eventually struck oil, and some of our shareholders actually did pretty well with that transaction.

What happened then?

Eventually the market started to normalize and we started to see opportunities again. But by that time we had a new problem. We had shrunk so much that we were no longer considered credible by the markets we were selling into. Suddenly, our dream of global market leadership was no longer attainable. We had fought and fought to retain our market leading IP and our smartest people but our very large, very conservative customer base now feared for our long term viability and ongoing ability to invest in the product

It became clear that we needed a strategic investor, but we were a 'C' round company with a complex preference share structure and a large group of existing investors. We had to first clean all of that up and somehow recapitalize into an all common-shares company that would be attractive to a new investor. That was incredibly difficult, as you can imagine, but we pulled it off. We have to give full kudos to our investors for working with us through this process.

We then approached new strategic investors who all told us the same thing, "we are intrigued by your insurance product but come back when you have a major customer and we will talk". This was easier said than done as the customers all wanted us to bring a strategic investor to the table before they would work with us. This lovely Catch 22 lead us down a double trigger strategy in which we went back and forth, back and forth between customers and investors, each time inching discussions further and further ahead, one non-binding letter after the other, until we had enough in writing from both sides to consummate a deal.

In addition, our potential investors demanded that we too step up to the plate and put skin in the game so we had to demonstrate our belief by putting our own cash back on the table. We came full circle, putting everything back on the line again. In the end, it took us 8 months, with each month inching closer than the month before to the end of the line, but we got a deal done with a major customer and with the Oracle group of companies as a strategic investor.

Were you pleased with the outcome?

The market was still soft and we were in a weak negotiating position. We could neither dictate valuation nor terms, so we agreed to a deal that was stepped and provided considerable upside to our shareholders, if we could deliver results over the next couple of years.

We were confident that as soon as the market came back to life we would soar once again, so we figured this was our best bet. And sure enough over the next two years we shot the lights out on revenues and drove uptake in the market. Seeing that its risk had now been mitigated, Oracle exercised its option early to buy the rest of the company so that it could fully integrate the intellectual property and the team into its Financial Services Global Business Unit.

Looking back, what were the most important lessons learned?

We learned many things. We learned that stuff happens and that running a business involves the ability to play offence and defense as needed. You can only see so far ahead and one has to be able to adapt to what comes along. There are no straight lines to success.

Second, we always espoused an open book philosophy and that saved us many times. We were truthful and forthright with our employees and I believe that played a big role in them trusting and following us through thick and thin. We were also always honest and open with our investors and board. We cannot tell you how important that became when things got tough. To their immense credit, each and every one of them hung in there and worked with us to find solutions that ultimately saved the company and allowed us to fight another day.

Third, Castek turned out to be an eighteen year old overnight success story. We were a testament to the unpredictability of building successful organizations and the need for time. Time to learn, time to execute, time to adapt, time to recover and figure things out. Investors truncate time. By virtue of the life spans of their funds and the expectations of their own limited partners, time becomes the cost of money rather than an asset. Entrepreneurs need to manage this dynamic very carefully. While promises of hockey stick growth curves and short term exits are music to investors' ears, they will get you killed when you cannot deliver to the perfect alignment of those stars. This is why a measure of honesty and over-communication with boards and investors is so important because you will need to buy buffers of good faith for the surprises which are certain to hit you.

Finally, never ever quit. We never stopped believing in ourselves or our company despite its many ups and downs. Maybe it is because we were the founders and it was very personal to us, but there was no way we were going to fail. Perseverance is a funny thing. It was when the road got darkest and most treacherous that we found a way to materialize the impossible which often was just around the corner.

We are convinced that adversity is like some cosmic test for which only adaptability and perseverance combined with operating smarts can get you to the right answer. We believe in this so much that we have set up a new business venture to provide financing and expertise to companies in order to accelerate them to next level. It is called NFQ! Ventures, with the first word being 'never' and the last being 'quit'. You can fill in the blank for the middle word.

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