Harvard Business Review
www.hbrreprints.org

HBR Case Study

Should Harbinson recommend further investment in Seven Peaks?

Good Money After Bad?

by John W. Mullins

Reprint R0703X

Jack Brandon's initial idea has not panned out, and the cash is nearly gone. But he's got a new plan. Will you back him a second time?

HBR CASE STUDY

Good Money After Bad?

by John W. Mullins

From a rocky perch overlooking the sparkling lights of San Francisco, Christian Harbinson gazed across the bay to the hills above Sausalito. "There's nothing like a vigorous hike," he thought, "to clear the mind before a crucial meeting." It was a mild March evening, and the 35-year-old venture capitalist was reflecting on the recommendation he would have to make to his firm's investment committee the next morning about Jack Brandon's young company, Seven Peaks Technologies.

Seven Peaks had developed an innovative device for cauterizing blood vessels during electrosurgery, and although the feedback from surgeons had been excellent, sales had been slow. The Palo Alto–based venture capital firm where Harbinson worked, Scharfstein Weekes, had invested $600,000 in Seven Peaks from its newly raised second fund of $100 million. SW's current investment strategy focused on early-stage medical technology companies, and Seven Peaks was a typical investment for the firm, which liked to get in on promising ideas modestly and then follow with additional rounds of capital after technological and market milestones had been met. The $600,000 was nearly gone; Harbinson and his colleagues had to decide whether to put more into the struggling company.

Seven Peaks was looking for another $400,000 to develop a second product based on its proprietary technology, which enabled surgical instruments to do their work without sticking to tissue—a frustrating problem for most electrosurgeons. Brandon still believed in his technology and in his ability to commercialize it. Harbinson was impressed both with Brandon and with the technology's potential, but some of the senior partners were not so sure. "Would we simply be throwing good money after bad?" SW's cofounder Joe Scharfstein had asked when Harbinson told the investment committee of

HBR's cases, which are fictional, present common managerial dilemmas.

the request from Seven Peaks. "Does Jack Brandon really deserve a second chance?"

Plan A

Brandon, now 37 years old and trained as an engineer, had worked on the R&D side of the medical devices industry for most of his career. Three years before Harbinson's evening hike, Brandon had discovered almost by accident that instruments made of a particular titanium alloy were much less likely than conventional stainless steel instruments to stick to tissue during surgery. When his employer chose not to support him in following up on this discovery, Brandon had decided to take the leap and try to commercialize it on his own.

He had used nearly $65,000 of his savings to build a rough prototype of a cauterization device. He chose cauterization because the alloy's nonstick quality would make a real difference to the success of the procedure. Prototype in hand, Brandon approached investors in the medical devices arena to raise the capital necessary to make his device fully functional, get FDA approval, and bring it to market.

SW was one of the first firms Brandon approached, about a year after his discovery. He was in luck, because the firm was actively looking to invest in medical devices as a means of diversifying its health care portfolio. Lynne Weekes, SW's other founding partner, had liked the technology and thought it had applications beyond Brandon's original vision. She was also impressed by his commitment, as evidenced by his leaving his job and investing his own money in the venture.

Harbinson joined the firm about six months later as an associate. He was immediately assigned to watch over the Seven Peaks project, which was ideally suited to his experience: Before joining SW out of Stanford Business School, Harbinson had worked in the medical devices industry both as a scientist (with two patents to his name) and as part of the business development group at a leading surgical instruments firm. He was quickly won over by the science behind the product and by Brandon's abilities as an entrepreneur.

The Launch

Brandon had certainly done his homework. As Harbinson knew from experience, word of mouth could make or break a new product in the industry; surgeons in particular liked to compare notes and talk to one another about new developments. To make sure he was on the right path, Brandon had given his prototype to a few surgeons he knew to learn what they thought of it. "Too large," one of them said. "It will block my view of the surgical site." Another told him, "I like how it works and saves me time, but it's a lot of trouble to take it apart after each procedure in order to sterilize it."

Brandon redesigned his device based on the feedback, and after several months of diligent work, he won FDA approval. The redesign was smaller and thinner for better access to the surgical site and required no disassembly for sterilization. It was time to see how the market would react.

Harbinson was equally impressed by Brandon's showmanship. The Seven Peaks cauterizer made its debut at a surgical trade show in Atlanta. It was the talk of the fair. Brandon had bought some fish from a local market, and he did side-by-side operations on them with his device and with conventional instruments to demonstrate how the former could cauterize blood vessels in less than half the time. Everyone came to look, if only to see what was causing the smell of cooking fish. A few surgeons who ran their own clinics ordered the device on the spot, while others asked for follow-up calls. Two surgical-products distributors agreed to take on the cauterizer and offer it to their clients. Within a month, a couple of leading surgeons had become so excited by its effectiveness that they agreed to provide testimonials and to let Seven Peaks shoot video footage of them using the device. One of the surgeons proclaimed on the video, "On a scale of one to ten in terms of sticking, it's a zero."

Brandon's device gave surgeons the ability to quickly and reliably stop bleeding. Conventionally, surgeons would use electrosurgical forceps to cauterize capillaries or arteries one by one—a time-consuming procedure. Time is money to a busy surgeon. More important, in Brandon's view, because adjacent tissue often stuck to the forceps, as a surgeon sealed one vessel, another would frustratingly open. The cauterizer could seal multiple vessels at once, and it didn't stick.

Plan B

Despite the testimonials and more than a year of further efforts, Brandon had little tangible

John W. Mullins (jmullins@london.edu) is an associate professor at London Business School in England. He is the author of *The New Business Road Test: What Entrepreneurs and Executives Should Do Before Writing a Business Plan* (FT/Prentice Hall, 2006).

Harbinson was quickly won over by Brandon's abilities as an entrepreneur and by his showmanship. When the cauterizing device made its debut at a surgical trade show in Atlanta, it was the talk of the fair.

progress to report. The new instrument was proving difficult to sell, and because it could be reused hundreds of times with no decline in performance, surgeons who had tried it and liked it had no reason to reorder. One of the distributors had returned most of its initial inventory; a single-product line in only two sizes simply wasn't a top priority in sales calls to surgeons and hospital buying groups. The distributor had commented, "We really need a device that sells itself."

Brandon was confident that he understood the problem. "It's a tough sale for a number of reasons," he had told Harbinson and the other Seven Peaks board members during a review of preliminary sales figures. "We're a new company that most surgeons have never heard of. What's more, to make a sale, we have to convince the surgeon that the device works as advertised, and also that using a specialized cauterizer instead of forceps makes sense. It's new to most surgeons, and changing their behavior doesn't come easily. But perhaps the biggest problem is that distributors don't have much incentive to show our tool. It's a very small product line, and even if surgeons like it, there's little reason to reorder because of how long it lasts. The educational process is an uphill road."

"That seems like a pretty big hill to climb," Harbinson put in. "How do you propose to do it?"

"I don't propose to try," Brandon replied. "I think I've found a better way forward. A plastic surgeon told me last week, 'If you could make a line of electrosurgical forceps with the same nonstick properties, I'd buy them.' As we all know, surgeons use forceps in pretty much every surgical procedure, and they need them in a dozen or more sizes. We should be able to use our nonstick alloy in forceps, and forceps wouldn't have many of the drawbacks we've been facing to date. Surgeons use as many as six or eight of them for each procedure. If a surgeon does two or three procedures a day, that's a lot more demand than we seem to have for our current device. And we wouldn't have to change the surgeons' behavior, as we do now."

"If we go this way, there are a couple of questions we will have to address," Brandon continued. "First, what market should we target? Most plastic surgeons run their own clinics, and sticking tissue may be a crucial problem for them, given the importance of appearance to their surgical results. So they might be a good place to start. But other target markets could be attractive as well, including surgeons who do most of their work in hospitals. The typical hospital has half a dozen operating rooms and two or three procedures a day in each room, plus some backup stock. That's a lot of forceps to sell."

Brandon thought he could develop a forceps prototype in less than a year and put it into some surgeons' hands for feedback. FDA approval could also be won in that time, with limited production and sales starting soon thereafter. But his small team would have to spend nearly all its time developing a line of forceps, finding suppliers, working out a new design and production details, and filing patent applications—time that would have to be taken away from marketing the cauterizer, which still held some promise.

Brandon projected a spreadsheet on the room's whiteboard. His preliminary figures suggested that Seven Peaks would lose money in the first year on a modest level of sales and then double sales the following year. Revenues would come initially from sales to plastic surgeons, broadening to include other surgeons in hospitals after two years. He expected to reach break-even in the third year. It was clear that he had put a lot of work into the plan and was ready to move. Harbinson couldn't help feeling a little steamrollered, but he agreed to present the plan to the Scharfstein Weekes investment committee at its next meeting.

Will It Fly?

The investment committee met just three days later. The partners gave Brandon's idea a rough ride. Joe Scharfstein was especially critical. "Why didn't Brandon think about this issue with the distributors earlier?" he asked. "Given that mistake, how can we be sure that his marketing plan for the forceps will work? They take forever to make decisions in hospitals, and I can see us next year right back where we are today. And what about the competition? At least the cauterizer is something new. This is just a fancy twist on a product that a lot of big firms are already selling. I don't suppose they'll take this lying down. Does Seven Peaks have the ability to compete with the big guys? Is there anyone on Brandon's team who can put a real business plan together?"

"Distributors don't have much incentive to show our tool," Brandon said. "It's a very small product line, and there's little reason to reorder because of how long it lasts. The educational process is an uphill road."

Karl Schumacher, another SW partner, from the pharmaceutical side, joined in: "What about the technology, Christian? Can they adapt it to produce forceps? They're a lot smaller than the cauterizer, aren't they? I'm sure Seven Peaks can get a prototype going, but can they manufacture anything commercially? Perhaps we should be thinking in terms of making a trade sale to someone who can really develop the technology rather than putting more money in ourselves."

At this point, Scharfstein, whose own focus was on drug delivery technologies, added, "If nonstick instruments are such a good idea, why haven't the bigger players in the industry come calling yet? Where I come from, the big boys are all over the start-ups."

Lynne Weekes, who had approved the initial investment and later assigned Harbinson to supervise it, spoke up. "I think this should really be Christian's call," she said. "Christian, why don't you go over the plan and give us a recommendation at next week's meeting? If you feel strongly that Brandon deserves a second chance, then we'll invest. But don't be afraid to turn him down—there'll be other opportunities for SW. Think about the questions we've raised here today. Now let's move on to the next item. Christian, could you ask Peter to come in?"

Harbinson left the room with his mind racing. How should he interpret that exchange? Joe and Lynne were known to be very close, and yet here was Joe aggressively critiquing an investment that Lynne had made. "Whatever else," he thought, "this recommendation is not going to be easy to work out."

Put to the Test

A week later, from his perch above San Francisco, Harbinson thought he understood a little better what was going on. The recommendation was as much a test of his abilities as a VC as it was a decision on the investment itself. Joe and Lynne wanted to see what he had learned in his 18 months at SW. Joe's critique, another associate had told him shortly afterward, was typical. Whenever a particular investment got into trouble, Lynne and Joe always did some kind of double act, with one or the other of them as the bad cop.

"They play that game all the time," the associate said. "The idea is to prevent the associate from getting too close to the investment emotionally and to give each other an out, I think. Don't worry too much about it. Decide what you honestly believe the firm should do, but try to distance yourself. There really are more investments we can make, so don't feel that pulling out is such a failure. You know that we do it all the time."

Harbinson started back down the hill to his San Francisco home, nestled just east of the University of California's famous medical research hospital on Parnassus, where some of Brandon's early trials had been conducted. There was little doubt in his mind that Brandon's technology had real promise, somewhere, somehow. But how long—and how much of SW's money—would it take to find the right application and the right market? Very few deals actually panned out in any early-stage portfolio. "The easy answer is probably to say no," Harbinson thought, as he watched a container vessel pass under the Golden Gate Bridge and set forth into the open sea. "On the other hand, if we stay at it, can this be one of the winners?"

No one could have made a better effort than Brandon had, and his commitment was unquestionable. "Jack's a really good guy," Harbinson thought. "He's given it his all. I believe in him. But I wonder if I'm too close to the deal. Am I able to view it objectively, given that we've worked together to bring things this far? If I support the investment, will the partners think I'm not hard-nosed enough to be a VC?"

Should Harbinson recommend further investment in Seven Peaks?

Reprint R0703X
To order, see the next page
or call 800-988-0886 or 617-783-7500
or go to www.hbrreprints.org