Title: Homework Assignment No. 03
Sources of Capital and Legal Issues

Due Date: Tuesday, February 13, 2018, at the Beginning of Class

Description: This assignment is in the form of a short essay responding to a series of questions relative to the chapters assigned in the text thus far in the course, and to the attached supplementary articles.

Requirements: You are to develop an essay answering the following questions. The essay is to be completed individually, and should be between two (2) and four (4) type-written pages, single-spaced, and include a coversheet identifying the pertinent student and course information.

- What information would you consider most critical to present to potential investors?
- What are alternative sources for funding a new venture other than Venture Capital? What are the "pro's" and "con's" of those sources?
- Is Venture Capital worth the effort?
- The law gives provisions on how to protect one's intellectual property. Can a small entrepreneur really enforce it?
- Are patents only attainable for large firms or should a start-up firm consider obtaining one?

Articles: The following supplemental articles are to be used in conjunction with the course text in fulfilling this assignment:

Elsbach, Kimberly. (September 2003). "How to Pitch a Brilliant Idea." *Harvard Business Review.*

Kawasaki, Guy. (January 2001). "The Top Ten Lies of Entrepreneurs." *Harvard Business Review.*

Lobel, Orly. (November 2013). "Filing for a Patent Versus Keeping Your Invention a Trade Secret." *Harvard Business Review.*

Mulcahy, Diane. (May 2013). "Six Myths About Venture Capitalists." *Harvard Business Review.*

Ovans, Andrea. (July 2000). "Can You Patent Your Business Model?" *Harvard Business Review.*

Timmons and Sander. (November 1989). "Everything You (Don't) Want to Know About Raising Capital." *Harvard Business Review.*

Zider, Bob. (November 1998). "How Venture Capital Works." *Harvard Business Review.*

Submission: The assignment is to be submitted in hardcopy form only.

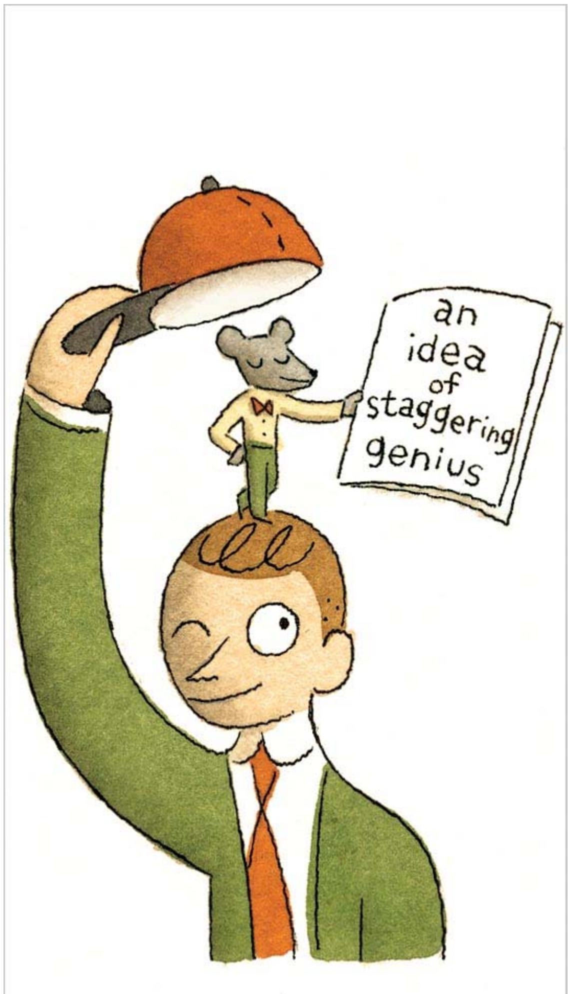
Harvard
Business
Review

COMMUNICATION

How to Pitch a Brilliant Idea

by Kimberly D. Elsbach

FROM THE SEPTEMBER 2003 ISSUE



Coming up with creative ideas is easy; selling them to strangers is hard. All too often, entrepreneurs, sales executives, and marketing managers go to great lengths to show how their new business plans or creative concepts are practical and high margin—only to be rejected by corporate decision makers who don't seem to understand the real value of the ideas. Why does this happen?

It turns out that the problem has as much to do with the seller's traits as with an idea's inherent quality. The person on the receiving end tends to gauge the pitcher's creativity as well as the proposal itself. And judgments about the pitcher's ability to come up with workable ideas can quickly and permanently overshadow perceptions of the idea's worth. We all like to think that people judge us carefully and objectively on our merits. But the fact is, they rush to place us into neat little categories—they stereotype us. So the first thing to realize when you're preparing to make a pitch to strangers is that your audience is going to put you into a box. And they're going to do it really fast. Research suggests that humans can categorize others in less than 150 milliseconds. Within 30 minutes, they've made lasting judgments about your character.

These insights emerged from my lengthy study of the $50 billion U.S. film and television industry. Specifically, I worked with 50 Hollywood executives involved in assessing pitches from screenwriters. Over the course of six years, I observed dozens of 30-minute pitches in which the screenwriters encountered the "catchers" for the first time. In interviewing and observing the pitchers and catchers, I was able to discern just how quickly assessments of creative potential are made in these high-stakes exchanges. (The deals that arise as a result of successful screenplay pitches are often multimillion-dollar projects, rivaling in scope the development of new car models by Detroit's largest automakers and marketing campaigns by New York's most successful advertising agencies.) To determine whether my observations applied to business settings beyond Hollywood, I attended a variety of product-design, marketing, and venture-capital pitch sessions and conducted interviews with executives responsible for judging creative, high-stakes ideas from pitchers previously unknown to them. In those environments, the results were remarkably similar to what I had seen in the movie business.

People on the receiving end of pitches have no formal, verifiable, or objective measures for assessing that elusive trait, creativity. Catchers—even the expert ones—therefore apply a set of subjective and often inaccurate criteria very early in the encounter, and from that point on, the tone is set. If a catcher detects subtle cues indicating that the pitcher isn't creative, the proposal is toast. But that's not the whole story. I've discovered that catchers tend to respond well if they are made to feel that they are participating in an idea's development.

The pitchers who do this successfully are those who tend to be categorized by catchers into one of three prototypes. I call them the *showrunner*, the *artist*, and the *neophyte*. Showrunners come off as professionals who combine creative inspiration with production know-how. Artists appear to be quirky and unpolished and to prefer the world of creative ideas to quotidian reality. Neophytes tend to be—or act as if they were—young, inexperienced, and naive. To involve the audience in the creative process, showrunners deliberately level the power differential between themselves and their catchers; artists invert the differential; and neophytes exploit it. If you're a pitcher, the bottom-line implication is this: By successfully projecting yourself as one of the three creative types and getting your catcher to view himself or herself as a creative collaborator, you can improve your chances of selling an idea.

My research also has implications for those who buy ideas: Catchers should beware of relying on stereotypes. It's all too easy to be dazzled by pitchers who ultimately can't get their projects off the ground, and it's just as easy to overlook the creative individuals who can make good on their ideas. That's why it's important for the catcher to test every pitcher, a matter we'll return to in the following pages.

The Sorting Hat

In the late 1970s, psychologists Nancy Cantor and Walter Mischel, then at Stanford University, demonstrated that we all use sets of stereotypes—what they called "person prototypes"—to categorize strangers in the first moments of interaction. Though such instant typecasting is arguably unfair, pattern matching is so firmly hardwired into human psychology that only conscious discipline can counteract it.

Yale University creativity researcher Robert Sternberg contends that the prototype matching we use to assess originality in others results from our implicit belief that creative people possess certain traits—unconventionality, for example, as well as intuitiveness, sensitivity, narcissism, passion, and perhaps youth. We develop these stereotypes through direct and indirect experiences with people known to be creative, from personally interacting with the 15-year-old guitar player next door to hearing stories about Pablo Picasso.

When a person we don't know pitches an idea to us, we search for visual and verbal matches with those implicit models, remembering only the characteristics that identify the pitcher as one type or another. We subconsciously award points to people we can easily identify as having creative traits; we subtract points from those who are hard to assess or who fit negative stereotypes.

In hurried business situations in which executives must evaluate dozens of ideas in a week, or even a day, catchers are rarely willing to expend the effort necessary to judge an idea more objectively. Like Harry Potter's Sorting Hat, they classify pitchers in a matter of seconds. They use negative stereotyping to rapidly identify the no-go ideas. All you have to do is fall into one of four common negative stereotypes, and the pitch session will be over before it has begun. (For more on these stereotypes, see the sidebar "How to Kill Your Own Pitch.") In fact, many such sessions are strictly a process of elimination; in my experience, only 1% of ideas make it beyond the initial pitch.

How to Kill Your Own Pitch

Before you even get to the stage in the pitch where the catcher categorizes you as a particular creative type, you have to avoid some dangerous pigeonholes: the four negative stereotypes that are guaranteed to kill a pitch. And take care, because negative cues carry more weight than positive ones.

Unfortunately for pitchers, type-based elimination is easy, because negative impressions tend to be more salient and memorable than positive ones. To avoid fast elimination, successful pitchers—only 25% of those I have observed—turn the tables on the catchers by enrolling them in the creative process. These pitchers exude

The pushover would rather unload an idea than defend it. ("I could do one of these in red, or if you don't like that, I could do it in blue.") One venture capitalist I spoke with offered the example of an entrepreneur who was seeking funding for a computer networking start-up. When the VCs raised concerns about an aspect of the device, the pitcher simply offered to remove it from the design, leading the investors to suspect that the pitcher didn't really care about his idea.

The robot presents a proposal too formulaically, as if it had been memorized from a how-to book. Witness the entrepreneur who responds to prospective investors' questions about due diligence and other business details with canned answers from his PowerPoint talk.

The used-car salesman is that obnoxious, argumentative character too often deployed in consultancies and corporate sales departments. One vice president of marketing told me the story of an arrogant consultant who put in a proposal to her organization. The consultant's offer was vaguely intriguing, and she asked him to revise his bid slightly. Instead of working with her, he argued with her. Indeed, he tried selling the same package again and again, each time arguing why his proposal would produce the most astonishing bottom-line results the company had ever seen. In the end, she grew so tired of his wheedling insistence and inability to listen courteously to her feedback that she told him she wasn't interested in seeing any more bids from him.

The charity case is needy; all he or she wants is a job. I recall a freelance consultant who had developed a course for executives on how to work with independent screenwriters. He could be seen haunting the halls of production companies, knocking on every open door, giving the same pitch. As soon as he sensed he was being turned down, he began pleading with the catcher, saying he really, *really* needed to fill some slots to keep his workshop going.

passion for their ideas and find ways to give catchers a chance to shine. By doing so, they induce the catchers to judge them as likable collaborators. Oscar-winning writer, director, and producer Oliver Stone told me that the invitation to collaborate on an idea is a "seduction." His advice to screenwriters pitching an idea to a producer is to "pull back and project what he needs onto your idea in order to make the story whole for him." The three types of successful pitchers have their own techniques for doing this, as we'll see.

The Showrunner

In the corporate world, as in Hollywood, showrunners combine creative thinking and passion with what Sternberg and Todd Lubart, authors of *Defying the Crowd: Cultivating Creativity in a Culture of Conformity*, call "practical intelligence"—a feel for which ideas are likely to contribute to the business. Showrunners tend to display charisma and wit in pitching, say, new design concepts to marketing, but they also demonstrate enough technical know-how to convince catchers that the ideas can be developed according to industry-standard practices and within resource constraints. Though they may not have the most or the best ideas, showrunners are those rare people in organizations who see the majority of their concepts fully implemented.

An example of a showrunner is the legendary kitchen-gadget inventor and pitchman Ron Popeil. Perfectly coiffed and handsome, Popeil is a combination design master and ringmaster. In his *New Yorker* account of Popeil's phenomenally successful Ronco Showtime Rotisserie & BBQ, Malcolm Gladwell described how Popeil fuses entertainment skills—he enthusiastically showcases the product as an innovation that will "change your life"—with business savvy. For his television spots, Popeil makes sure that the chickens are roasted to exactly the resplendent golden brown that looks best on camera. And he designed the rotisserie's glass front to reduce glare, so that to the home cook, the revolving, dripping chickens look just as they do on TV.

The first Hollywood pitcher I observed was a showrunner. The minute he walked into the room, he scored points with the studio executive as a creative type, in part because of his new, pressed jeans, his fashionable black turtleneck, and his nice sport coat. The clean hair draping his shoulders showed no hint of gray. He had come to pitch a weekly television series based on the legend of Robin Hood. His experience as a marketer was apparent; he opened by mentioning an earlier TV series of his that had been based on a comic book. The pitcher remarked that the series had enjoyed some success as a marketing franchise, spawning lunch boxes, bath toys, and action figures.

> Showrunners deliberately level the power differential between themselves and their catchers; artists invert the differential; and neophytes exploit it.

Showrunners create a level playing field by engaging the catcher in a kind of knowledge duet. They typically begin by getting the catcher to respond to a memory or some other subject with which the showrunner is familiar. Consider this give-and-take:

Pitcher: Remember Errol Flynn's *Robin Hood*?

Catcher: Oh, yeah. One of my all-time favorites as a kid.

Pitcher: Yes, it was classic. Then, of course, came Costner's version.

Catcher: That was much darker. And it didn't evoke as much passion as the original.

Pitcher: But the special effects were great.

Catcher: Yes, they were.

Pitcher: That's the twist I want to include in this new series.

Catcher: Special effects?

Pitcher: We're talking a science fiction version of *Robin Hood*. Robin has a sorcerer in his band of merry men who can conjure up all kinds of scary and wonderful spells.

Catcher: I love it!

The pitcher sets up his opportunity by leading the catcher through a series of shared memories and viewpoints. Specifically, he engages the catcher by asking him to recall and comment on familiar movies. With each response, he senses and then builds on the catcher's knowledge and interest, eventually guiding the catcher to the core idea by using a word ("twist") that's common to the vocabularies of both producers and screenwriters.

Showrunners also display an ability to improvise, a quality that allows them to adapt if a pitch begins to go awry. Consider the dynamic between the creative director of an ad agency and a prospective client, a major television sports network. As Mallorre Dill reported in a 2001 *Adweek* article on award-winning advertising campaigns, the network's VP of marketing was seeking help with a new campaign for coverage of the upcoming professional basketball season, and the ad agency was invited to make a pitch. Prior to the meeting, the network executive stressed to the agency that the campaign would have to appeal to local markets across the United States while achieving "street credibility" with avid fans.

FURTHER READING

Storytelling That Moves People

COMMUNICATION INTERVIEW by Bronwyn Fryer

Toss your PowerPoint slides and learn to tell good stories instead.

SAVE SHARE

The agency's creative director and its art director pitched the idea of digitally inserting two average teenagers into video of an NBA game. Initially, the catcher frowned on the idea, wondering aloud if viewers would find it arrogant and aloof. So the agency duo ad-libbed a rap that one teen could recite after scoring on all-star Shaquille O'Neal: "I'm fresh like a can of picante. And I'm deeper than Dante in the circles of hell." The catcher was taken aback at first; then he laughed. Invited to participate in the impromptu rap session, the catcher began inserting his own lines. When the fun was over, the presenters repitched their idea with a slight variation—inserting the teenagers into videos of home-team games for local markets—and the account was sold to the tune of hundreds of thousands of dollars.

Real showrunners are rare—only 20% of the successful pitchers I observed would qualify. Consequently, they are in high demand, which is good news for pitchers who can demonstrate the right combination of talent and expertise.

The Artist

Artists, too, display single-minded passion and enthusiasm about their ideas, but they are less slick and conformist in their dress and mannerisms, and they tend to be shy or socially awkward. As one Hollywood producer told me, “The more shy a writer seems, the better you think the writing is, because you assume they’re living in their internal world.” Unlike showrunners, artists appear to have little or no knowledge of, or even interest in, the details of implementation. Moreover, they invert the power differential by completely commanding the catcher’s imagination. Instead of engaging the catcher in a duet, they put the audience in thrall to the content. Artists are particularly adept at conducting what physicists call “thought experiments,” inviting the audience into imaginary worlds.

One young screenwriter I observed fit the artist type to perfection. He wore black leather pants and a torn T-shirt, several earrings in each ear, and a tattoo on his slender arm. His hair was rumpled, his expression was brooding: Van Gogh meets Tim Burton. He cared little about the production details for the dark, violent cartoon series he imagined; rather, he was utterly absorbed by the unfolding story. He opened his pitch like this: “Picture what happens when a bullet explodes inside someone’s brain. Imagine it in slow motion. There is the shattering blast, the tidal wave of red, the acrid smell of gunpowder. That’s the opening scene in this animated sci-fi flick.” He then proceeded to lead his catchers through an exciting, detailed narrative of his film, as a master storyteller would. At the end, the executives sat back, smiling, and told the writer they’d like to go ahead with his idea.

In the business world, artists are similarly nonconformist. Consider Alan, a product designer at a major packaged-foods manufacturer. I observed Alan in a meeting with business-development executives he’d never met. He had come to pitch an idea based on the premise that children like to play with their food. The proposal was for a cereal with pieces that interlocked in such a way that children could use them for building things, Legos style. With his pocket-protected laboratory coat and horn-rimmed glasses, Alan looked very much the absent-minded professor. As he entered the conference room where the suited-and-tied executives at his company had assembled, he hung back, apparently uninterested in the PowerPoint slides or the marketing and revenue projections of the business-development experts. His appearance and reticence spoke volumes about him. His type was unmistakable.

When it was Alan’s turn, he dumped four boxes of prototype cereal onto the mahogany conference table, to the stunned silence of the executives. Ignoring protocol, he began constructing an elaborate fort, all the while talking furiously about the qualities of the corn flour that kept the pieces and the structure together. Finally, he challenged the executives to see who could build the tallest tower. The executives so enjoyed the demonstration that they green-lighted Alan’s project.

While artists—who constituted about 40% of the successful pitchers I observed—are not as polished as show-runners, they are the most creative of the three types. Unlike showrunners and neophytes, artists are fairly transparent. It’s harder to fake the part. In other words, they don’t play to type; they *are* the type. Indeed, it is very difficult for someone who is not an artist to pretend to be one, because genuineness is what makes the artist credible.

The Neophyte

Neophytes are the opposite of showrunners. Instead of displaying their expertise, they plead ignorance. Neophytes score points for daring to do the impossible, something catchers see as refreshing. Unencumbered by tradition or past successes, neophytes present themselves as eager learners. They consciously exploit the power differential between pitcher and catcher by asking directly and boldly for help—not in a desperate way, but with the confidence of a brilliant favorite, a talented student seeking sage advice from a beloved mentor.

Consider the case of one neophyte pitcher I observed, a young, ebullient screenwriter who had just returned from his first trip to Japan. He wanted to develop a show about an American kid (like himself) who travels to Japan to learn to play *taiko* drums, and he brought his drums and sticks into the pitch session. The fellow looked as though he had walked off the set of *Doogie Howser, M.D.* With his infectious smile, he confided to his catchers that he was not going to pitch them a typical show, “mainly because I’ve never done one. But I think my inexperience here might be a blessing.”

He showed the catchers a variety of drumming moves, then asked one person in his audience to help him come up with potential camera angles—such as looking out from inside the drum or viewing it from overhead—inquiring how these might play on the screen. When the catcher got down on his hands and knees to show the neophyte a particularly "cool" camera angle, the pitch turned into a collaborative teaching session. Ignoring his lunch appointment, the catcher spent the next half hour offering suggestions for weaving the story of the young drummer into a series of taiko performances in which artistic camera angles and imaginative lighting and sound would be used to mirror the star's emotions.

Many entrepreneurs are natural neophytes. Lou and Sophie McDermott, two sisters from Australia, started the Savage Sisters sportswear line in the late 1990s. Former gymnasts with petite builds and spunky personalities, they cartwheeled into the clothing business with no formal training in fashion or finance. Instead, they relied heavily on their enthusiasm and optimism and a keen curiosity about the fine points of retailing to get a start in the highly competitive world of teen fashion. On their shopping outings at local stores, the McDermott sisters studied merchandising and product placement—all the while asking store owners how they got started, according to the short documentary film *Cutting Their Own Cloth*.

The McDermott sisters took advantage of their inexperience to learn all they could. They would ask a store owner to give them a tour of the store, and they would pose dozens of questions: "Why do you buy this line and not the other one? Why do you put this dress here and not there? What are your customers like? What do they ask for most?" Instead of being annoying, the McDermotts were charming, friendly, and fun, and the flattered retailers enjoyed being asked to share their knowledge. Once they had struck up a relationship with a retailer, the sisters would offer to bring in samples for the store to test. Eventually, the McDermotts parlayed what they had learned into enough knowledge to start their own retail line. By engaging the store owners as teachers, the McDermotts were able to build a network of expert mentors who wanted to see the neophytes win. Thus neophytes, who constitute about 40% of successful pitchers, achieve their gains largely by sheer force of personality.

> If they rely too heavily on stereotypes, idea buyers might overlook creative individuals who can truly deliver the goods.

Which of the three types is most likely to succeed? Overwhelmingly, catchers look for showrunners, though artists and neophytes can win the day through enchantment and charm. From the catcher's perspective, however, showrunners can also be the most dangerous of all pitchers, because they are the most likely to blind through glitz.

Catchers Beware

When business executives ask me for my insights about creativity in Hollywood, one of the first questions they put to me is, "Why is there so much bad television?" After hearing the stories I've told here, they know the answer: Hollywood executives too often let themselves be wooed by positive stereotypes—particularly that of the showrunner—rather than by the quality of the ideas. Indeed, individuals who become adept at conveying impressions of creative potential, while lacking the real thing, may gain entry into organizations and reach prominence there based on their social influence and impression-management skills, to the catchers' detriment.

Real creativity isn't so easily classified. Researchers such as Sternberg and Lubart have found that people's implicit theories regarding the attributes of creative individuals are off the mark. Furthermore, studies have identified numerous personal attributes that facilitate practical creative behavior. For example, cognitive flexibility, a penchant for diversity, and an orientation toward problem solving are signs of creativity; it simply isn't true that creative types can't be down-to-earth.

Those who buy ideas, then, need to be aware that relying too heavily on stereotypes can cause them to overlook creative individuals who can truly deliver the goods. In my interviews with studio executives and agents, I heard numerous tales of people who had developed reputations as great pitchers but who had trouble producing usable scripts. The same thing happens in business. One well-known example occurred in 1985, when Coca-Cola announced it was changing the Coke formula. Based on pitches from market researchers who had tested the sweeter, Pepsi-like "new Coke" in numerous focus groups, the company's top management decided that the new formula could effectively compete with Pepsi. The idea was a marketing disaster, of course. There was a huge backlash, and the company was forced to reintroduce the old Coke. In a later discussion of the case and the importance of relying on decision makers who are both good pitchers and industry experts, Roberto Goizueta, Coca-Cola's CEO at the time, said to a group of MBAs, in effect, that there's nothing so dangerous as a good pitcher with no real talent.

If a catcher senses that he or she is being swept away by a positive stereotype match, it's important to test the pitcher. Fortunately, assessing the various creative types is not difficult. In a meeting with a showrunner, for example, the catcher can test the pitcher's expertise and probe into past experiences, just as a skilled job interviewer would, and ask how the pitcher would react to various changes to his or her idea. As for artists and neophytes, the best way to judge their ability is to ask them to deliver a finished product. In Hollywood, smart catchers ask artists and neophytes for finished scripts before hiring them. These two types may be unable to deliver specifics about costs or implementation, but a prototype can allow the catcher to judge quality, and it can provide a concrete basis for further discussion. Finally, it's important to enlist the help of other people in vetting pitchers. Another judge or two can help a catcher weigh the pitcher's—and the idea's—pros and cons and help safeguard against hasty judgments.

One CEO of a Northern California design firm looks beyond the obvious earmarks of a creative type when hiring a new designer. She does this by asking not only about successful projects but also about work that failed and what the designer learned from the failures. That way, she can find out whether the prospect is capable of absorbing lessons well and rolling with the punches of an unpredictable work environment. The CEO also asks job prospects what they collect and read, as well as what inspires them. These kinds of clues tell her about the applicant's creative bent and thinking style. If an interviewee passes these initial tests, the CEO has the prospect work with the rest of her staff on a mock design project. These diverse interview tools give her a good indication about the prospect's ability to combine creativity and organizational skills, and they help her understand how well the applicant will fit into the group.• • •

One question for pitchers, of course, might be, "How do I make a positive impression if I don't fit into one of the three creative stereotypes?" If you already have a reputation for delivering on creative promises, you probably don't need to disguise yourself as a showrunner, artist, or neophyte—a résumé full of successes is the best calling card of all. But if you can't rely on your reputation, you should at least make an attempt to match yourself to the type you feel most comfortable with, if only because it's necessary to get a foot in the catcher's door.

Another question might be, "What if I don't *want* the catcher's input into the development of my idea?" This aspect of the pitch is so important that you should make it a priority: Find a part of your proposal that you are willing to yield on and invite the catcher to come up with suggestions. In fact, my observations suggest that you should engage the catcher as soon as possible in the development of the idea. Once the catcher feels like a creative collaborator, the odds of rejection diminish.

Ultimately, the pitch will always remain an imperfect process for communicating creative ideas. But by being aware of stereotyping processes and the value of collaboration, both pitchers and catchers can understand the difference between a pitch and a hit.

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Harvard Business Review

ENTREPRENEURIAL FINANCE

The Top Ten Lies of Entrepreneurs

by Guy Kawasaki

FROM THE JANUARY 2001 ISSUE

For a few months, I've had a constant ringing in my right ear. The condition is called tinnitus, and my doctors say that it can be caused by an ear infection, too much salt in one's diet, a stressful life-style, or even a neuroma.

I have a different theory. I think that listening to the lies, exaggerations, and wishful thinking of entrepreneurs has caused the ringing. You see, I'm in the business of helping entrepreneurs raise venture capital, and I listen to hundreds of pitches every year. I hear the same fabrications and delusions over and over again. So, as a public service, I am now going to disclose the top ten lies told by entrepreneurs—and what investors say to themselves when they hear them. I'm not expecting to cure entrepreneurs of lying (fat chance), but I hope I'll at least encourage them to be a little more creative. And I may just save the hearing of a few VCs.

1. Entrepreneur:

"Our projections are conservative."

Investor:

"Multiply this forecast by .1 and add five years."

God bless the entrepreneur who forecasts sales greater than Exodus, JDS Uniphase, and Cisco and then states that the forecasts are conservative. Nobody believes the financial forecasts—investors simply want to see that the entrepreneur understands the industry, the logic involved in putting together a reasonable financial model, and how companies grow. If every man, woman, and child needs to buy two WAP phones for a company to reach profitability, something is wrong.

2. Entrepreneur:

"IDC (or Jupiter or Yankee Group or Gartner Group) forecasts that our market will be $50 billion by 2003."

Investor:

"This is the fifth $50 billion market I've heard about today."

When every plan makes the same grandiose claims about market size, investors have a hard time taking the projections seriously. Instead of trying to prove that the market will be big, enable investors to fantasize about its size. Give them the facts and the context they need to understand the scale of the opportunity for themselves. For example, if you can demonstrate that every corporate Web site on the planet needs your company's product, an investor can figure out that the opportunity is big.

3. Entrepreneur:

"Amazon will sign our deal next week."

Investor:

"Call me when you get Bezos's signature."

Few new economy companies ever definitively say no to any alliance, partnership, or offer. They're all afraid of missing the Next Big Thing. Instead, everyone says, "You have an interesting idea. We'll get back to you about it," and then they don't. Unfortunately, the entrepreneur hears, "Yes, we're doing it." Never talk about a Big Deal until it's a Signed Deal.

4. Entrepreneur:

"Key employees are set to join us as soon as we get funded."

Investor:

"Give me their phone numbers so I can verify this story."

There's no chicken-and-egg problem here. The order is clear: you get the human capital, you get the venture capital. If an entrepreneur can't persuade key execs to join because of the opportunity, she probably can't entice them with big salaries. Indeed, one of the litmus tests of fundability and entrepreneurial skill is the ability to attract talent without money.

5. Entrepreneur :

"We have no competition."

Investor:

"Either there's no market or you don't know how to use a search engine."

To this day, investors get business plans for on-line bookstores claiming a first-mover advantage. If an idea is good, five companies are already working on it. If an idea is great, ten companies are working on it. Claiming that there is no competition to an investor who's heard a similar pitch five times in the last six months is like screaming, "I am a bozo!" Bozos don't get funded.

6. Entrepreneur

"We need you to sign a nondisclosure agreement."

Investor :

"You're clueless: no one signs a nondisclosure agreement."

Investors won't sign your nondisclosure agreement because they usually see several similar plans: what if they sign one company's nondisclosure agreement and fund another? In reality, the ability to implement an idea, not the ability to keep it a secret, is the key to a successful start-up. Investors don't fund treasure maps; they fund teams that can get the job done. If an investor is willing to sign a nondisclosure agreement, an entrepreneur might not want his money.

7. Entrepreneur:

"Cisco (or Oracle or HP or Sun) is too slow to be a threat."

Investor:

"If arrogance were venture capital, your deal would be oversubscribed."

These companies didn't get where they are by being big, dumb, and slow. I love Clayton Christensen's *Innovator's Dilemma* as much as anyone, but funding the next curve is a scary proposition. It's even scarier when an entrepreneur dismisses the current curve's gorillas. Show a healthy respect for the incumbents while demonstrating a compelling and believable way to compete with them.

8. Entrepreneur:

"We're glad the bubble has burst."

Investor:

"We are, too, because your valuation just dropped 50%."

Let's be honest: no one is glad the bubble has burst. For entrepreneurs, it's harder to get funded, valuations are lower, and due diligence takes longer. For investors, portfolios are worth a lot less (and the lockup period isn't over), and the employees of portfolio companies are quitting because their stock options are under water. Since the bubble burst, everyone has been trying to spin a silver lining, but the sun shines brighter and birds sing sweeter when Nasdaq is at 5,000.

9. Entrepreneur:

"Our patents make our business defensible."

Investor:

"Hire more engineers, not patent attorneys."

Unless you're a biotech or medical-device company, it's hard to support this claim. If an idea is worth copying, there's a will and a way to get around the patent. File all the patents you like, but investors believe that what makes a company defensible is the ability to out-implement, not out-litigate.

10. Entrepreneur:

"All we have to do is get 1% of the market."

Investor:

"I want to fund a company that will get 99% of the market."

I call this the "Chinese soda syndrome": if just 1% of the people in China drink a company's soda, it will sell a ton of soda. The problem is that getting 1% of the Chinese to drink the company's soda isn't so easy. Another problem is that no one wants to invest in a company that aspires to grab only 1% of the market. (It's every investor's dream to learn that his company is on the radar screen of the Justice Department's Antitrust Division.) Shooting for the top-dog position is much more attractive to an investor than claiming it will take only a miniscule market share to succeed.

So if you're an entrepreneur, do me a favor and don't repeat any of these whoppers in my presence. If you pitch me and I turn my bad ear toward you, I'm trying to tell you something.

Guy Kawasaki is the author of *Enchantment: The Art of Changing Hearts, Minds, and Actions* and the former chief evangelist of Apple.

This article is about ENTREPRENEURIAL FINANCE

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ENTREPRENEURSHIP

Filing for a Patent Versus Keeping Your Invention a Trade Secret

by Orly Lobel

NOVEMBER 21, 2013

For many years, beginning in 1942, Premarin was the only hormone replacement therapy drug on the market derived from a natural source. The drug, provided as a treatment for negative symptoms of menopause, became the most widely prescribed drug in the US and Canada during that time. Wyeth, a pharmaceutical acquired by Pfizer in 2009, was the sole supplier of Premarin. A series of patents were issued on the drug in the 1940s, but long after they had expired, there were still no generic competitors on the market. How could Wyeth sustain this exclusivity for such an extended period of time, decades beyond the 20 years of the patent's term?

The answer is that no one succeeded at duplicating the extraction process, which Wyeth had not patented, but rather kept as a trade secret. The key ingredient in Premarin is conjugated estrogens extracted from pregnant mare urine. That's right. The secret sauce of the multimillion drug is horse pee, and the process for extracting the equine estrogens was kept in Wyeth's manufacturing plant in Brandon, Canada. While heated debates continue over the impact of the patent wars on market competitiveness, the implications trade secrets are more likely to be misunderstood. Trade secrets are thought to be the real workhorse of the knowledge economy, because of their pervasive importance. At the same time, trade secrets are viewed as the stepchild of intellectual property because they operate, by definition, in secrecy, and we know much less about their role in market competition than we know about patents, copyrights, and trademarks.

Why do some companies choose to patent their innovation while others choose to hide it? Compare the paradigmatic early American trade secret - the one and only recipe for Coca Cola - to the paradigmatic patent - the telephone. Alexander Graham Bell patented the telephone in 1876 as United States Patent No. 174,465, the most valuable patent in history. Ten years later, in 1886, Dr. John Pemberton created what is now the world's most famous trade secret: the Coca-Cola formula. Insiders know it as Merchandise 7X. No single contractor has the full recipe; each is tasked to prepare only parts of the classic blend. The company has kept the secret for over a century by purportedly storing it in a vault in downtown Atlanta, and restricting access to only a handful of executives. Coca Cola could have patented the formula, but that would only give the company twenty years of exclusivity rights to their classic taste. Instead the formula is locked up, literally and indefinitely.

A well-kept trade secret could theoretically last forever. But there is a risk. Unlike with patents, it is perfectly legal to reverse engineer and copy a trade secret. A patent lasts only 20 years, but *during* that period, the protection is far stronger: independent invention is no defense in a patent suit. In 1998, a group of horse ranchers suddenly set up a production facility and filed an Abbreviated New Drug Application (ANDA) for a generic version of Premarin. They claimed to have succeeded in mare urine extraction where others had failed. This, of course, represented a serious threat to a hugely profitable product. If the horse ranchers had indeed been independently and honestly lucky in their discovery, Wyeth would have lost its market dominance. Such was not the case. Wyeth launched an extensive, and expensive, investigation leading to evidence that the horse ranchers had improperly encouraged one of Wyeth's own former scientists to provide the secrets to the manufacturing process. The court issued a sweeping and devastating judgment against these new competitors, ordering a permanent stop to the use of the trade secret.

Patents and trade secrets present opposing choices. Trade secrets derive their legal protection from their inherently secret nature. Patents, by contrast, can only be protected through public disclosure. In fact, a patent will be invalidated if the inventor refrains from describing important details. This requirement, called *enablement*, requires a patentee to disclose enough information for others to use the invention after the patent has expired.

Budget constraints and the costs for filing a patent force a smart evaluation of your options. When facing the choice of patenting or hiding a valuable innovation, you must first ask yourself whether the invention is patentable at all. Does is it meet the legal requirements of non-obviousness, novelty, and usefulness to be granted a patent? Even if it does, ask yourself:

- Will the invention be useful beyond 20 years?
- Is it possible for other companies to reverse engineer it?
- Is the invention detectable and embedded in the product itself or is it part of an internal manufacturing process?
- Is the invention likely to be independently discovered in the near future?
- Is the product regularly observed in public settings?

The answers to these questions are company- and invention-specific. A company that has high turnover among its employees and that uses a range of partners in its production process might rightly fear going the path of trade secrets.

Importantly, as with Premarin, trade secret law and patent law can coexist. Different forms of intellectual property rights can be used to protect valuable information. Patents often protect the broad concept, while trade secrets protect the production details. The Leahy-Smith America Invents Act was passed into law in 2011 and most of its provisions came into effect earlier this year. The law lowers the disclosure requirements for inventions, for the first time effectively removing the threat of invalidating a patent for failure to disclose the best mode of implementation. This may lead inventors to rely more on the dual strategy of patent and trade secret protection for a single invention.

Another important change in the recent patent reform is a defense against claims of patent infringement for anyone who commercially used an invention, even if in secret, at least one year before the patent filing. This change may further tip the balance for more reliance on secrecy for certain innovations.

These choices are strategic, and a company must think about the broader picture too of the overall intangible assets your company possesses. The different forms of protection should be understood as an asset portfolio - you might want to diversify and spread your risk. A friend of mine who is the Vice President of a highly innovative company in the shipping industry appropriately describes intellectual property protection as a volume business: “You never know what will be the diamond in the rough.”

Orly Lobel is a law professor at the University of San Diego and the author of *Talent Wants to Be Free: Why We Should Learn to Love Leaks, Raids, and Free-Riding*. She is @OrlyLobel on Twitter.

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lucianosalerno a year ago

Here are some fun facts:
PREMARIN's name comes by combining the words PREgnant MAre uRIN which is the source of its active ingredients (Natural Conjugated Estrogens).
It was originally developed by a Canadian company called Ayerst which Wyeth acquired in 1987. Then as referenced in the article Wyeth was acquired by Pfizer in 2009.

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ENTREPRENEURIAL FINANCE

Six Myths About Venture Capitalists

by Diane Mulcahy

FROM THE MAY 2013 ISSUE

PHOTOGRAPHY: COURTESY OF THE ARTIST AND GOW LANGSFORD GALLERY
ARTWORK: SARA HUGHES, MILLIONS OF COLOURS 3 (DETAIL), 2003, ACRYLIC PAINT ON LINEN

Steve Jobs, Mark Zuckerberg, Sergey Brin: We celebrate these entrepreneurs for their successes, and often equally extol the venture capitalists who backed their start-ups and share in their glory. Well-known VC firms such as Kleiner Perkins and Sequoia have cultivated a branded mystique around their ability to find and finance the most successful young companies. Forbes identifies the top individual VCs on its Midas List, implicitly crediting them with a mythical magic touch for investing. The story of venture capital appears to be a compelling narrative of bold investments and excess returns.

The reality looks very different. Behind the anecdotes about Apple, Facebook, and Google are numbers showing that many more venture-backed start-ups fail than succeed. And VCs themselves aren't much better at generating returns. For more than a decade the stock markets have outperformed most of them, and since 1999 VC funds on average have barely broken even.

The VC industry wouldn't exist without entrepreneurs, yet entrepreneurs often feel as if they're in the backseat when it comes to dealing with VCs. For someone who's starting (or thinking of starting) a company, the myths surrounding venture capital can be powerful. In this article I will challenge some common ones in order to help company founders develop a more realistic sense of the industry and what it offers.

Myth 1: Venture Capital Is the Primary Source of Start-Up Funding

Venture capital financing is the exception, not the norm, among start-ups. Historically, only a tiny percentage (fewer than 1%) of U.S. companies have raised capital from VCs. And the industry is contracting: After peaking in the late 1990s, the number of active VC firms fell from 744 to 526 in the decade 2001-2011, and the amount of venture capital raised was just under $19 billion in 2011, down from $39 billion in 2001, according to the National Venture Capital Association (NVCA).

But less venture capital doesn't mean less start-up capital. Non-VC sources of financing are growing rapidly and giving entrepreneurs many more choices than in the past. Angel investors—affluent individuals who invest smaller amounts of capital at an earlier stage than VCs do—fund more than 16 times as many companies as VCs do, and their share is growing. In 2011 angels invested more than $22 billion in approximately 65,000 companies, whereas venture capitalists invested about $28 billion in about 3,700 companies. AngelList, an online platform that connects start-ups with angel capital, is one example of the enormous growth in angel financing. Since it launched, in 2010, more than 2,000 companies have raised capital using the platform, and start-ups now raise more than $10 million a month there. (Disclosure: The Kauffman Foundation is an investor in AngelList.)

Another new source of start-up investment is crowdfunding, whereby entrepreneurs raise small amounts of capital from large numbers of people in exchange for nonequity rewards such as products from the newly funded company. Kickstarter reports that more than 18,000 projects raised nearly $320 million through its platform in 2012—triple the amount raised in 2011. Passage of the JOBS (Jumpstart Our Business Startups) Act last year promises to support even faster growth by allowing crowdfunders to invest in exchange for equity and by expanding the pool of investors who can participate.

Myth 2: VCs Take a Big Risk When They Invest in Your Start-Up

VCs are often portrayed as risk takers who back bold new ideas. True, they take a lot of risk with their *investors'* capital—but very little with their own. In most VC funds the partners' own money accounts for just 1% of the total. The industry's revenue model, long investment cycle, and lack of visible performance data make VCs less accountable for their performance than most other professional investors. If a VC firm invests in your start-up, it will be rooting for you to succeed. But it will probably do just fine financially even if you fail.

Why? Because the standard VC fund charges an annual fee of 2% on committed capital over the life of the fund—usually 10 years—plus a percentage of the profits when firms successfully exit, usually by being acquired or going public. So a firm that raised a $1 billion fund and charged a 2% fee would receive a fixed fee stream of $20 million *a year* to cover expenses and compensation. VC firms raise new funds about every three or four years, so let's say that three years into the first fund, the firm raised a second $1 billion fund. That would generate an additional $20 million in fees, for a total of $40 million annually. These cumulative and guaranteed management fees insulate VC partners from poor returns because much of their compensation comes from fees. Many partners take home compensation in the seven figures regardless of the fund's investment performance. Most entrepreneurs have no such safety net.

Other investment professionals often face far greater performance pressure. Consider mutual fund managers, whose fund performance is reported daily, whose investors can withdraw money at any time, and who are often replaced for underperformance. VC performance is ultimately judged at the end of a fund's 10-year life, so venture capitalists are free from the level of accountability that's common in other investment realms. They take on less personal risk than angel investors or crowdfunders, who use their own capital. And all investors take fewer risks than most entrepreneurs, who put much of their net worth and all of their earning capacity into their start-ups.

Myth 3: Most VCs Offer Great Advice and Mentoring

A common VC pitch to entrepreneurs is that the firm brings much more than money to the table: It offers experience, operational and industry expertise, a broad network of relevant contacts, a range of services for start-ups, and a strong track record of successful investing.

In some cases those nonmonetary resources really are valuable. But VCs vary tremendously—both as firms and as individuals—in how much effort they put into advising and assisting portfolio companies. Among those who do mentor their CEOs, ability and the quality of advice can differ widely. There are no solid data about the industry's delivery on this mentoring promise. But if you asked the CEOs of 100 VC-funded companies how helpful their VCs are, some would say they're fabulous, some would say they're active but not a huge help, and some would say they do little beyond writing checks. This last group isn't necessarily bad, of course: Some CEOs may be happy to skip the mentoring and just take the cash. But for founders who have bought into the idea that VCs provide lots of value-added help, it can be a source of great disappointment.

The best way to determine whether a VC firm or partner brings resources other than capital to the table is to conduct your own due diligence, just as you'd do a thorough reference check on a key hire. Talk with the CEOs of the firm's other portfolio companies and ask if the partner is accessible, how much he or she adds to boardroom discussion, and whether the CEO has received constructive help in dealing with company problems. Ask about resources the firm offers—PR, recruiting, and so forth—and whether those have been useful.

Some questions you should ask the VC firm directly, such as: Whom does it intend to put on your board? Is the person a partner or an associate? Does the person have any experience (or any other portfolio companies) in your industry? On how many other boards does he or she serve? Asking such questions may seem like common sense, but it's shocking how few company founders actually make the necessary calls before signing up for a long-term relationship with a VC. If part of what makes a firm attractive is that it offers expertise, mentoring, and services, the entrepreneur needs to confirm that both the firm and the partner have a track record of delivering them.

Myth 4: VCs Generate Spectacular Returns

Last year my colleagues at the Kauffman Foundation and I published a widely read report, "We Have Met the Enemy...and He Is Us," about the venture capital industry and its returns. We found that the overall performance of the industry is poor. VC funds haven't significantly outperformed the public markets since the late 1990s, and since 1997 less cash has been returned to VC investors than they have invested. A tiny group of top-performing firms do generate great "venture rates of return": at least twice the capital invested, net of fees. We don't know definitively which firms are in that group, because performance data are not generally available and are not consistently reported. The average fund, however, breaks even or loses money.

We analyzed the Kauffman Foundation's experience investing in nearly 100 VC funds over 20 years. We found that only 20 of our funds outperformed the markets by the 3% to 5% annually that we expect to compensate us for the fees and illiquidity we incur by investing in private rather than public equity. Even worse, 62 of our 100 funds failed to beat the returns available from a small-cap public index.

Venture capital investments are generally perceived as high-risk and high-reward. The data in our report reveal that although investors in VC take on high fees, illiquidity, and risk, they rarely reap the reward of high returns. Entrepreneurs who are distressed when VCs decline to fund their ventures need only review the performance data to see that VCs as a group have no Midas touch for investing.

Myth 5: In VC, Bigger Is Better

Venture capital in the United States began as a cottage industry, notable in the early years for investments in companies such as Intel, Microsoft, and Apple. In 1990, 100 VC firms were actively investing, with slightly less than $30 billion under management, according to the NVCA. During that era venture capital generated strong, above-market returns, and performance by any measure was good. What happened? During the peak of the internet boom, in 2000, the number of active firms grew to more than 1,000, and assets under management exceeded $220 billion. VC didn't scale well. As in most asset classes, when the money flooded in, returns fell, and venture capital has not yet recovered. The number of firms and the amount of capital have declined since the boom, though they are both still far above the levels of the early and middle 1990s.

> Venture capital financing is the exception, not the norm, among start-ups.

What's true for the industry is also true for individual funds: Bigger isn't better. Company founders often feel that signing a deal with a large VC firm lends cachet, just as MBA students may get special pleasure from being offered a job by a big, well-known employer. But industry and academic studies show that fund performance declines as fund size increases above $250 million. We found that the VC funds larger than $400 million in Kauffman's portfolio generally failed to provide attractive returns: Just four out of 30 outperformed a publicly traded small-cap index fund.

Myth 6: VCs Are Innovators

It’s ironic that VC firms position themselves as supporters, financers, and even instigators of innovation, yet the industry itself has been devoid of innovation for the past 20 years. Venture capital has seen plenty of changes over time—more funds, more money, bigger funds, declining returns—but funds are structured, capital is raised, and partners are paid just as they were two decades ago. Any innovation in financing start-ups, such as crowdfunding and platforms like AngelList and SecondMarket, has come from outside the VC industry.The story of venture capital is changing. Entrepreneurs have more choices for financing their companies, shifting the historical balance of power that has too long tilted too far toward VCs. Entrepreneurs will enjoy a different view as they move from the backseat into the driver’s seat in negotiating with VCs. An emerging group of “VC 2.0” firms are going back to raising small funds and focusing on generating great returns rather than large fees. And the industry’s persistent underperformance is finally causing institutional investors to think twice before investing in venture capital. As a result, VCs will continue to play a significant, but most likely smaller, role in channeling capital to disruptive start-ups.

Diane Mulcahy, a former venture capitalist, is the director of private equity for the Ewing Marion Kauffman Foundation, an adjunct lecturer in the entrepreneurship division at Babson College, and an Eisenhower Fellow.

Harvard
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BUSINESS PROCESSES

Can You Patent Your Business Model?

by Andrea Ovans

FROM THE JULY 2000 ISSUE

The high-profile court cases over Amazon's patent on its one-click shopping process and Priceline's patent on its reverse auctions have propelled the notion of patenting business methods into the limelight. It's not, however, a new phenomenon; businesses have always been free to patent their methods. Companies have, for instance, patented the way they sell airline tickets and the way they manage money-market accounts. But in an information economy, in which entire business models can be embedded in digital code, attempts to use patents as competitive weapons have intensified. So have the attendant controversies. To shed light on this contentious topic, HBR's Andrea Ovans recently spoke with **Q. Todd Dickinson,** director of the U.S. Patent and Trademark Office, about the myths and realities of business patents.

What constitutes a patentable business model?

We distinguish between a business model, which is a general vision or strategy, and a business method, which is a specific way of doing business. In law, there's a four-part test for patentability of a business method, as there is for any invention. The way of doing business has to be useful. It has to be new. It can't be so incremental that it would be obvious to a skilled practitioner. And in the application process, disclosure of the innovation has to be so complete that fellow practitioners can understand it.

Why are we seeing a rush to patent business methods now?

For a couple of reasons. First is the court opinion on State Street Bank versus Signature Financial that was handed down about two years ago, which definitively stated that software that governs business methods can be patented as long as it produces some concrete, useful, and tangible result. That ruling made companies much more aware that they could patent software-based business methods. At the same time, there's been a general rise in software patents of all types, fueled in part by the burst of innovation generated by the Internet. That being said, though, let me put it in context. We issued about 161,000 patents last year. Some 600 were software-related business methods. I expect we'll issue another 1,000 such patents this year. That's a fairly modest amount overall.

Are you concerned that patenting business methods will ultimately dampen innovation?

This is not the first time that argument has been raised. It was raised over telephony. It was raised in the chemical industry when companies applied for patents on various monomers and copolymers. And it was argued originally in relation to patenting any kind of software at all. But in all those cases, innovation in the general industry actually increased.

Patents give their owners rights to their innovations—for 20 years from the date they file the application, currently. But then patent owners must make their innovations public, which lets other people build on them. Historically—and I would argue it's no different now—that can give small companies and entrepreneurs some parity with large, powerful business concerns, rather than the other way around.

But what about complaints in some quarters that companies are getting patents for business methods that aren't really new?

The patent office does not issue patents for old business methods simply made electronic. It is partly our responsibility to find evidence of existing methods—what the patent office calls prior art—to make sure that doesn't happen. We have a very good collection of software prior art in a range of disciplines, including business, and we continue to expand that collection. We held hearings last year to make sure we were getting access to prior art that exists outside of the patent process, particularly as it relates to software.

But people have pointed out that, in the past, when a lot of the software was released, prior art was not available. And even now, we don't have a consolidated, comprehensive database—a one-stop shop—of prior art for software that embodies business methods, as we do in other fields. In chemistry, for example, there's the Chem Abstracts, and in medical technology there's Medline. If some party would develop that, it would be a great help. But remember, too, that applicants must understand that they are legally required to disclose all relevant prior art themselves. If they do not, they risk invalidating their patent.

Andrea Ovans is a senior editor at Harvard Business Review.

Harvard Business Review

ENTREPRENEURSHIP

Everything You (Don't) Want to Know About Raising Capital

by Jeffry A. Timmons and Dale A. Sander

FROM THE NOVEMBER 1989 ISSUE

Most entrepreneurs understand that if the fundamentals of a business idea—the management team, the market opportunities, the operating systems and controls—are sound, chances are there's money out there. The challenge of landing that capital to grow a company can be exhilarating. But as exciting as the money search may be, it is equally threatening. Built into the process are certain harsh realities that can seriously damage a business. Entrepreneurs cannot escape them but, by knowing what they are, can at least prepare for them.

After ten years of hard work and sleepless nights to get the company to $5 million in sales, the founder of Seattle Software (the disguised name of a real company) was convinced he could hit $11 million in the next three years. All he needed was cash. Ten banks refused to extend his credit line and advised him to get more equity. He met a lawyer at a seminar for entrepreneurs who said he would take the company public in Vancouver or London and raise $2.5 million fast. The founder was tempted to sign him on.

Texas Industrial (again, disguised) had grown from an idea to a $50-million-a-year leader in the industrial mowing-equipment business. The company wanted to keep growing and in 1987 decided it was time for an initial public offering. The underwriters agreed. They started the paperwork and scheduled a road show for early November.

The founders of both these companies thought they were prepared for the fund-raising process. They put together business plans and hired advisers. But that isn't enough. Every fund-raising strategy and every source of money implies certain out-of-pocket expenses and commitments of various kinds. Unless the entrepreneur has thought them through and decided how to handle them ahead of time, he or she may end up with a poorly structured deal or an inefficient search for capital.

Entrepreneurs should not be afraid to seek the money they need. Though they may be setting sail on dark waters and will always be at a disadvantage when negotiating with people who make deals every day, they can take steps to ensure that they get the capital they need, when they need it, on terms that do not sacrifice their future options. The first of those steps is knowing the downside of the fund-raising process.

Raising Money Costs a Lot

The lure of money leads founders to grossly underestimate the time, effort, and creative energy required to get the cash in the bank. This is perhaps the least appreciated aspect of raising money. In emerging companies, during the fund-raising cycle, managers commonly devote as much as half their time and most of their creative energy trying to raise outside capital. We have seen founders drop nearly everything else they were working on to find potential money sources and tell their story.

The process is stressful and can drag on for months as interested investors engage in "due diligence" examinations of the founder and the proposed business. Getting a yes can easily take six months; a no can take up to a year. All the while, the emotional and physical drain leaves little energy for running the business, and cash is flowing out rather than in. Young companies can go broke while the founders are trying to get capital to fund the next growth spurt.

Performance invariably suffers. Customers sense neglect, however subtle and unintended; employees and managers get less attention than they need and are accustomed to; small problems are overlooked. As a result, sales flatten or drop off, cash collections slow, and profits dwindle. And if the fund-raising effort ultimately fails, morale suffers and key people may even leave. The effects can cripple a struggling young business.

One start-up began its search for venture capital when, after nearly ten years of acquiring the relevant experience and developing a track record in their industry niche, the founders sensed an opportunity to launch a company in a field related to telecommunications. The three partners put up $100,000 of their own hard-earned cash as seed money to develop a business plan, and they set out to raise another $750,000. Eight months later, their seed money was spent, and every possible source of funding they could think of—including more than 25 venture capital firms and some investment bankers—had failed to deliver. The would-be founders had quit their good jobs, invested their nest eggs, and worked night and day for a venture that was failing before it even had a chance to get started.

The entrepreneurs might have spent their time and money differently. We asked them what their sales would have been if they had spent the $100,000 seed money over the previous 12 months to generate their first customers. Their answer? One million dollars. The founders had not been prepared to divert so much of their attention away from getting the operations up and running. Raising money was actually less important to the company's viability than closing orders and collecting cash.

Even when the search for capital is successful, out-of-pocket costs can be surprisingly high. The costs of going public—fees to lawyers, underwriters, accountants, printers, and regulators—can run 15% to 20% of a smaller offering and can go as high as 35% in some instances. And a public company faces certain incremental costs after the issue, like administration costs and legal fees that increase with the need for more extensive reporting to comply with the SEC. In addition, there are directors' fees and liability insurance premiums that will also probably rise. These expenses often add up to $100,000 a year or more.

Similarly, bank loans over $1 million may require stringent audits and independent reviews to ensure that the values of inventory and receivables are bona fide. The recipient of the funds shoulders all these costs.

The demands on time and money are unavoidable. What entrepreneurs can avoid is the tendency to underestimate these costs and the failure to plan for them.

You Have No Privacy

Convincing a financial backer to part with money takes a good sales job—and information. When seeking funds, you must be prepared to tell 5, 10, even 50 different people whether you are dependent on one brilliant technician or engineer, what management's capabilities and shortcomings are, how much of the company you own, how you're compensated, and what your marketing and competitive strategies are. And you will have to hand over your personal and corporate financial statements.

Revealing such guarded secrets makes entrepreneurs uneasy, and understandably so. Although most potential sources respect the venture's confidentiality, information sometimes leaks inadvertently—and with destructive consequences. In one instance, a startup team in Britain had devised a new automatic coin-counting device for banks and large retailers. The product had a lot of promise, and the business plan was sound. When the lead investor was seeking coinvestors, he shared the business plan with a prospective investor who ultimately declined to participate. The deal came together anyway, but months later the entrepreneurs discovered that the investor, who had decided not to join, had shared the business plan with a competitor.

In another instance, an adviser was helping an entrepreneur sell his business to a Midwestern company. Sitting in the office of a senior bank officer who was considering financing the purchase, the seller asked for more information about the buyer's personal financial position. The bank officer called the buyer's bank a thousand miles away, got a low-level assistant on the line, and listened in amazement as the clerk said, "Yes, I've got his personal balance sheet right here," and proceeded to read it line by line.

The chance that information will get into the wrong hands is an inherent risk in the search for capital—and is one reason to make sure you really need the money and are getting it from highly reputable sources. While you cannot eliminate the risk, you can minimize it, by discussing the issue with the lead investor, avoiding some sources that are close to competitors, and talking to only reputable sources. You should in effect do your own "due diligence" on the sources by talking with entrepreneurs and reputable professional advisers who have dealt with them.

Experts Can Blow It

Decisions about how much money to raise, from what sources, in debt or equity, under what terms—all limit management in some way and create commitments that must be fulfilled. These commitments can cripple a growing business, yet managers are quick to delegate their fund-raising strategies to financial advisers. Unfortunately, not all advisers are equally skilled. And of course, it's the entrepreneur—not the outside expert—who must live or die by the consequences.

Opti-Com (the fictitious name of a real company) was a start-up spun off from a public company in the fiber optics industry. Though not considered super-stars, the start-up managers were strong and credible. Their ambition was to take the company to $50 million in sales in five years (the "5-to-50 fantasy"), and they enlisted the help of a large, reputable accounting firm and a law firm to advise them, help prepare their business plan, and forge a fund-raising strategy. The resultant plan proposed to raise $750,000 for about 10% of the common stock.

The adviser urged Opti-Com's founders to submit the business plan to 16 blue-ribbon, mainstream venture capital firms in the Boston area; four months later, they had received 16 rejections. Next they were told to see venture capital firms of the same quality in New York, since—contrary to conventional money-raising wisdom—the others were "too close to home." A year later, the founders were still unsuccessful—and nearly out of money.

Opti-Com's problem was that the entrepreneurs blindly believed that the advisers knew the terrain and would get results. The fact is, the business proposal was not a mainstream venture capital deal, yet the search included none of the smaller, more specialized venture capital funds, private investors, or strategic partners that were more likely to fund that type of business. Furthermore, the deal was overvalued by three to four times, which undoubtedly turned off investors.

Opti-Com eventually changed its adviser. Under different guidance, the company approached a small Massachusetts fund specifically created to provide risk capital to emerging companies not robust enough to attract conventional venture capital but important to the state's economic renewal. This was the right fit. Opti-Com raised the capital it needed and at a valuation more in line with the market for start-up deals: about 40% of the company instead of the 10% that the founders had offered.

The point is not to avoid using outside advisers but to be selective about them. One rule of thumb is to choose individuals who are actively involved in raising money for companies at your stage of growth, in your industry or area of technology, and with similar capital requirements.

Money Isn't All the Same

Although money drives your fund-raising effort, it is not the only thing potential financial partners have to offer. If you overlook considerations such as whether the partner has experience in the industry, contacts with potential suppliers or customers, and a good reputation, you may shortchange yourself.

How fast the investor can respond is sometimes another crucial variable. One management group had four weeks to raise $150 million to buy a car phone business before it would be auctioned on the open market. It did not have enough time to put together a detailed business plan but presented a summary plan to five top venture capital and LBO firms.

One of the firms asked a revealing question: "How do you prevent these phones from being stolen? You can't penetrate the market unless you solve that problem." The founders soon concluded that this source was not worth pursuing. The firm obviously knew little about the business: at that time, car phones weren't stolen like CB radios because they couldn't be used until they'd gone through an authorized installation and activation. The entrepreneurs didn't have time to wait for the investor to get up to speed. They focused their efforts on two investors with experience in telecommunications and got a commitment expediently.

Yet another entrepreneur had a patented, innovative device for use by manufacturers of semiconductors. He was running out of cash from an earlier round of venture capital and needed more to get the product into production. His backers would not invest further since he was nearly two years behind his business plan.

When the well-known venture capital firms turned him down, he sought alternatives. He listed the device's most likely customers and approached the venture capital firms that backed those companies. The theory was that they would be able to recognize the technology's merit and the business opportunity. From a list of 12 active investors in the customer's industry, the entrepreneur landed three offers within three months, and the financing was closed soon thereafter.

The Search Is Endless

After months of hard work and tough negotiations, cash hungry and unwary entrepreneurs are quick to conclude that the deal is closed with the handshake and letter-of-intent or executed-terms sheet. They relax the street-wise caution they have exercised so far and cut off discussions with alternative sources of funds. This can be a big mistake.

An entrepreneur and one of his vice presidents held simultaneous negotiations with several venture capitalists, three or four strategic partners, and the source of a bridge capital loan. After about six months, the company was down to 60 days of cash, and the prospective backer most interested in the deal knew it. It made a take-it-or-leave-it offer of a $10 million loan of 12% with warrants to acquire 10% of the company. The managers felt that while the deal was not cheap, it was less expensive than conventional venture capital, and they had few alternatives since none of the other negotiations had gotten that serious.

Yet the entrepreneurs were able to hide their bargaining weakness. Each time a round of negotiations was scheduled, the company founder made sure he scheduled another meeting that same afternoon several hours away. He created the effect of more intense discussion elsewhere than in fact existed. By saying that he had to get to Chicago to continue discussions with venture capitalist XYZ, the founder kept the investors wondering just how strong their position was.

The founder finally struck a deal with the one investor that was interested and on terms he was quite comfortable with. The company has since gone public and is a leader in its industry.

The lead entrepreneur understood what many others do not: you must assume the deal will never close and keep looking for investors even when one is seriously interested. While it is tempting to end the hard work of finding money, continuing the search not only saves time if the deal falls through but also strengthens your negotiating position.

Lawyers Can't Protect You

Why should you have to get involved in the minutiae of legal and accounting documents when you pay professionals big fees to handle them? Because you are the one who has to live with them.

Deals are structured many different ways. The legal documentation spells out the terms, covenants, conditions, responsibilities, and rights of the parties in the transaction. The money sources make deals every day, so naturally they are more comfortable with the process than the entrepreneur who is going through it for the first or second time. Covenants can deprive a company of the flexibility it needs to respond to unexpected situations, and lawyers, however competent and conscientious, cannot know for sure what conditions and terms the business is unable to withstand.

Consider a small public company we'll call Com-Comp. After more than two months of tough negotiations with its bank to convert an unsecured demand bank note of over $1.5 million to a one-year term note, the final documentation arrived. Among the many covenants and conditions was one clause buried deep in the agreement: "Said loan will be due and payable on demand in the event there are any material events of any kind that could affect adversely the performance of the company."

The clause was so open to interpretation that it gave the bank, which was already adversarial, a loaded gun. Any unexpected event could be used to call the loan, thereby throwing an already troubled company into such turmoil that it probably would have been forced into bankruptcy. When the founders read the fine print, they knew instantly that the terms were unacceptable, and the agreement was then revised.

An infusion of capital—be it debt or equity, from private or institutional sources—can drive a company to new heights, or at least carry it through a trying period. Many financing alternatives exist for small enterprises, and entrepreneurs should not be afraid to use them.

They should however, be prepared to invest the time and money to do a thorough and careful search for capital. The very process of raising money is costly and cumbersome. It cannot be done casually, nor can it be delegated. And it has inherent risks.

Since no deal is perfect and since even the most savvy entrepreneurs are at a disadvantage in negotiating with people who strike deals for a living, there is strong incentive for entrepreneurs to learn as much as they can about the process—including the very things they are probably least interested in knowing.

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ACCOUNTING

How Venture Capital Works

by Bob Zider

FROM THE NOVEMBER 1998 ISSUE

Invention and innovation drive the U.S. economy. What's more, they have a powerful grip on the nation's collective imagination. The popular press is filled with against-all-odds success stories of Silicon Valley entrepreneurs. In these sagas, the entrepreneur is the modern-day cowboy, roaming new industrial frontiers much the same way that earlier Americans explored the West. At his side stands the venture capitalist, a trail-wise sidekick ready to help the hero through all the tight spots—in exchange, of course, for a piece of the action.

As with most myths, there's some truth to this story. Arthur Rock, Tommy Davis, Tom Perkins, Eugene Kleiner, and other early venture capitalists are legendary for the parts they played in creating the modern computer industry. Their investing knowledge and operating experience were as valuable as their capital. But as the venture capital business has evolved over the past 30 years, the image of a cowboy with his sidekick has become increasingly outdated. Today's venture capitalists look more like bankers, and the entrepreneurs they fund look more like M.B.A.'s.

The U.S. venture-capital industry is envied throughout the world as an engine of economic growth. Although the collective imagination romanticizes the industry, separating the popular myths from the current realities is crucial to understanding how this important piece of the U.S. economy operates. For entrepreneurs (and would-be entrepreneurs), such an analysis may prove especially beneficial.

Profile of the Ideal Entrepreneur

From a venture capitalist's perspective, the ideal entrepreneur:

- is qualified in a "hot" area of interest,
- delivers sales or technical advances such as FDA approval with reasonable probability,
- tells a compelling story and is presentable to outside investors,
- recognizes the need for speed to an IPO for liquidity,
- has a good reputation and can provide references that show competence and skill,

Venture Capital Fills a Void

Contrary to popular perception, venture capital plays only a minor role in funding basic innovation. Venture capitalists invested more than $10 billion in 1997, but only 6%, or $600 million, went to startups. Moreover, we estimate that less than $1 billion of the total venture-capital pool went to R&D. The majority of that capital went to follow-on funding for projects originally developed through the far greater expenditures of governments ($63 billion) and corporations ($133 billion).

Where venture money plays an important role is in the next stage of the innovation life cycle—the period in a company's life when it begins to commercialize its innovation. We estimate that more than 80% of the money invested by venture capitalists goes into building the infrastructure required to grow the business—in expense investments (manufacturing, marketing, and sales) and the balance sheet (providing fixed assets and working capital).

- understands the need for a team with a variety of skills and therefore sees why equity has to be allocated to other people,
- works diligently toward a goal but maintains flexibility,
- gets along with the investor group,
- understands the cost of capital and typical deal structures and is not offended by them,
- is sought after by many VCs,
- has realistic expectations about process and outcome.

Venture money is not long-term money. The idea is to invest in a company's balance sheet and infrastructure until it reaches a sufficient size and credibility so that it can be sold to a corporation or so that the institutional public-equity markets can step in and provide liquidity. In essence, the venture capitalist buys a stake in an entrepreneur's idea, nurtures it for a short period of time, and then exits with the help of an investment banker.

Venture capital's niche exists because of the structure and rules of capital markets. Someone with an idea or a new technology often has no other institution to turn to. Usury laws limit the interest banks can charge on loans—and the risks inherent in start-ups usually justify higher rates than allowed by law. Thus bankers will only finance a new business to the extent that there are hard assets against which to secure the debt. And in today's information-based economy, many start-ups have few hard assets.

Furthermore, investment banks and public equity are both constrained by regulations and operating practices meant to protect the public investor. Historically, a company could not access the public market without sales of about $15 million, assets of $10 million, and a reasonable profit history. To put this in perspective, less than 2% of the more than 5 million corporations in the United States have more than $10 million in revenues. Although the IPO threshold has been lowered recently through the issuance of development-stage company stocks, in general the financing window for companies with less than $10 million in revenue remains closed to the entrepreneur.

Venture capital fills the void between sources of funds for innovation (chiefly corporations, government bodies, and the entrepreneur's friends and family) and traditional, lower-cost sources of capital available to ongoing concerns. Filling that void successfully requires the venture capital industry to provide a sufficient return on capital to attract private equity funds, attractive returns for its own participants, and sufficient upside potential to entrepreneurs to attract high-quality ideas that will generate high returns. Put simply, the challenge is to earn a consistently superior return on investments in inherently risky business ventures.

Sufficient Returns at Acceptable Risk

Investors in venture capital funds are typically very large institutions such as pension funds, financial firms, insurance companies, and university endowments—all of which put a small percentage of their total funds into high-risk investments. They expect a return of between 25% and 35% per year over the lifetime of the investment. Because these investments represent such a tiny part of the institutional investors' portfolios, venture capitalists have a lot of latitude. What leads these institutions to invest in a fund is not the specific investments but the firm's overall track record, the fund's "story," and their confidence in the partners themselves.

How do venture capitalists meet their investors' expectations at acceptable risk levels? The answer lies in their investment profile and in how they structure each deal.

The Investment Profile.

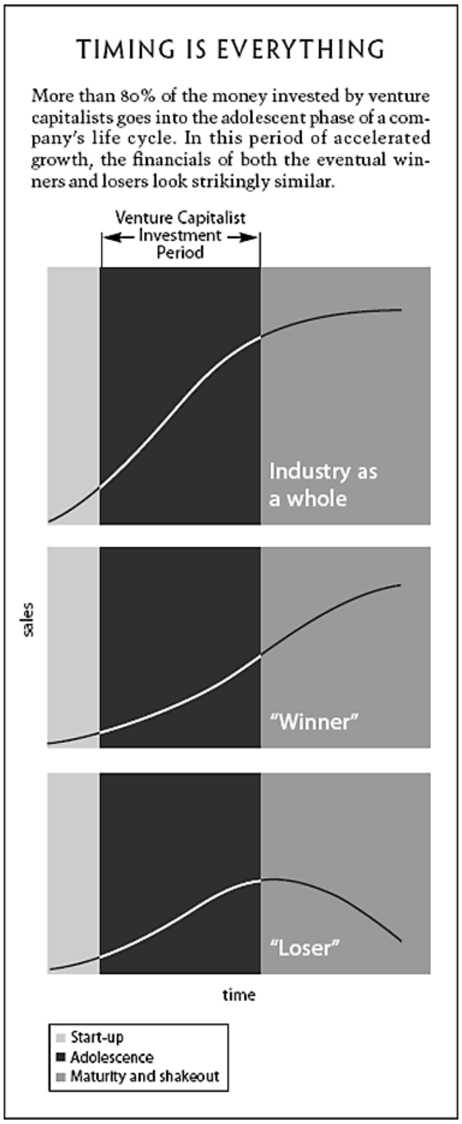
One myth is that venture capitalists invest in good people and good ideas. The reality is that they invest in good industries—that is, industries that are more competitively forgiving than the market as a whole. In 1980, for example, nearly 20% of venture capital investments went to the energy industry. More recently, the flow of capital has shifted rapidly from genetic engineering, specialty retailing, and computer hardware to CD-ROMs, multimedia, telecommunications, and software companies. Now, more than 25% of disbursements are devoted to the Internet "space." The apparent randomness of these shifts among technologies and industry segments is misleading; the targeted segment in each case was growing fast, and its capacity promised to be constrained in the next five years. To put this in context, we estimate that less than 10% of all U.S. economic activity occurs in segments projected to grow more than 15% a year over the next five years.

> The myth is that venture capitalists invest in good people and good ideas. The reality is that they invest in good industries.

In effect, venture capitalists focus on the middle part of the classic industry S-curve. They avoid both the early stages, when technologies are uncertain and market needs are unknown, and the later stages, when competitive shakeouts and consolidations are inevitable and growth rates slow dramatically. Consider the disk drive industry. In 1983, more than 40 venture-funded companies and more than 80 others existed. By late 1984, the industry market value had plunged from $5.4 billion to $1.4 billion. Today only five major players remain.

Growing within high-growth segments is a lot easier than doing so in low-, no-, or negative-growth ones, as every businessperson knows. In other words, regardless of the talent or charisma of individual entrepreneurs, they rarely receive backing from a VC if their businesses are in low-growth market segments. What these investment flows reflect, then, is a consistent pattern of capital allocation into industries where most companies are likely to look good in the near term.

During this adolescent period of high and accelerating growth, it can be extremely hard to distinguish the eventual winners from the losers because their financial performance and growth rates look strikingly similar. (See the chart "Timing Is Everything.") At this stage, all companies are struggling to deliver products to a product-starved market. Thus the critical challenge for the venture capitalist is to identify competent management that can execute—that is, supply the growing demand.



Timing Is Everything More than 80% of the money invested by venture capitalists goes into the adolescent phase of a company's life cycle. In this period of accelerated growth, the financials of both the eventual winners and losers look strikingly similar.

Picking the wrong industry or betting on a technology risk in an unproven market segment is something VCs avoid. Exceptions to this rule tend to involve "concept" stocks, those that hold great promise but that take an extremely long time to succeed. Genetic engineering companies illustrate this point. In that industry, the venture capitalist's challenge is to identify entrepreneurs who can advance a key technology to a certain stage—FDA approval, for example—at which point the company can be taken public or sold to a major corporation.

By investing in areas with high growth rates, VCs primarily consign their risks to the ability of the company's management to execute. VC investments in high-growth segments are likely to have exit opportunities because investment bankers are continually looking for new high-growth issues to bring to market. The issues will be easier to sell and likely to support high relative valuations—and therefore high commissions for the investment bankers. Given the risk of these types of deals, investment bankers' commissions are typically 6% to 8% of the money raised through an IPO. Thus an effort of only several months on the part of a few professionals and brokers can result in millions of dollars in commissions.

As long as venture capitalists are able to exit the company and industry before it tops out, they can reap extraordinary returns at relatively low risk. Astute venture capitalists operate in a secure niche where traditional, low-cost financing is unavailable. High rewards can be paid to successful management teams, and institutional investment will be available to provide liquidity in a relatively short period of time.

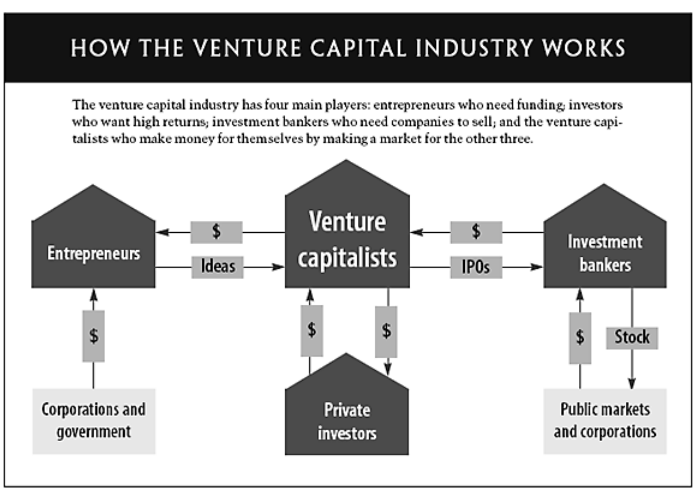
The Logic of the Deal.

There are many variants of the basic deal structure, but whatever the specifics, the logic of the deal is always the same: to give investors in the venture capital fund both ample downside protection and a favorable position for additional investment if the company proves to be a winner.

In a typical start-up deal, for example, the venture capital fund will invest $3 million in exchange for a 40% preferred-equity ownership position, although recent valuations have been much higher. The preferred provisions offer downside protection. For instance, the venture capitalists receive a liquidation preference. A liquidation feature simulates debt by giving 100% preference over common shares held by management until the VC's $3 million is returned. In other words, should the venture fail, they are given first claim to all the company's assets and technology. In addition, the deal often includes blocking rights or disproportional voting rights over key decisions, including the sale of the company or the timing of an IPO.

The contract is also likely to contain downside protection in the form of antidilution clauses, or *ratchets*. Such clauses protect against equity dilution if subsequent rounds of financing at lower values take place. Should the company stumble and have to raise more money at a lower valuation, the venture firm will be given enough shares to maintain its original equity position—that is, the total percentage of equity owned. That preferential treatment typically comes at the expense of the common shareholders, or management, as well as investors who are not affiliated with the VC firm and who do not continue to invest on a pro rata basis.

Alternatively, if a company is doing well, investors enjoy upside provisions, sometimes giving them the right to put additional money into the venture at a predetermined price. That means venture investors can increase their stakes in successful ventures at below market prices.



How the Venture Capital Industry Works The venture capital industry has four main players: entrepreneurs who need funding; investors who want high returns; investment bankers who need companies to sell; and the venture capitalists who make money for themselves by making a market for the other three.

VC firms also protect themselves from risk by coinvesting with other firms. Typically, there will be a "lead" investor and several "followers." It is the exception, not the rule, for one VC to finance an individual company entirely. Rather, venture firms prefer to have two or three groups involved in most stages of financing. Such relationships provide further portfolio diversification—that is, the ability to invest in more deals per dollar of invested capital. They also decrease the workload of the VC partners by getting others involved in assessing the risks during the due diligence period and in managing the deal. And the presence of several VC firms adds credibility. In fact, some observers have suggested that the truly smart fund will always be a follower of the top-tier firms.

Attractive Returns for the VC

In return for financing one to two years of a company's start-up, venture capitalists expect a ten times return of capital over five years. Combined with the preferred position, this is very high-cost capital: a loan with a 58% annual compound interest rate that cannot be prepaid. But that rate is necessary to deliver average fund returns above 20%. Funds are structured to guarantee partners a comfortable income while they work to generate those returns. The venture capital partners agree to return all of the investors' capital before sharing in the upside. However, the fund typically pays for the investors' annual operating budget—2% to 3% of the pool's total capital—which they take as a management fee regardless of the fund's results. If there is a $100 million pool and four or five partners, for example, the partners are essentially assured salaries of $200,000 to $400,000 plus operating expenses for seven to ten years. (If the fund fails, of course, the group will be unable to raise funds in the future.) Compare those figures with Tommy Davis and Arthur Rock's first fund, which was $5 million but had a total management fee of only $75,000 a year.

The real upside lies in the appreciation of the portfolio. The investors get 70% to 80% of the gains; the venture capitalists get the remaining 20% to 30%. The amount of money any partner receives beyond salary is a function of the total growth of the portfolio's value and the amount of money managed per partner. (See the exhibit "Pay for Performance.")

PAY FOR PERFORMANCE

ANNUAL IRR OF FUND OVER FIVE YEARS:	0%	10%	20%	30%	40%	50%
AVERAGE ANNUAL COMPENSATION (IN MILLIONS) $20 million managed per partner:	0.2	0.6	1.4	2.4	3.8	5.4
AVERAGE ANNUAL COMPENSATION (IN MILLIONS) $30 million managed per partner:	0.3	0.9	2.1	3.6	5.5	8.1

Pay for Performance

Thus for a typical portfolio—say, $20 million managed per partner and 30% total appreciation on the fund—the average annual compensation per partner will be about $2.4 million per year, nearly all of which comes from fund appreciation. And that compensation is multiplied for partners who manage several funds. From an investor's perspective, this compensation is acceptable because the venture capitalists have provided a very attractive return on investment and their incentives are entirely aligned with making the investment a success.

What part does the venture capitalist play in maximizing the growth of the portfolio's value? In an ideal world, all of the firm's investments would be winners. But the world isn't ideal; even with the best management, the odds of failure for any individual company are high.

On average, good plans, people, and businesses succeed only one in ten times. To see why, consider that there are many components critical to a company's success. The best companies might have an 80% probability of succeeding at each of them. But even with these odds, the probability of eventual success will be less than 20% because failing to execute on any one component can torpedo the entire company.

INDIVIDUAL EVENT	PROBABILITY
Company has sufficient capital	80%
Management is capable and focused	80%
Product development goes as planned	80%
Production and component sourcing goes as planned	80%
Competitors behave as expected	80%
Customers want product	80%
Pricing is forecast correctly	80%
Patents are issued and are enforceable	80%
COMBINED PROBABILITY OF SUCCESS	17%

If just one of the variables drops to a 50% probability, the combined chance of success falls to 10%.

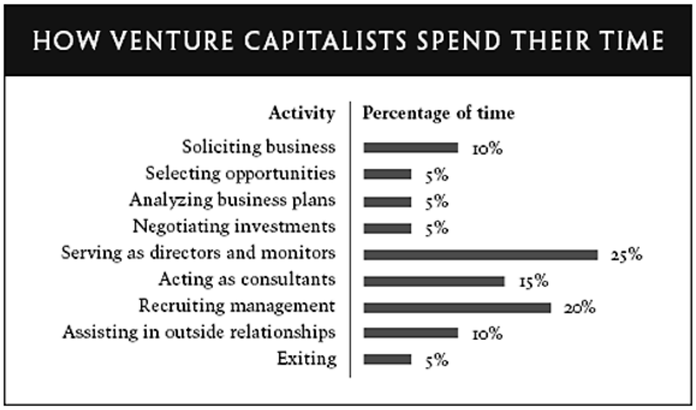
These odds play out in venture capital portfolios: more than half the companies will at best return only the original investment and at worst be total losses. Given the portfolio approach and the deal structure VCs use, however, only 10% to 20% of the companies funded need to be real winners to achieve the targeted return rate of 25% to 30%. In fact, VC reputations are often built on one or two good investments.

A typical breakout of portfolio performance per $1,000 invested is shown below:

	BAD	ALIVE	OKAY	GOOD	GREAT	TOTAL
$ INVESTED	200	400	200	100	100	1,000
PAYOUT YEAR 5	0	1X	5X	10X	20X	
GROSS RETURN	0	400	1,000	1,000	2,000	4,400
NET RETURN	(200)	0	800	900	1,900	3,400

Those probabilities also have a great impact on how the venture capitalists spend their time. Little time is required (and sometimes best not spent) on the real winners—or the worst performers, called *numnuts* ("no money, no time"). Instead, the VC allocates a significant amount of time to those middle portfolio companies, determining whether and how the investment can be turned around and whether continued participation is advisable. The equity ownership and the deal structure described earlier give the VCs the flexibility to make management changes, particularly for those companies whose performance has been mediocre.

Most VCs distribute their time among many activities (see the exhibit "How Venture Capitalists Spend Their Time"). They must identify and attract new deals, monitor existing deals, allocate additional capital to the most successful deals, and assist with exit options. Astute VCs are able to allocate their time wisely among the various functions and deals.



How Venture Capitalists Spend Their Time

Assuming that each partner has a typical portfolio of ten companies and a 2,000-hour work year, the amount of time spent on each company with each activity is relatively small. If the total time spent with portfolio companies serving as directors and acting as consultants is 40%, then partners spend 800 hours per year with portfolio companies. That allows only 80 hours per year per company—less than 2 hours per week.

The popular image of venture capitalists as sage advisors is at odds with the reality of their schedules. The financial incentive for partners in the VC firm is to manage as much money as possible. The more money they manage, the less time they have to nurture and advise entrepreneurs. In fact, "virtual CEOs" are now being added to the equity pool to counsel company management, which is the role that VCs used to play.

Today's venture capital fund is structurally similar to its late 1970s and early 1980s predecessors: the partnership includes both limited and general partners, and the life of the fund is seven to ten years. (The fund makes investments over the course of the first two or three years, and any investment is active for up to five years. The fund harvests the returns over the last two to three years.) However, both the size of the typical fund and the amount of money managed per partner have changed dramatically. In 1980, the average fund was about $20 million, and its two or three general partners each managed three to five investments. That left a lot of time for the venture capital partners to work directly with the companies, bringing their experience and industry expertise to bear. Today the average fund is ten times larger, and each partner manages two to five times as many investments. Not surprisingly, then, the partners are usually far less knowledgeable about the industry and the technology than the entrepreneurs.

The Upside for Entrepreneurs

Even though the structure of venture capital deals seems to put entrepreneurs at a steep disadvantage, they continue to submit far more plans than actually get funded, typically by a ratio of more than ten to one. Why do seemingly bright and capable people seek such high-cost capital?

Venture-funded companies attract talented people by appealing to a "lottery" mentality. Despite the high risk of failure in new ventures, engineers and businesspeople leave their jobs because they are unable or unwilling to perceive how risky a start-up can be. Their situation may be compared to that of hopeful high school basketball players, devoting hours to their sport despite the overwhelming odds against turning professional and earning million-dollar incomes. But perhaps the entrepreneur's behavior is not so irrational.

Consider the options. Entrepreneurs—and their friends and families—usually lack the funds to finance the opportunity. Many entrepreneurs also recognize the risks in starting their own businesses, so they shy away from using their own money. Some also recognize that they do not possess all the talent and skills required to grow and run a successful business.

Most of the entrepreneurs and management teams that start new companies come from corporations or, more recently, universities. This is logical because nearly all basic research money, and therefore invention, comes from corporate or government funding. But those institutions are better at helping people find new ideas than at turning them into new businesses (see the exhibit "Who Else Funds Innovation?"). Entrepreneurs recognize that their upside in companies or universities is limited by the institution's pay structure. The VC has no such caps.

Who Else Funds Innovation?

The venture model provides an engine for commercializing technologies that formerly lay dormant in corporations and in the halls of academia. Despite the $133 billion U.S. corporations spend on R&D, their basic structure makes entrepreneurship nearly impossible. Because R&D relies on a cooperative and collaborative environment, it is difficult, if not impossible, for companies to differentially reward employees working side by side, even if one has a brilliant idea and the other doesn't. Compensation typically comes in the form of status and promotion, not money. It would be an organizational and compensation nightmare for companies to try to duplicate the venture capital strategy.

Furthermore, companies typically invest in and protect their existing market positions; they tend to fund only those ideas that are central to their strategies. The result is a reservoir of talent and new ideas, which creates the pool for new ventures.

For its part, the government provides two incentives to develop and commercialize new technology. The first is the patent and trademark system, which provides monopolies for inventive products in return for full disclosure of the technology. That, in turn, provides a base for future technology development. The second is the direct funding of speculative projects that corporations and individuals can't or won't fund. Such seed funding is expected to create jobs and boost the economy.

Although many universities bemoan the fact that some professors are getting rich from their research, remember that most of the research is funded by the government. From the government's perspective, that is exactly what their $63 billion in R&D funding is intended to do.

The newest funding source for entrepreneurs are so-called angels, wealthy individuals who typically contribute seed capital, advice, and support for businesses in which they themselves are experienced. We estimate that they provide $20 billion to start-ups, a far greater amount than venture capitalists do. Turning to angels may be an excellent strategy, particularly for businesses in industries that are not currently in favor among the venture community. But for angels, these investments are a sideline, not a primary business.

Downsizing and reengineering have shattered the historical security of corporate employment. The corporation has shown employees its version of loyalty. Good employees today recognize the inherent insecurity of their positions and, in return, have little loyalty themselves.

Additionally, the United States is unique in its willingness to embrace risk-taking and entrepreneurship. Unlike many Far Eastern and European cultures, the culture of the United States attaches little, if any, stigma to trying and failing in a new enterprise. Leaving and returning to a corporation is often rewarded.

For all these reasons, venture capital is an attractive deal for entrepreneurs. Those who lack new ideas, funds, skills, or tolerance for risk to start something alone may be quite willing to be hired into a well-funded and supported venture. Corporate and academic training provides many of the technological and business skills necessary for the task while venture capital contributes both the financing and an economic reward structure well beyond what corporations or universities afford. Even if a founder is ultimately demoted as the company grows, he or she can still get rich because the value of the stock will far outweigh the value of any forgone salary.

By understanding how venture capital actually works, astute entrepreneurs can mitigate their risks and increase their potential rewards. Many entrepreneurs make the mistake of thinking that venture capitalists are looking for good ideas when, in fact, they are looking for good managers in particular industry segments. The value of any individual to a VC is thus a function of the following conditions:

- the number of people within the high-growth industry that are qualified for the position;
- the position itself (CEO, CFO, VP of R&D, technician);

- the match of the person’s skills, reputation, and incentives to the VC firm;
- the willingness to take risks; and
- the ability to sell oneself.

Entrepreneurs who satisfy these conditions come to the table with a strong negotiating position. The ideal candidate will also have a business track record, preferably in a prior successful IPO, that makes the VC comfortable. His reputation will be such that the investment in him will be seen as a prudent risk. VCs want to invest in proven, successful people.

Just like VCs, entrepreneurs need to make their own assessments of the industry fundamentals, the skills and funding needed, and the probability of success over a reasonably short time frame. Many excellent entrepreneurs are frustrated by what they see as an unfair deal process and equity position. They don’t understand the basic economics of the venture business and the lack of financial alternatives available to them. The VCs are usually in the position of power by being the only source of capital and by having the ability to influence the network. But the lack of good managers who can deal with uncertainty, high growth, and high risk can provide leverage to the truly competent entrepreneur. Entrepreneurs who are sought after by competing VCs would be wise to ask the following questions:

- Who will serve on our board and what is that person’s position in the VC firm?
- How many other boards does the VC serve on?
- Has the VC ever written and funded his or her own business plan successfully?
- What, if any, is the VC’s direct operating or technical experience in this industry segment?
- What is the firm’s reputation with entrepreneurs who have been fired or involved in unsuccessful ventures?

The VC partner with solid experience and proven skill is a true “trail-wise sidekick.” Most VCs, however, have never worked in the funded industry or have never been in a down cycle. And, unfortunately, many entrepreneurs are self-absorbed and believe that their own ideas or skills are the key to success. In fact, the VC’s financial and business skills play an important role in the company’s eventual success. Moreover, every company goes through a life cycle; each stage requires a different set of management skills. The person who starts the business is seldom the person who can grow it, and that person is seldom the one who can lead a much larger company. Thus it is unlikely that the founder will be the same person who takes the company public.

Ultimately, the entrepreneur needs to show the venture capitalist that his team and idea fit into the VC’s current focus and that his equity participation and management skills will make the VC’s job easier and the returns higher. When the entrepreneur understands the needs of the funding source and sets expectations properly, both the VC and entrepreneur can profit handsomely.• • •

Although venture capital has grown dramatically over the past ten years, it still constitutes only a tiny part of the U.S. economy. Thus in principle, it could grow exponentially. More likely, however, the cyclical nature of the public markets, with their historic booms and busts, will check the industry’s growth. Companies are now going public with valuations in the hundreds of millions of dollars without ever making a penny. And if history is any guide, most of these companies never will.

The system described here works well for the players it serves: entrepreneurs, institutional investors, investment bankers, and the venture capitalists themselves. It also serves the supporting cast of lawyers, advisers, and accountants. Whether it meets the needs of the investing public is still an open question.

Bob Zider is president of the Beta Group, a firm that develops and commercializes new technology with funding from individuals, companies, and venture capitalists. It is located in Menlo Park, California.

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