Venture Capital Issues for G-lab Projects

Outline

1) Venture Capital in Context
   - What are the odds?
   - Stages of Startup Process

2) The Role of Venture Capital

3) Building the Company

What Are the Odds?

- The average VC funds 6 out of every 1,000 business plans received each year.
- Around 60% of funded high-tech startups go bankrupt.
- Around 30% get acquired by other companies or just never hit it big.
- Less than 10% go public.
- Of every 1 million ideas for a high-tech company, six lead to successful public companies.

Source: Nesheim, 2000.

Stages of the Startup Process

- Stage 1: Create the vision
- Stage 2: Get funding
- Stage 3: Build the team and the organization
- Stage 4: Go to market
- Stage 5: Go public

Note: These stages often overlap. Many tasks, such as getting funding, are an ongoing (sometimes seemingly endless) process.

We'll focus here on Stage 2: using finance effectively in building a company

Stage 1: Create the Vision (A)

- What is a vision?
  - Vision ≠ Technology
  - Vision ≠ Product
  - Vision ≠ Market

    (15 business plans to sell pet food over the Internet circulating in Silicon Valley in a single month in 1995)
  - Vision = Technology + Product +Market + Strategy for Creating Sustainable Competitive Advantage

Stage 1: Create the Vision (B)

- But any vision usually starts with a great idea--a breakthrough technology, product, or market opportunity
- Where do great ideas come from?
  - Customers and the people who work with them
    - 71% of entrepreneurs had the idea for their company while at a previous employer: e.g., Oracle as "source organization" for new marketplace software
    - But watch out for the "innovator's dilemma" (Clay Christensen): sticking too close to your customers can lead you to overlook disruptive technologies (e.g, the PC)

Stage 1: Create the Vision (C)

- Where do great ideas come from?
  - Failure
    - Palm Computing's 1st product (the Zoomer) bombed: too big, too slow, too expensive, lousy handwriting recognition

    => Jeff Hawkins learned what a PDA needed to be: small (shirt-pocket size), fast (no boot-up delay), cheap ($300 entry point), and simple to use (one-button synchronization with PCs, Graffiti)

    ⇒Palm's Pilot grabbed 51% of the market in 1st year
  - Ability to overcome adversity: optimism

Stage 2: Get Funding (A)

- How much capital do most startups need?
  - Typically ~$50,000-$200,000 to get off the ground; sources = savings (bootstrap method), friends & family, angels
  - But eventually most companies need real money, ~$1 million or more:
    - could come from angels or strategic partners/corporate investors
    - US: usually comes from venture capital

(US funds: $179m in 1979; $24bn by 1986; >$100bn today)

    - Non-US: often from retained earnings

Stage 2: Get Funding (B)

- What do VCs look for?
  - A large-fast growing market
  - Great technology that can be commercialized
  - A business, not a product
  - Most important: "I invest in people, not ideas" (Arthur Rock)
    - Only around 1/4 of entrepreneurs write full-blown business plans
    - A typical VC fund receives over 2,000 plans each year and automatically sends a rejection letter, *unless there is already a key endorsement or the founder is a "serial entrepreneur."*

Stage 2: Get Funding (C)

- What can a VC do for you?
  - Help in recruiting CEO and other key staff
  - Provide key endorsements, open doors to partners and other investors
  - Advise on strategy and operations (even if you don't want advice…)
- Bottom line: It's not just about money: There's smart money, and then there's dumb money.

  =>Get smart money

  Or find alternative ways to get the same kind of help

Stage 2: Get Funding (D)

- What does a VC want in return?
- Investors in VC pools want to average 25% annual returns, and each success has to pay for 9 failures
  - => In order to make his/her business work, a VC has to get a big chunk of each startup at the lowest possible price
    - => Danger for entrepreneurs of giving away the store: need to keep equity for personal return and ability to recruit
    - ⇒Danger of losing control over the company
- Get professional advice on the term sheet (it's not that difficult, and a little experience will get you a long way)

Stage 2: Get Funding (E)

- Who are the owners when the typical startup goes public in the US?
  - Founders usually have 2%-10% of company
  - CEO has at least 3% (more if very experienced)
  - Other employees share around 20%
  - Investors own in the range of 50% (Internet) and 60% (software) and 70% (hardware)
- Outside the US, many entrepreneurs prefer to retain control; their fear of powerful shareholders is completely justified…

Stage 3: Build the Team & Organization

- Be prepared for the team and organization to evolve as the company grows
  - Time 0 to Time 1: Dynamic enthusiasts
  - Time 1 to Time 10: People who prefer rules and precise job descriptions (Gary Mueller, Internet Securities)
- This is particularly true at the top of the organization: Founder CEOs seldom remain in an operating capacity for more than 3 years

Stage 4: Go to Market (A)

- Two common misconceptions
  - Being the first mover is everything
  - Market share is everything
- In fact:
  - Even in markets with strong network effects and potential for lock-in, execution is at least as important as speed.
  - Market share with no prospect of profitability won't get you very far (now that the Internet bubble has burst…)
- Bottom line: Just because you're running a startup, doesn't mean the basic rules of strategy don't apply.

Stage 4: Go to Market (B)

- In today's environment, cash is king
- All investors are looking for projects that are already or can quickly become cash flow positive
  - these may not be instant hits but they won't bleed the VC fund/create need for "down rounds"
- Maybe start with a service that can be sold to large customers with deep stable pockets; turn this into products later

Stage 5: Go Public?

- IPOs seen as the ultimate goal
  - IPO market in the US has been a great success; there has been some acceleration of company development: median company that did go public took 9.4 years to get there in 1980 and only 4.1 years in 1999
  - But going public is not the only way to succeed
    - public market is highly cyclical, so it can be hard to raise capital in this way at the right time
    - selling to large company can be attractive (e.g., Intel, Cisco)
    - can also stay private & keep control (Microsoft was private for 11 years)

Implications

- "Stigma of failure" is fading in Europe, Asia and Latin America, encouraging more entry
- Easier start-up process means intensity of competition is increasing
- Wave of new technology-based entrepreneurship outside the US is probably only beginning (not ending)
- Access to finance for startups varies widely depending on local capital markets and financial conditions

Venture capital will become more readily available

(but not for the next 12 months)

- For now, emphasize quality growth in which the firm maintains a healthy cash flow and the entrepreneurs keep control (check any exceptions very carefully)