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Entrepreneurship for the Long Term

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ENTREPRENEURSHIP FOR THE LONG TERM

A new breed of company founders is over-throwing conventional wisdom by staying with their start-up long term, professionalizing the workforce as they scale up, and figuring out how to keep the entrepreneurial spark alive over decades.

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A VALUABLE RESOURCE FOR FAMILY BUSINESSES

SPONSOR'S PERSPECTIVE

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Family owned businesses are intrinsically complex because families are complex. A specific event may illuminate this complexity—a key family member may become ill, another may raise questions about business succession, or an unsolicited offer to buy the business may be presented. These situations and many others encountered by family business owners illustrate the need for an experienced, trustworthy advisor to offer support and guidance; an advisor who can bring together expert advice and specialized knowledge from a variety of disciplines.

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Achieve Greater

Our experts understand that family business owners are unique, and collaborate with them to plan for every phase of their lives, whether it's continuing to build and grow a business, or move on to life's next chapter. Northern Trust advisors provide sound, objective advice that helps our clients achieve greater.

To learn more about Northern Trust business owner services, visit northerntrust.com/business or call 866-803-5857.

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USING SUPPLY CHAINS TO GROW YOUR BUSINESS

DANIEL ISENBERG AND TIMOTHY COATES

Until a few years ago Steve Cronce's Raphael Industries did $1 million dollars a year of specialized industrial painting for customers within driving distance of their plant in Milwaukee, Wisconsin. One of them happened to be GE Healthcare, which sent Raphael "dead" X-Ray tube parts for re-coating and re-commissioning. Challenged by other entrepreneurs in Scale Up Milwaukee's Scalerator program to come up with a plan for rapidly ramping up his business, Cronce wondered: "What if I redefined Raphael as a strategic link in the global medical imaging supply chain, rather than as a paint shop?" This supply chain epiphany is taking Raphael toward $10 million of work a year by burrowing into GE's global network as well as serving its competitors. He is poised to become the leader in this segment of a multibillion dollar market. "By serving as GE's and other equipment makers' supply partner, the whole world is now my scope. I am no longer limited by geography."

This story leads us to a question: Which sounds sexier: sassy Silicon Valley startup or nose-to-the-grindstone supplier? No doubt the tech startup wins the popularity contest hands down.

But let's change what we're asking: Which has the better potential to scale up and create long term value for customers, owners, investors, and employees? According to a study by the Center for an Urban Future, small businesses that win large supply contracts report average revenue growth more than 250% in the two years after their first sale. The reality is that the vast majority of successfully scaled ventures are not mythical unicorns with billion dollar paper values, but workhorses that plug along, steadily producing results year after year.

Although big, global supply chains certainly have their own dynamism, they mostly evolve incrementally through innovation rather than disruption — and thus get short shrift in the business media and amongst aspiring entrepreneurs, hungry to create successful ventures. But entrepreneurial know-how and energy can work very effectively in the context of plugging-in as a supplier, as Steve Cronce and thousands of others are learning.

Taking this path isn't a cake walk, however. Corporate procurement processes are opaque, secretive, and can be influenced by political pull as well as pure performance. Here is some advice on how to tap into supply chains for successful scale-up:

Reveal more than is comfortable. Like it or not, the reality (in supply chains, as elsewhere) is that power is asymmetrical — large customers typically have more clout than you do, and they know it. One result is that they keep their cards close to their chests about what they are looking for (at first), while expecting you to reveal everything — your finances, pricing, ownership, human resources, production processes, quality assurance, customer service procedures, KPIs, and existing customers. Not only does this take time (corporate customers in IBM's free Supplier Connection portal require advance answers to over 140 questions before they will even consider you), frankly, it is downright frightening for most of us.

Jorge Rodriguez-Gonzalez, founder of PACIV in Puerto Rico, flipped this dynamic on its head. Compliance is crucial for pharmaceutical makers such as Abbott and Amgen — a "Form 483" warning from an FDA inspector can shut down a drug facility in an instant and even land top executives in jail. Thus, the supplier of compliance services is of strategic importance. As an industry newcomer, to gain the absolute trust of his first customer, Eli Lilly, Rodriguez-Gonzalez took transparency to a new level: Not only did he reveal his exact labor, materials costs, and profits, Rodriguez-Gonzalez even sent the client his personal income tax returns, so that Lilly purchasing executives would have no doubts about the veracity of his representations. In the clubby world of pharmaceutical purchasing executives, PACIV's reputation for transparency spread, setting a higher bar that his competitors begrudgingly were now asked to jump over.

Manage culture by setting expectations appropriately. Global supply chains can cut across many "cultures": national, industry, technology, market segment, and more. Innovative, proudly geeky Norwegian software company, Trolltech, an open-source pioneer, landed a contract with the mobile division of Sharp, the Japan-based consumer electronics global powerhouse. Ultimately, the contract helped Trolltech break into the then-nascent mobile handset supply chain, go public, and later, to be acquired by Nokia for $153 million.

But Trolltech almost pulled the plug on the "Project from Hell," as they called it, because the style and values of the Scandinavian technology supplier and the Japanese manufacturer led to conflict after tense conflict. What helped Trolltech ultimately save the relationship was learning how to set expectations appropriately in light of the divergent cultures. They realized they needed to invest time, and talent, in analyzing the implications of corporate cultural differences on their ability to supply the goods, not just win the first contract or certification. That meant ensuring their people spoke the language of large consumer electronics supply chains, understood how manufacturers think, and had the perspective and adaptability to fit into a long line of actors from programming in Scandinavia, to manufacturing in Japan, to the consumer in New York.

Manage the arduously long sales cycle. One of the most important realities of tapping into supply chains is: it takes time. An initial sales cycle can easily mean waiting one-and-a-half to two years before receiving a first commercial order. Ane Ohm,CEO of HarQen, a startup supplier of automated recruiting systems in Milwaukee, and her staff held over 100 patience-sapping meetings with a Fortune 500 customer before getting a first contract. Luckily, this single contract was pivotal in helping HarQen reposition themselves from a technology-driven voice response company, to a market-driven recruiting systems one.

Of course, time is money, and in light of the long selling cycles, creative financing is often the name of the game: banks will sometimes step up to finance part of a firm contract with a large customer. Private investors might buy some equity or lend against future royalties if they can see the customer is serious. If you have an innovative edge and are willing to give attractive discounts, sometimes customers will make pre-payments against purchases; even if they are small they can relieve the cash pressures. In fact, advanced payments may be just the kind of proof that banks or equity investors need to open their pocket books.

If you have one big customer, enlist them to help you grow. When one customer is responsible for the lion's share of your sales, it's like golden handcuffs. The challenge is to cast off the handcuffs while keeping the gold. Sometimes this means utilizing your one big customer to get others. This was the situation facing Collins Consulting, a Chicago area provider of contingent staffing services. For more than a decade Collins had almost exclusively supported IBM's commercial and government businesses. Collins worked primarily on IT related work, such as systems integration and software development. When an opportunity arose to work on a financial audit and accounting contract, IBM helped Collins broaden its skill set and diversify its offerings into financial management. IBM then recommended Collins to KPMG, a competitor, when the latter won a large contract with the Department of Defense. Collins' new capability, matured and developed by a dominant major customer, is now a competitive and profitable business area for the company. It is true that some large customers will jealously guard you in a quasi-exclusive relationship. But more often than not, you can persuade and use the customer to help you work with even their arch competitors, to their own advantage as well as yours.

Partner with procurement. Corporations naturally build impersonal procurement policies and processes to support their growth. On the other hand, every successful sales person knows that personal relationships help win new business. In 2006,Havens & Company risked losing 30% of its business when IBM acquired Havens' major customer, KeyMRO, and naturally reassigned Havens' sales contacts at KeyMRO within IBM's large organization. Havens, accustomed to selling benefits services to Fortune 1000 human resources departments, found its key contact person assigned to IBM procurement instead. Nonetheless, Laura Havens, president and owner, recognized an even bigger opportunity to partner with IBM's large corporate procurement organization. She took advantage of the trust with the now-purchasing executive, who became their internal advocate with HR leaders across IBM's divisions and geographies. In 2011, Havens' collaboration with IBM procurement paid off, winning Havens four significant projects.

Corporate purchasing is not as all-powerful and monolithic as it might seem from the outside. As Havens and many other corporate suppliers have learned, just because you have a contract with one part of the business doesn't mean another part works the same way. Many corporations have at least some elements of purchasing which are decentralized, meaning the different units may have separate sourcing criteria, payment terms and supplier management practices, creating separate supply opportunities.

Innovate and invest, even when it hurts. We know it sounds almost contradictory because the media is replete with stories of "disruptive startups," but most small companies are loath to make innovation investments, with fewer than 15%evidencing tangible innovative activity in their first four years. In 2004, when ZeroChaos, a provider of contingent workforce solutions, began courting IBM as a customer, IBM was concerned with losing the war for engineering talent to new startups such as Yahoo and Google. After listening to IBM executives' concerns, CEO Harold Mills invested over a year of the smaller company's limited bandwidth to build a "virtual bench" of technical talent dedicated to IBM, a product they named "Blue Direct." They were able to recruit 200,000 developers and product designers, allowing ZeroChaos to communicate directly with potential recruits about new and relevant IBM initiatives, and giving IBM access to this critical talent pool. Signing up IBM as a paying customer allowed ZeroChaos to expand from an initial contract in the US to now supporting IBM in 13 countries. Today, ZeroChaos is a $3 billion company and as Mills says, "a significant amount of that growth was enabled by the IBM partnership."

Entrepreneurial opportunity is not limited to disruptive startups. While the idea of embedding yourself in a vigorous supply chain may not seem so exciting, if done well, it can be a powerful way to scale-up for success.

THE BEST PART OF ENTREPRENEURSHIP? GIVING UP AND GETTING A JOB

WALTER FRICK

Entrepreneurship isn't usually worth the risk, some research says, at least strictly in financial terms. Thankfully, plenty of people take the plunge anyway, because they're drawn to it for other reasons, such as wanting to be their own boss, or wanting to pursue a personal passion.

But that conventional view is misleading, argues a recent paper by Gustavo Manso at the University of California, Berkeley. Instead, he finds that self-employment does pay off financially, but not in the way entrepreneurs might expect. The financial benefit doesn't usually come from the entrepreneurship itself, but in the form of higher wages when the entrepreneur returns to the workforce.

Research in this area typically compares salaried workers to those working for themselves; the latter group tends to make less, on average, after controlling for factors like level of education, hence the finding that entrepreneurship isn't worth it financially.

Instead of that approach, Manso looked at workers over a longer time period, capturing the earnings of more than 5,000 American adults between 1979 and 2012. The average annual earnings for a self-employed person in the sample is higher than for a salaried worker, while the median is lower. That squares with previous research, and with intuition: a small number of entrepreneurs will make a lot of money, but the typical entrepreneur will make less than they could at a bigger company.

However, according to Manso's data, most entrepreneurs eventually go back to salaried work; just over half of self-employment stints last for two years or less.

When Manso looked at lifetime earnings, he found that individuals who had been self-employed at one point in their career fared better, when compared to similar workers who hadn't.

"Individuals who attempt to be entrepreneurs but abandon entrepreneurship in less than two years are not punished, achieving approximately the same earnings as similar individuals who have not attempted to be entrepreneurs," he reports in the paper. "At the same time, entrepreneurs who stay longer than two years, make substantially more than similar salaried workers."

"Overall," he concludes, "I find that entrepreneurs earn approximately 10% more than salaried workers with similar characteristics."

Manso's theory of why people might try entrepreneurship and then head back to the labor market just a year or two later hinges on experimentation. Stepping away from a job to start a company offers a chance to experiment with a new idea, and to see if it works or not. If the idea works, the entrepreneur stays self-employed; if the idea doesn't work, they get another job.

The data can't explain *why* that next job pays as much or more than the entrepreneur would have made if they'd never been self-employed. "It seems that the labor market values the experience [of being] self-employed," said Manso by email. "Maybe the skills developed during [a] self-employment spell are useful as [a] salaried worker."

As Manso notes, and as economist Noah Smith noted in a column about the paper last year, this data isn't limited to the sort of entrepreneurs who raise venture capital or typify Silicon Valley. More likely, it includes mostly small business owners in sectors like retail or food service. Still, it's at least plausible that something similar happens for growth entrepreneurs. There are plenty of ways for an entrepreneur to mitigate the risk of starting a business, for instance by developing an area of expertise, which could conceivably translate into higher wages should the venture fail. And for younger workers, founding or joining a startup can mean a more senior title with more responsibility, which might translate into a better job at an established firm later on.

Like everything else, the devil is probably in the details. Whether a stint as an entrepreneur pays off financially will depend on the person, the career, and the business in question. Manso's research is a reminder that entrepreneurship needn't be a lifelong commitment. It is possible to found a startup and later return to an established company. Sometimes it's even the best way to ensure a return on your entrepreneurial investment.

MEANINGFUL WORK BEATS OVER-THE-TOP PERKS EVERY TIME

PATTY McCORD

A few years ago, I visited a Bay Area startup, and when the receptionist greeted me in the lobby, she asked a standard question: "Would you care for something to drink?" I asked for a water, but she responded with a counteroffer: "We're pouring a very oaky Chardonnay today."

It was just after lunchtime — a little early for wine, at least for me — but when I raised an eyebrow at my would-be sommelier, she continued: "We also have a bartender who comes in at 3 pm every day, and he makes a mean mojito."

When I made it past the lobby and into the CEO's office, I asked about the daily booze service. The CEO talked about how difficult it is to recruit top talent. For a startup, differentiating yourself with pay and stock options isn't enough anymore, he said, so over-the-top perks have become the coin of the realm. The afternoon cocktails make people happy, and they're something few competing employers are offering. To him, it makes sense.

I hear this message frequently as I visit startups, and I empathize with the basic sentiment. Earlier in my career I spent 14 years as chief talent officer at Netflix, where I helped create some of the innovative talent management policies — such as no-formal-limit vacation policies — that have since become widespread. (I described the creation of the Netflix culture in a 2014 HBR article.) Since leaving Netflix in late 2013, I've served as a consultant, both to startups and to growth companies that are moving well beyond the startup stage (including Warby Parker, Harry's Grooming, and HubSpot). So I'm well-versed in the challenges of recruiting (and retaining) top technical talent in a tight market.

As I visit young companies, I've seen every kind of perk imaginable. Razor scooters, take-your-dog-to-work, in-house baristas, free snacks and lunches: Yawn. Yoga classes, massage therapy, acupuncture, pre-paid Uber accounts: *Been there, done that.*

These amenities generally start with good intentions. Startups require ferociously hard work and long hours, and companies like Google realized very early on that if employees spend less time worrying about where to eat lunch or when to pick up their dry cleaning, both employee and employer will benefit.

But at times I see examples of this perk warfare going a bit too far. I understand the scientific evidence that afternoon naps can boost productivity, and I understand the appeal of companies installing nap rooms. Instead of a private nap room, however, I recently visited a startup that installed hammocks just off the lobby, so employees could swing while they snooze.

Really? The first thing a visitor sees when entering the door is your employees sleeping at work? Is that the message you want to send?

Some of the strange perks I see are simply examples of starting with a good idea ("let's have occasional company happy hours!") and taking them too far ("let's have daily bartender service!"). But much of the perk-creep I witness is driven by a different force: startups with cash that's burning holes in their respective pockets.

Until fairly recently, one of the distinguishing characteristics of managing at a startup was that you were dealing with constrained resources. Historically, one of the reasons startups offered employees stock options was because they wanted to conserve scarce cash by paying lower salaries. Cash constraints were a fact of life during my years managing in a startup. In the early days at Netflix, for instance, when DVDs-by-mail was still our primary business model, I used to look at every expense through a simple framework: How many DVDs would it cost? For example, if an employee griped that other companies were providing fancy $800 Aeron chairs, I'd offer a simple reply: "We can buy 40 DVDs for every Aeron chair we don't buy, and since money is tight, we need to spend it on things that benefit customers."

That equation has completely changed during the current boom, when venture capitalists are pouring money into new ventures. Cash is no longer a key constraint, so some talent managers are becoming really creative in finding new ways to spend it to make employees smile.

In time, this phenomenon will prove self-correcting. Venture capitalists don't give money away; eventually, they want a return. If they're not getting it, the cash will dry up. When the economy slows, companies always tighten up on employee benefits, and the current wave of startup perks will go through that same boom-and-bust cycle.

Until then, the startups that I'd bet on to succeed (or I'd choose to work at if I were just starting my career) are not the ones where people are lying in hammocks drinking the craft beer *du jour*. They're the ones where people are going to work because they get to collaborate with great colleagues on important products. Perks are nice, but meaningful work is better. And as someone who spent many years working to retain talent at a startup, I think there's only one appropriate response if an employee decides to quit because another company offers tastier free lunches or a wider selection of kegerators: "Have fun. Good luck. Party on, Garth."

EVERY COMPANY NEEDS A GROWTH MANAGER

JEFF BUSSGANG AND NADAV BENBARAK

Growing revenue and profits is a core objective of most companies, and it is the responsibility of every function to contribute to the pursuit of this goal. Yet, in recent years technology startups have embraced a new role, Growth Manager — alternatively Growth Hacker, Growth PM, or Head of Growth — that focuses on it exclusively. By viewing product development and marketing as integrated functions, not silos, leading tech companies like Facebook and Pinterest are rethinking their approach to driving growth and achieving breakthrough results.

Yet, the Growth Manager role remains poorly understood, especially outside Silicon Valley. As part of an entrepreneurial research effort for Harvard Business School, we interviewed more than a dozen Growth Managers at fast-growing startups and explored what they are doing to design a growth function within an organization.

The Growth Manager function typically lives at the intersection of marketing and product development, and is focused on customer and user acquisition, activation, retention, and upsell. The Growth Manager usually reports either to the CEO, the vice president of Product Management, or the vice president of Marketing. They work cross-functionally with engineering, design, analytics, product management, operations, and marketing to design and execute growth initiatives.

As for responsibilities, the Growth Manager's job has three core components: first, to define the company's growth plan, second, to coordinate and execute growth programs, and third, to optimize the revenue funnel.

But before any of these things can take place, the Growth Manager needs to make sure the right data infrastructure is in place.

Data is the fuel of the growth function and growth teams invest a significant share of their resources to create the infrastructure that enables analysis of user behavior, scientific experimentation, and targeted promotions. While many growth teams have special requirements that compel them to build their own custom data infrastructure, many choose to work with commercially available SaaS products. These include everything from analytics tools like Adobe Analytics and Google Analytics, to A/B testing tools like Oracle's Maxymiser and Optimizely.

Growth Managers are typically responsible for selecting and integrating these products into the company's analytics framework and working either on their own or in partnership with the analytics team to provide dashboards and testing tools as services across the organization.

Once data is available, the Growth Manager must help the company define its growth objective, typically by answering two core questions. First, at which layers of the funnel should growth initiatives be focused? For instance, should resources go to user acquisition or to combatting churn? Second, the Growth Manager needs to help the company to quantify and understand progress against goals. This task is accomplished through the selection of key performance indicators, and the development of reports on these metrics for consumption across the organization.

Growth Managers also provide customer insight, by blending data with a deep understanding of user needs, habits, and perceptions developed through targeted interviews, usability studies, and customer feedback. Growth Managers utilize the data they have to answer some of the troubling "whys" that a company may have. For instance: Why are users dropping out of the sign up experience? Why don't users come back to the application after the initial download? Why aren't users responding to special offers? These insights are then fed back into the product team to help prioritize product priorities, which impacts the product roadmap, as discussed below.

Furthermore, the Growth Manager is responsible for prioritizing growth initiatives and product changes. Ideas for initiatives to create growth originate in virtually all functions in the organization. The Growth Manager is the catcher and champion for product requests from outside the growth team. Further, the Growth Manager must implement a framework for prioritizing growth-specific product improvements, and organizing the testing rhythm.

Sean Ellis, founder of Growthhackers.com and former vice president of marketing at LogMeIn, proposes a simple framework for prioritizing project ideas via ranking on three core dimensions:

1. The impact of the change if it is successful
2. Confidence that the test will yield a successful result
3. Cost to execute the test.

Taken together, these three elements can help to negotiate priority across the pool of ideas.

With a clearly defined growth objective, and a prioritized roadmap of ideas to test, a Growth Manager turns their attention to designing and implementing tests. If the test is to be conducted within the product, the Growth Manager leads a product development process to implement the change. The process often begins with a Product Requirements Document (PRD) or a summary slide presentation that articulates the product changes needed. Next, the Growth Manager works with a cross functional team including engineering, analytics, design, marketing, and product marketing to execute the test.

So what makes a good Growth Manager?

If data is the fuel of growth, then analytics is its engine. The Growth Manager must master statistical reasoning, understand how to design effective experiments, and develop a quantitative intuition for interpreting user experience data. Effective Growth Managers are conversant with data analysis and the best tools for retrieving, manipulating, and visualizing data including tools like MySQL, Excel, R, and Tableau.

Growth Managers also need to be fluent in the full spectrum of acquisition channels at their disposal. James Currier, founder of Ooga Labs, identifies three general types of acquisition channels:

- Owned Media: Email, Facebook, Craigslist, Twitter, Pinterest, Apps
- Paid: Ads (Mobile, Web, Video, TV, Radio, SEM, Affiliate), Sponsorships
- Earned Media: SEO, PR, Word of Mouth

Each channel has its own advantages, tradeoffs, and idiosyncrasies. An intimate and specific knowledge of the channels that are most effective in reaching a product's target audience is critical.

The Growth Manager also needs creativity, strategic thinking, and of course leadership. The latter is particularly important since the Growth Manager must align all market-facing functions to a shared growth objective without direct authority, and must build a growth team whose culture is suited to the challenging and experimental nature of the work.

Experience at numerous growing tech firms confirms that Growth Managers are getting results across all parts of the user journey and at all levels of the funnel.

By comparing behavior of retained users versus those users who churned, the early Facebook growth team determined that a key driver of new user retention was finding and connecting with at least 10 friends within the first two weeks after signup. With this insight in hand, Facebook developed features to allow users to quickly see and connect with friends who were already using the service.

The growth team at Pinterest was able to increase new user activation by more than 20% with an improved flow for new users. By changing the on-boarding experience — from a text-intensive explanation of the service, followed by a generic feed of the most popular content, to a visual explanation and personalized content feed based on a survey of user interests — the team was able to better explain the value proposition and train the user, which ultimately led to better conversion.

Expect the Growth Manager to become a standard function in the coming years. As with many organizational innovations, what begins in startups migrates to larger organizations that wish to operate in an entrepreneurial fashion.

IS THERE A CONNECTION BETWEEN ENTREPRENEURSHIP AND MENTAL HEALTH CONDITIONS?

DAN McGINN

Biographers have long been interested in exploring the psychological issues that drove and afflicted great thinkers and achievers such as Charles Darwin and Albert Einstein. In her new book, Andy Warhol was a Hoarder: Inside the Minds of History's Great Personalities, medical and science journalist Claudia Kalb looks at twelve famous figures and weighs the evidence suggesting that each suffered from a different kind of mental health condition. While not a business book per se, her work does have relevance as more people are becoming aware of mental illness as a workplace issue. Kalb spoke with HBR about how mental health conditions can be particularly relevant in understanding entrepreneurs. Edited excerpts:

One of the themes in your book is that people with mental illness often find ways to turn their behaviors into an advantage, and in fact there's emerging research on this phenomenon among entrepreneurs. How common is this?

You have to remember that mental illness exists on a spectrum. At one end are people who are unable to function — think of someone lying in bed with severe depression. Being productive would be out of the question. But someone who comes out of a bout of depression and is back at work may have a greater ability to empathize, and to see situations more realistically without excessive optimism. There's a whole area of research into so-called "depressive realism." Abraham Lincoln, who I write about in my book, is often cited as a leader who suffered depression, and there are many theories about how his melancholy and depressive character fueled his ability to understand the realities of the Civil War, and to be sensitive to what was happening on both sides. He also used work as a way to get himself out of his melancholy, so there is a sense that the condition may have helped motivate him. This doesn't happen in every case, of course, but there have been books written about people for whom mental illness helps propel them to a position they might not otherwise attain.

What other mental illnesses figure prominently in entrepreneurial narratives?

The most common one may be narcissism. Frank Lloyd Wright is a good example. He had classic narcissistic qualities — a sense of grandiosity, superiority, a huge and complete belief in his aesthetic sensibility, and disregard for architecture that did not live up to his standard. Narcissists also have an ability to be charming, and to lure people into their orbit. That's obviously useful for an entrepreneur. The issue is that while these qualities may make you a good leader, they may not make you a winning boss. Employees often feel that narcissistic bosses are ruthless or lacking in empathy. Also, unlike people with depression or anxiety disorders, narcissists don't suffer as much personally from their condition — but the way they behave can be much harder on the people around them.

That sounds a lot like Steve Jobs.

That's right — he's often cited as an example. There are many researchers looking into narcissism in business. They're conducting surveys of executives, entrepreneurs, even MBA students. It makes sense that people who are risk-takers, who have high self-confidence and a sense of superiority may be better equipped to rise above competitors. Other kinds of mental health conditions can be more immobilizing. It's much more difficult to think about an anxiety disorder or obsessive compulsive disorder helping a person excel in business. Howard Hughes, who I wrote about in my book, was a successful entrepreneur, but in the latter part of his life, as his OCD characteristics became worse, he became totally isolated. He couldn't interact with people in business or in society.

What about ADD or ADHD and its effect on entrepreneurs?

That's often seen as a positive quality in entrepreneurs. People who have ADD tend to be risk-takers, have high energy and drive, and are always on the go. David Neeleman, the founder of JetBlue, is often cited as an example of this. While there can be downsides to having ADD, it isn't perceived as negatively as narcissism, since the qualities of entitlement and superiority can take such a big toll on colleagues and subordinates.

Tech leaders, like Bill Gates, are sometimes described as having symptoms suggestive of Asperger's. Does that sound plausible?

I don't know about Bill Gates — I haven't studied him. And what used to be called Asperger's is now folded into the broader term Autism Spectrum Disorder. But yes, there is interesting research looking into a possible link between scientific talent or even genius and Asperger's. Albert Einstein is one example. His ability to withdraw into his mind and be hyper-focused, to really zone everything else out, was an important part of how he made discoveries. But it also caused some problems for him. As a teacher, he was disorganized — he wasn't very clear in how he presented information to students. In a business setting, that could be a problem. People with Asperger's often experience difficulty when it comes to social interaction, social bonding, and effective communication. However, sometimes they are such geniuses at what they do that people overlook their differences. That could be the case with leaders of tech companies.

Do you think someone with a mental illness is more likely to thrive in a smaller, entrepreneurial setting, instead of in a bureaucratic environment?

That's an interesting idea. Hypothetically, in a smaller place, if you have some of the characteristics we've been talking about — which might appear eccentric or quirky — people may be more accepting, because it's a smaller community of employees. There's probably more opportunity to be open, and if somebody

has a mental health condition that he's able to acknowledge and get treatment for, he's in a better position to succeed than someone who's floundering or doesn't understand the detrimental impact the condition is having on his work. Stigma stems from not understanding what mental health conditions are all about, and not realizing that we all have at least some of these characteristics. We all have a little bit of an impulse to hoard, or to be obsessive or compulsive, or to exhibit signs of ADD. Part of the reason to learn more about these conditions is not to label people, but to better understand where people are coming from — and how, in a business setting, some of these attributes can be positive.

THE VERY FIRST MISTAKE MOST STARTUP FOUNDERS MAKE

NOAM WASSERMAN AND THOMAS HELLMANN

Founders face a wide range of decisions when building their startups: market decisions, product decisions, financing decisions, and many more. The temptation is to prioritize these choices over decisions about how to structure their own founding teams. That's understandable, but perilous. Our research, forthcoming in *Management Science*, identifies one of those important pitfalls: founder equity splits, i.e., the way founders allocate the ownership amongst themselves when starting their company.

Since 2008, we have studied the equity splits adopted by over 3,700 founders from over 1,300 startups in the U.S. and Canada. This builds on Noam's work over the last fifteen years, which has shown that even the best of ideas can falter when the founding team neglects to carefully consider early decisions about the team: the relationships, roles, and rewards that will make the founders a winning team.

It is said that a team has succeeded at splitting the equity if all of the cofounders are equally unhappy. Unfortunately, founder unhappiness tends to get even worse with hindsight; the percentage of founders who say they are unhappy with their equity split increases by 2.5x as their startups mature. Increasing discontent within the founding team is a prime indicator that destructive turnover may be on the horizon. Exhibit A: Facebook. As memorialized in the movie The Social Network, Mark Zuckerberg's initial equity split with Eduardo Saverin went sour as the company evolved. Mark's attempt to reclaim Eduardo's equity landed him in court—maybe good for winning Academy Awards, but not good for business, let alone personal relationships.

When and How to Split Founder Equity

Different teams have different ways of splitting the equity: some do it up-front, others wait to get to know each other; some go through a careful negotiation process, others are quick to shake hands and get on with it. Most important, some divide the equity equally amongst all founders, others come to the conclusion that the fair outcome is actually an uneven split that reflects differences among founders.

Robin Chase, cofounder of Zipcar, a car-sharing company, had heard a horror story from a friend about how the negotiation over founder equity had derailed the friend's startup. Eager to avoid that outcome, Robin proposed to her cofounder a 50/50 split at their very first meeting, just as they were getting to know each other professionally. The cofounders quickly shook hands and accepted the equal split. Robin breathed a sigh of relief, they had avoided the high tensions that often accompany an equity-split negotiation.

At Smartix, Inc., which created a smart-ticketing system for sports venues, the founders adopted a very different model for splitting the equity. The founding team believed that "it's best to delay [the equity split] because things are still unknown and changing." When they finally split the equity, they took a very deliberate approach, fearing the effects that might emerge if any founder felt that the equity-split process was unfair. In their dialogue, the team delved into each founder's past contributions, outside opportunities, preferences, and anticipated future contributions. They decided to split the equity unequally, with the founder-CEO receiving more than twice the stake of the cofounder with the lowest stake.

When founders are splitting the equity early in their company's life, they face the heights of uncertainty — about their business strategy and business model, about their eventual roles within the team, about whether each founder will be fully committed to the startup, and about many more unknowns that will become clearer as they get to know each other. Things are even more uncertain for cofounders who have never worked together. Bypassing a serious dialogue about what each of the founders wants or deserves might be easier in the short-term, but is unlikely to be the right thing for the long-term health of the company.

Dive In or Take Time to Discover?

Robin Chase of Zipcar soon became very disillusioned with her "quick handshake" decision. She had never worked with her cofounder before, and had made some bold assumptions about how well they would work together, whose skills would be most valuable, and what the level of commitment would be. She threw herself into building the startup, crafting its business plan, and going parking lot to parking lot, looking for those precious parking spots that her company so desperately needed. Her cofounder? She didn't even quit her day job, and contributed from the sidelines, at best. Robin soon came to realize the perils of that quick handshake. Her rushed negotiation had compromised her team's longer-term effectiveness by causing her "a huge amount of angst over the next year and a half."

Our research sheds light on what Robin learned the hard way. We look at the amount of time founding teams spend discussing their equity splits, and find statistically significant differences between teams who split quickly — neglecting to have a serious dialogue about personal uncertainties and expected contributions — and those who have a lengthier and more robust dialogue. Robin rushed through that discussion, forfeiting the chance to discover what made her cofounder tick, whether her cofounder was enjoying her existing job, whether she was even willing to join Zipcar full time, and so on. In our data we find that those teams that negotiate longer are more likely to decide on an unequal split: the harder you look, the more likely you are to discover important differences. More generally, we argue that if cofounders haven't learned something surprising about each other from their dialogue, they probably haven't engaged in a serious enough discussion yet.

The Perils of Family

Our data also indicate that splitting founder equity well between family members is particularly challenging. Cofounders who are relatives usually believe that they already know each other intimately and therefore don't have much to discover about each other. However, we often act very differently at home than we do at the office, and also very differently under the extreme stresses that accompany startup life. If you've never cofounded together, it's likely that you will be surprised by how your relative acts as a cofounder, often in negative ways. In short, relatives bypass detailed founder discussions at their peril, yet they are statistically more likely to do so.

Equity splits are a microcosm that beautifully reflect this. In our analyses, we find that founding teams that include relatives spent significantly less time negotiating equity splits. They were also much more likely to split the equity equally. Indeed, our research suggests that many founding teams care about displaying outwardly visible equality: not only does everyone gets the same equity share, everyone also gets exactly the same salary. This way no one can say afterwards that it wasn't "fair." This logic frequently trumps the alternative logic that a "fair" split should take into account that different founders contribute different skills, spend different amounts of time on the venture, or give up different job opportunities.

Equity Splits Have Longer-Term Impacts

Founders tend to think "our equity split is just between us; it doesn't affect anyone else." However, that "first deal" between founders could be a first sign of what troubles lie ahead. What do investors make of teams that split the equity equally? Our data suggest that they are less than thrilled. Even after statistically controlling for a lot of factors, our data still suggest the same basic message: companies that have equal splits have more difficulty raising outside finance, especially venture capital. Venture capitalists could obviously tell the founders to come up with a different equity split, but that causes a lot of strife and heightens cofounder turmoil and turnover. Given that venture capitalists invest in less than one out of every hundred companies that come across their desk, they are looking for reasons to say no. An equal split can send worrisome signals about the team's ability to negotiate with others and to deal with difficult issues themselves. Interestingly, our research suggests that equal splits are more a symptom than the cause of trouble. It is not the equal split per se that turns off the investors, it is that equal splits are a symptom of bigger issues with the company.

Go Organic

Robin Chase's painfully-learned advice: Adopt a "more organic" agreement than the static one typically adopted by founders. Vesting, in which each founder has to earn his or her equity stake by remaining involved in the startup or by achieving pre-defined milestones, is one way to achieve the dynamic approach advocated by Robin. Yet, for founders' initial equity splits, such agreements are still the exception rather than the rule because there are many barriers to having the difficult conversation about adopting such mechanisms.

Essentially, such agreements are the equivalent of a newly engaged couple grappling with adopting a pre-nuptial agreement. Despite knowing about the high rate of divorce among married couples, we can't bring ourselves to discuss the adoption of pre-nups with our fiancés. The same goes for the discussion of a "pre-nup" within a founding team. Setting up an agreement up front that outlines negative scenarios that might occur in the future, with corresponding actions to help avoid them, could help founders avoid headaches and increase startups' chances of success.

This article has been corrected to clarify the early roles of the Zipcar founders.

A RECESSION DOESN'T MEAN YOUR STARTUP CAN'T GROW

MARK ROBERGE

So far this year, the stock market has been anything but stable. The correction for tech companies appears to be well underway. Instability overseas continues, causing rising concerns about the effect on the global economy. In the U.S., the Federal Reserve finds it difficult to commit to a plan for 2016.

If the economy continues to head south, what does it mean for entrepreneurs ready to scale their business? Should they hold off on growing sales? Should they take a more conservative approach?

My answer is no.

In my view, a down economy is the best time to build a sales team. In fact, I lived through the journey to tell the tale. I joined HubSpot, an inbound marketing software company, as the fourth employee and first salesperson in 2007. My role was to scale the sales team. Within a year, we had scaled from 100 customers to 700 customers. We had dozens of employees and a dozen or so salespeople. With $17 million in venture capital, we were ready to accelerate sales hiring even further. Life was good.

Then came October of 2008, the worst financial meltdown in decades. As an executive team, we were rattled. Would budget freezes slow down sales? Would future funding options dry up? Would we need to lay people off? Would our dreams of building "the next big thing" be foiled by circumstances outside of our control?

To my surprise, things did not slow down. We were able to secure our next round of funding. We accelerated our pace of sales hiring. Seven years after that infamous day in 2008, we are a post-IPO company with a market cap of over $1 billion dollars.

Looking back, the 2008 economic downturn may have helped us more than it hurt us. Here are five reasons why:

High availability of talent. The "war on talent" has been a hot topic over the past few years. Attracting top caliber people into an early stage venture is arguably one of the most important tasks for the founding team. These early hires will figure out the business model, establish the culture, and ultimately recruit the next wave of employees to drive the business forward.

From the perspective of talent availability, the HubSpot sales team benefited immensely from the 2008 financial crisis. Within months of the market crash, layoffs at other companies yielded a sudden spike in available sales talent. The salespeople that lost their jobs were not necessarily the bottom of the barrel, either. In many cases, they were simply in the wrong division working on the wrong product at the wrong time.

As we continued to expand the sales team post crisis, the increased talent pool enabled us to raised the bar on the quality of salespeople we hired. These new hires went on to play crucial roles in developing our sales playbook and hiring and developing our next wave of salespeople. Eight years later, many of these early hires are still with HubSpot serving in senior sales leadership roles.

"Must-have" versus "nice-to-have" value propositions. In a strong economy, "nice-to-have" value propositions can survive. Budgets are plump. Spending barriers are relaxed. As a salesperson, it is not overly challenging to "arm-twist" a friend or call in a favor to make a sale.

In a weak economy, "nice-to-have" value propositions are left to the wayside. Unless the product or service solves a mission critical issue at the buyer organization, no sale is made. A weak economy forces an organization to discover their "must-have" value proposition. For HubSpot, "more quality sales leads"— the value proposition offered by our software — spurred even the most risk averse organizations to open their purse strings. The 2008 financial crisis pushed us to discover this "must-have" value proposition early in our development, providing a strong foundation from which to build.

Unit economics versus unnatural growth. Over the past few years, market valuations, both public and private, have rewarded growth over unit economics. Historically, economic downturns have reversed the situation.

Market conditions in late 2008 forced us to re-focus HubSpot's attention to unit economics. Customer success, revenue churn, and customer lifetime value often trumped conversations around revenue growth at board and executive meetings. The sales team was at the heart of this re-focusing effort. We began measuring salespeople based on the LTV of their customers, not their revenue generation. We even aligned sales commissions with unit economic metrics. Had we waited until we were two, thee, or even four times the size, this transition would have been exponentially harder — if not impossible. Our early focus on unit economics laid a healthier foundation from which to scale sales.

A better work ethic. "Motivating the salesforce" has crept up to be the top concern amongst sales leaders in recent market studies. It can be harder to motivate salespeople in a strong economy. They are constantly distracted with calls from outside recruiters, emails from friends about new high-paying jobs, and stories about products that are "selling themselves."

In a down economy, self-motivation comes much easier. Suddenly, the recruiter calls offering lush salaries are replaced with horror stories from friends witnessing massive layoffs and the inability to find work. Employees and founders collectively realize an increased urgency to succeed as they are the final mile in ensuring the early stage venture survives financially.

Less competition. In a strong economy, venture and angel capital are flowing. Many people argue the supply of early stage capital in strong economies exceeds the volume of good ideas and good startup teams. This outcome is bad for everyone. Investors lose money on bad deals. Customers lose money purchasing bad

services. Entrepreneurs attempting to create real value face distractions from bad competition.

As the market turned in 2008, we saw many of HubSpot's early competition fade away, due to lack of execution, a weak value proposition, or both. The timing of this dynamic meant one less obstacle for us as we navigated our growth phase. By the time the capital markets bounced back, HubSpot had already established barriers that made it difficult for new entrants to gain traction.

The fate of the markets for the remainder of 2016 and beyond is yet to be seen. However, as an entrepreneur entering the growth phase of your business, reconsider whether a market turn is necessarily bad for your business. It could be a blessing in disguise.

BIG COMPANIES SHOULD COLLABORATE WITH STARTUPS

EDDIE YOON AND STEVE HUGHES

Campbell, the food company best known for its soups, is investing $125 million in a venture fund to help finance food startups, according to the *Wall Street Journal*. Other large consumer companies are doing the same. They share a motive: Growth is increasingly hard to come by, so large companies are increasingly looking to entrepreneurs to help them find it.

Consider the numbers. Over the last four years, the entire U.S. grocery store's entire food and beverage category grew just 2.3% a year. The largest 25 food and beverage companies contributed only 0.1% of that annual growth rate. Who drove the growth? It came from 20,000 small companies outside of the top 100, which together saw revenue grow by $17 billion dollars.

Despite that aggregate revenue growth, not every startup is successful — in fact, the vast majority will fail.

Ironically, startups and established companies would both improve their success rates if they collaborated instead of competed. Startups and established companies bring two distinct and equally integral skills to the table. Startups excel at giving birth to successful proof of concepts; larger companies are much better at successfully scaling proof of concepts.

Startups are better at detecting and unlocking emerging and latent demand. But they often stumble at scaling their proof of concept, not only because they're often doing it for the first time, but also because the skills necessary for creating are not the same as scaling. Startups must be agile and adapt their value proposition several times until they get it right. According to Forbes, 58% of startups successfully figure out a clear market need for what they have.

In contrast, big companies often end up launching things they can make, not what people want. Successful established companies are focused on increasing scale and are often better at scaling proof of concepts than creating new products from scratch. They have huge advantages in procurement, distribution, and manufacturing, as well as sales and marketing advantages. But they have a challenge not only creating a proof of concept, but leaving it alone until it is ready to scale.

Large companies can assist and gain access to startups' prowess at creating proof of concepts via early-stage funding and later-stage M&A. But ideally these relationships are more than just financial and transactional. That's because capital is abundant, and there are more buyers than sellers; if the first time an established company is made aware of a startup is by receiving a deal book from an investment banker, it's already too late. Moreover, established companies that try to win by making the biggest bid will hurt themselves by driving acquisition multiples even higher. Successful collaboration between startups and established companies must go beyond financial deals: it must be personal and mission-oriented.

Personal knowledge is the first place to start. Most times, established companies are woefully unaware of startups. These companies are too small and fly under their radar. Big-company executives must choose to become personally more aware of new, growing companies. This is actually easier than it sounds, because areas of emerging and latent demand are often highly concentrated. A consumer packaged goods executive should regularly spend time in Boulder, Colorado and Austin, Texas, a couple of the hothouses of consumer packaged goods startups. They should take their teams and regularly walk the aisles of Whole Foods, which is as much a greenhouse incubator of the hottest new brands as it is a retailer. They should explore up and coming datasets. SPINs is a retail measurement company that covers the natural and organic grocers. Yet too many companies don't even bother to acquire this data because they dismiss it as too small to matter.

Just as important as personal knowledge are personal relationships. A McKinsey global survey notes that CEOs spend about 17% of their time with customers. Not only should that number be higher, but the mix needs to skew more toward emerging customers. The community of entrepreneurs is also very tightly knit. Building personal relationships within these communities is essential. It's also vital to connect with key people who have tight connections with both startups and established companies in your industry. For example, one of us (Steve) was successful at big companies (ConAgra, Tropicana) and also smaller companies (White Wave, Boulder Brands). Reach out to executives like these to help you navigate and build relationships in these communities.

Finally, collaboration needs to be mission-oriented, meaning it has to be focused on something larger than financial success. Within both the startup and established companies, there are missionaries and mercenaries. For successful collaboration between a startup and established company, correctly match-making like mindsets is critical. But beyond that, our experience is that missionary mindsets have more upside than a mercenary mindset. A missionary mindset provides protection to a proof of concept that is being scaled or sold in an established company or as a startup.

Steve has personal experience around building a new brand in a mission-oriented fashion. Mike Harper, the former CEO of ConAgra, had a heart attack in 1986. It caused him to want to improve his lifestyle, but also put him on a mission to create a heart-healthy food brand: Healthy Choice. He anointed Steve, who'd previously worked at ConAgra and Tropicana, as the "brand mama" who helped grow this from launch to over $1 billion dollars in a few years. Much of its success was due to Mike protecting Steve and allowing him to adhere to the mission of the brand and grow the business without the usual "organ rejection" that can happen in a new company.

Later, when Steve was CEO of Boulder Brands, he acquired Udi's, a gluten-free brand, for $125

million. When he bought it in 2012 it had $93 million in revenue. Three years later, it had $300 million in revenue, as Steve adhered to its mission of providing delicious, safe food for gluten-intolerant consumers. In fact, on each of Boulder Brand's acquisitions — Smart Balance, Earth Balance, Glutino's, and Evol — Steve retained key leadership teams and founders to ensure the mission and DNA of each brand was retained as the Boulder Brand's platform was leveraged to drive scale.

Executives who wish to tap into the growth of these smaller companies will find that having a big checkbook is not going to be enough, and that waiting for an investment banker to bring them deals is the wrong approach. A mercenary mindset will only go so far. When big companies try to engage with startups, a missionary mindset will create better odds of success.

DON'T TAKE MONEY FROM VCS UNTIL YOU'VE ASKED 4 QUESTIONS

DIANE MULCAHY

In the race to get the check in hand, most entrepreneurs don't do in-depth due diligence — or any due diligence — on the venture capital (VC) firms they pitch. Founding teams eager to raise capital to grow their companies enter into long-term partnerships with VC firms they don't know well. It's a risky strategy that can leave startup CEOs in mis-aligned partnerships with unrealistic expectations.

To better understand their investors, entrepreneurs should start by asking these four questions:

What is the VC's track record?

Most entrepreneurs, if they had full visibility into the performance of each VC firm, would choose to partner with a top performer. After all, the best performing VC firms, by definition, have experience identifying and working with high-performing teams, helping startup companies grow rapidly, and guiding them through successful exits.

VC firms with poor or unrealized performance are riskier partners for entrepreneurs. They are at higher risk of losing investment partners — including, potentially, the one that championed your company — due to unattractive fund economics, such as low levels of carry. Underperforming VCs are likely to have more trouble raising subsequent funds, which means significant partner time and energy devoted to fundraising instead of to portfolio companies. They can also run into trouble syndicating later rounds of financing if other VC firms see that they are losing partners, or suspect that they are a "zombie" firm, unable to raise a subsequent fund. VCs understand these dynamics, and work hard to keep their performance numbers confidential.

Instead of looking at fund returns to judge VCs, many entrepreneurs treat a firm's brand or logos as a proxy for performance. The narrative of this approach is that the best entrepreneurs will seek capital from brand VC firms, which will be able to invest in the best companies, and ultimately, generate the best returns. It's an interesting hypothesis, but is not supported by actual returns data. Investors in VC funds see returns data from a wide range of firms, and those performance figures make it clear that many well-known "brand" VC funds consistently fail to generate minimum venture rates of return.

The *minimum* "venture rate of return" investors expect to receive from a VC fund is twice the money they invested, net of fees and carry. Entrepreneurs should remember that VC firms exist solely to generate great returns for their investors, which means significantly outperforming the public equity markets by at least 300-500 basis points annually. Most VC funds fail, by a wide margin, to deliver those minimum returns.

To evaluate a VC firm's track record, entrepreneurs can ask about actual performance. Many VCs will be open with entrepreneurs who ask about their firm's returns. Beware those who won't offer visibility, or focus on anecdotes of a few good exits without addressing the fund's overall performance. Good returns from one or two exits don't mean great returns for the fund, and one or two "logo investments" — where VCs invest in hot companies just to add their logos to the portfolio — don't mean anything unless you understand the amount and timing of the investment, and the valuation.

Another way to ask about performance is to determine the timing and size of the last fundraise. Firms that haven't raised a fund in more than four years, or who are raising smaller and smaller sized funds, could have performance issues. Entrepreneurs can also find a surprising amount of VC firm performance data through public investors such as pension funds like CALSTRS, and universities like the University of Texas. These public investors are generally required to disclose the performance of the individual venture capital funds in which they invest. Rules vary by state, but if the portfolio results aren't available online (and many are), submitting a simple online Freedom of Information Act request will allow you to obtain it. The data isn't perfect, and it's time lagged, but it's better information than none.

How much money is the VC personally investing?

Entrepreneurs go all in financially when they start a company — taking relatively low salaries in the hope of big upside if the company succeeds. As a result, entrepreneurs are fully committed to the economic performance of their company. Most VCs don't take anywhere near that level of financial risk because they don't invest significant personal capital into their own funds and portfolio companies.

The industry standard has long been that a mere 1% of a VC fund is raised from the partners themselves, as opposed to outside investors. This lack of "skin in the game" financially insulates VCs from any fund underperformance. It also creates a misalignment of economic incentives between the entrepreneur and VC that can lead to disagreements around company strategy, fundraising, and exit timelines.

Many VCs are increasing the amounts they invest in their funds in order to signal a strong sense of personal conviction and confidence in their own performance, and create better alignment with their investors and their portfolio companies. Entrepreneurs should ask VCs how much they've invested personally in their fund, and run, not walk, away from funds in which the VC hasn't enthusiastically committed a meaningful amount of personal capital.

How big is the VC fund?

Fund size also impacts the economic alignment between the VC and entrepreneur. VCs are compensated through a '2 and 20' structure that gives them a fixed annual management fee of 2% of committed capital, and a 20% carry on investment profits (if there are any). VC partners at smaller funds rely on carry for most of their compensation since the management fee stream isn't large enough to give them outsized salaries. Their compensation is closely tied to

the performance of their portfolio, so they are most aligned with the entrepreneurs in whom they invest. At larger VC funds, partners lock in high salaries from fixed management fees, regardless of their investment performance.

Do you have a list of portfolio company CEOs?

Entrepreneurs should reference check any VC they are considering as an investor. Talk to at least three to five other CEOs the VC has invested in — both on and off the list of references they provide — and ask about the VC's level of involvement, contribution to Board of Director dynamics, and where they've been helpful (or not) to the company's growth, and to the CEO. Make sure to talk to founders whose companies have done well, as well as ones that have struggled. Most VCs support entrepreneur due diligence and will actively encourage you to talk to their portfolio company teams. If a VC resists the process, it's a red flag.

These four questions offer a starting point for entrepreneur due diligence on potential investors. It's worth paying attention to both the attitude and answers from the VC when asked these questions. If the VC you're considering won't openly and quickly provide answers, it might be time to ask yourself whether that VC is the right investor and partner for your company.

HOW TO BRING IN A NEW CEO FOR YOUR STARTUP

SUREN DUTIA

Most startup founders are deeply committed to the companies they have launched and heavily invested in the dream of leading the company to long-term business success. Not surprisingly, they often have a hard time asking themselves if their talents are best suited to lead their company as it transitions through the various stages of its growth life cycle. They have an even harder time admitting that the answer might be new leadership.

Research shows that only a small percentage of founder-CEOs have the skills and experience needed to ensure company growth and shareholder value beyond a startup's early stage. As a venture begins achieving a solid foothold in the marketplace, it needs different leadership capabilities to create maximum shareholder value.

A smart founder understands that there is often a trade-off between creating sustainable market value and preserving control. For many, this means recognizing the need for a new CEO. But how can founders handle that transition?

Once the decision is made to hire a new CEO, the founder-CEO and board should work together, ideally over a six-month period, to strategically plan the transition. The following steps can be used to successfully manage the transition to new leadership:

Determine the strategy for the startup and identify CEO candidates' experience executing a similar strategy. The right replacement CEO will complement the existing leadership team's skill sets and have experience in scaling and managing a company through the startup's upcoming stages of growth.

Select a CEO based on leadership, interpersonal skills, and a knack for creating a supportive culture of collaboration. The most important requirements of the new CEO are familiar: they should understand the entire value chain of the market in which the startup operates, and must have the ability to take on a larger, more crucial role in structuring the company. An ideal CEO must also be able to pivot and make tactical adjustments that will lead to strong and sustainable growth even under uncertain business conditions. In addition, it is critical to hire a CEO who will create the right culture. The culture should be both responsive to customers and collaborative, supporting effective teamwork.

Break away from the past. In the process of shaping the management team and company, a common challenge is that one or more of the company's top-notch personalities are impeding growth. Founders and board members have to address this difficult dilemma — deciding whether to let these employees who contributed to the startup's initial success go or whether to keep them on.

As the company grows, its management skills need to evolve. Resistance to change must be overcome. This is especially true when early contributors' influence and status diminish, as this may lead them to try to undermine new leadership.

Facilitate close connections between the founder, the new CEO, and the team. It is essential to start building a truly empowered executive team based on the right chemistry and relationship with the new CEO. At many startups, teams are structured loosely and often work in informal ("tribal") groups. A key part of the CEO transition is bringing these groups together, transforming the tribes into a cohesive team that works effectively with the CEO and across functions.

Ensure knowledge capture and transfer. A critical factor in managing this transition is ensuring that relevant knowledge is documented to the greatest extent possible. Inattention to this can be disastrous. Founders hold vast amounts of information in their heads, and when they hand over the reins, the new team can experience a knowledge gap. This can result in chaos, confusion, and a situation where the management team is scrambling to operate effectively.

Knowledge capture and transfer will assist in a smooth transition. Knowledge repositories should be built into the company's wiki or intranet so that information is readily accessible. A CRM or other systems for maintaining day-to-day information on all the company's customers, major contracts, investors, products, technologies, sales, and marketing activities are essential, practical ways of sharing information.

Minimize the handover period. A handover period for retaining and transferring knowledge is a golden opportunity to ensure that all tacit knowledge from the founder is transferred to the new CEO and that there are no knowledge gaps. The ideal handover period should be approximately two weeks. Depending on the complexity of the transition, a longer time may be required, but the handover period should not exceed thirty days.

Define the strategic significance of the transition and keep communication channels open. Finally, it is important to help the rest of the team cope with the transition, especially if most team members have been there from the outset. The new structure, roles and responsibilities, and information about how the new management intends to take the startup to the next level need to be carefully presented for buy-in.

Letting go of the reins of a startup is not easy. After all, founders have been intimately and emotionally involved with their creation. If the founder-CEO wishes to stay engaged, there is often a role where their expertise could be an asset. I've seen founders stay on successfully as chief technology officer, chief marketing officer, or as a board member. However, a new position for the founder-CEO should be sanctioned only after careful consideration by the board.

Ultimately, the success of a company's growth strategy hinges on bringing in the right CEO at the right time. The best CEO for the job will enable the founder's vision to flourish.

WHAT STARTUP ACCELERATORS REALLY DO

IAN HATHAWAY

The well-advertised boom in startups and venture capital in recent years has coincided with the emergence of new players in startup ecosystems. One of these, startup accelerators, has received a great deal of attention but also little scrutiny. Moreover, they are commonly misunderstood or mistakenly lumped in with other institutions supporting early-stage startups, such as incubators, angel investors, and early-stage venture capitalists.

In a recent analysis published by the Brookings Institution, I tackle some of the confusion around startup accelerators by laying out a clearer picture of what they do, and how they differ from other early-stage institutions. I also provide a review of the research literature on the effectiveness of accelerators to achieve their stated aims, some best practices for accelerator programs, and some figures on the size, scope, and impact of these organizations in the United States.

Accelerators are playing an increasing role in startup communities throughout the United States and beyond. Early evidence demonstrates the significant potential of accelerators to improve startups' outcomes, and for these benefits to spill over into the broader startup community. However, the measurable impact accelerators have on performance varies widely among programs — not all accelerators are created equally. Quality matters.

What are startup accelerators?

Startup accelerators support early-stage, growth-driven companies through education, mentorship, and financing. Startups enter accelerators for a fixed-period of time, and as part of a cohort of companies. The accelerator experience is a process of intense, rapid, and immersive education aimed at accelerating the life cycle of young innovative companies, compressing years' worth of learning-by-doing into just a few months.

Susan Cohen of the University of Richmond and Yael Hochberg of Rice University highlight the four distinct factors that make accelerators unique: they are fixed-term, cohort-based, and mentorship-driven, and they culminate in a graduation or "demo day." None of the other previously mentioned early-stage institutions — incubators, angel investors, or seed-stage venture capitalists — have these collective elements. Accelerators may share with these others the goal of cultivating early-stage startups, but it is clear that they are different, with distinctly different business models and incentive structures.

Yet the confusion is real, including within the startup sector itself. In fact, of the nearly 700 U.S.-based organizations that were identified as an "accelerator" or "accelerator/incubator" or similar — either through self-identification or through leading investor databases — I could confirm these four criteria in fewer than one-third of them. In other words, two of every three "accelerators" are not in fact accelerators, based on this criterion.

The Four Institutions That Support Startups

	INCUBATORS	ANGEL INVESTORS	ACCELERATORS	HYBRID
Duration	1 to 5 years	Ongoing	3 to 6 months	3 months to 2 years
Cohorts	No	No	Yes	No
Business model	Rent; nonprofit	Investment	Investment; can also be nonprofit	Investment; can also be nonprofit
Selection	Noncompetitive	Competitive, ongoing	Competitive, cyclical	Competitive, ongoing
Venture stage	Early or late	Early	Early	Early
Education	Ad hoc, human resources, legal	None	Seminars	Various incubator and accelerator practices
Mentorship	Minimal, tactical	As needed by investor	Intense, by self and others	Staff expert support, some mentoring
Venture location	On-site	Off-site	On-site	On-site

SOURCE "WHAT DO ACCELERATORS DO? INSIGHTS FROM INCUBATORS AND ANGELS" BY SUSAN COHEN, 2013; ADAPTATIONS BY IAN HATHAWAY

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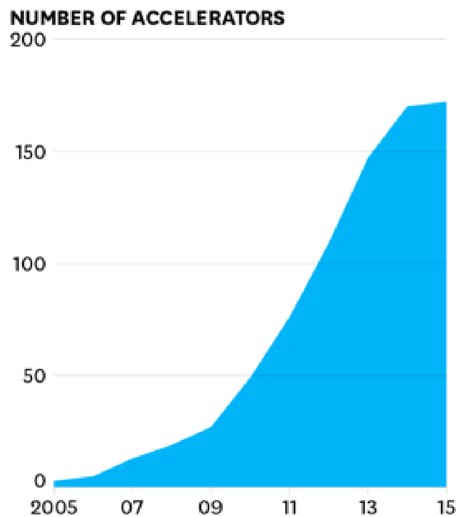
Accelerators in the United States

Silicon Valley—based Y Combinator launched the first seed accelerator program, in 2005, in Boston, followed closely by TechStars, which was founded the next year in Boulder, Colorado. Both programs have evolved over the years and have traditionally been considered the two premier accelerator programs globally.

Growth in U.S.-based accelerators really took off after 2008, as it did for startups, early-stage capital, and venture investment more broadly. The number of U.S.-based accelerators increased by an average of 50% each year between 2008 and 2014.

I was able to identify 172 U.S.-based accelerators in existence during the 2005—2015 period. Collectively, they invested in more than 5,000 U.S. startups. During this period, these companies have raised a total of $19.5 billion in funding, a number that will surely increase as accelerator programs continue to turn out companies and recent graduates work their way to maturity.

The Number of Startup Accelerators in the U.S. Has Risen Dramatically



SOURCE PITCHBOOK DATA; PRIMARY RESEARCH AND CALCULATIONS BY IAN HATHAWAY © HBR.ORG

Accelerator graduates that went on to raise additional venture capital investment had a median valuation of $15.6 million during this period, and an average valuation of $90 million. Some very well-known companies belong to this group, including "unicorns" AirBnB, Dropbox, and Stripe, among others.

Why Startup Accelerators

Accelerators have clearly taken hold in recent years. But what is it about what accelerators do that makes them so different from other early stage investors and support organizations and so valuable to the startups that are apparently falling over each other to be in their ranks?

I recently posed this question to Brad Feld, a cofounder of TechStars, and he likened the accelerator experience to immersive education, where a period of intense, focused attention provides company founders an opportunity to learn at a rapid pace. Learning-by-doing is vital to the process of scaling ventures, and the point of accelerators, suggests Feld and others, is to accelerate that process. In this way, founders compress years' worth of learning into a period of a few months.

Feld's explanation seems sensible to me, but what evidence is there? The relative novelty of accelerators means that little systematic research exists on the effect they have on the participating companies and on the broader startup community. Four papers stand out as contributing to our understanding. Here's what they've found:

- When matched with a comparable group of companies that didn't participate in accelerator programs, those that graduated from top programs saw an acceleration in reaching key milestones, such as time to raising venture capital, exit by acquisition, and gaining customer traction. However, these positive effects dissipate when looking at a broader sample of accelerators: many programs do not seem to accelerate startup development, and in some cases may even slow them down.
- A comparison of graduates of top accelerators with a set of similar startups that instead raised angel funding from leading angel investment groups found that the accelerator graduates were more likely to receive their next round of financing significantly sooner and were more likely to be either acquired or to fail.
- Additional research indicates the channels through which accelerators aid venture development, demonstrating that it is primarily about learning in the accelerator experience, not potentially confounding factors such as credential signaling to future investors, selection bias, or previous founder experience at top companies. In other words, the value of accelerators seems real and likely comes from the intensive learning environment itself.
- Accelerators have a positive impact on regional entrepreneurial ecosystems, particularly with regard to the financing environment. Metropolitan areas where an accelerator is established subsequently have more seed and early-stage entrepreneurial financing activity, which appears not to be restricted to accelerated startups themselves, but spills over to non-accelerated companies as well — occurring primarily from an increase in investors.

To summarize, accelerators *can* have a positive effect on the performance of the startups they work with, even compared with other key early-stage investors. But this finding is not universal among all accelerators and so far has been isolated to leading programs. Early evidence also shows that accelerators may have a positive effect on attracting seed and early-stage financing to a community, bringing spillover benefits to the wider regional economy.

Considering the growth of accelerators in recent years, this evidence is encouraging. By and large, accelerators seem to be a positive addition to startup ecosystems across the country and the world. Some may not make much of a difference, but many clearly do, and the best ones are poised to meaningfully improve the odds of success for the startups that graduate from them.

WHY EVERY STARTUP SHOULD BOOTSTRAP

RYAN SMITH

As the past few years have shown, raising money for a startup is easy. But building a profitable, sustainable business is still really hard. Public and private markets alike are starting to remember this, correcting for years of overly exuberant startup funding. As financing dries up, entrepreneurs would do well to remember the benefits of bootstrapping.

Though taking money from investors might seem like the path to success, bootstrapping has several advantages. First, it helps you to stay scrappy and to realize talents you may not know you even had. Second, and counterintuitively, it can help attract the right talent. And, finally, it helps you maintain control of your company while finding the right partners to help you scale.

When you bootstrap, you are forced to get good fast. As humans, we prefer to put in only as much effort as we need to, but whether we recognize it or not, we all have extra gears. Sometimes it's not until things get really tough that we find the gears that allow us to shift into overdrive — that is what bootstrapping does for you. Admittedly, it is hard, but it forces you to get creative with your strategy and come up with solutions you would never have thought of.

In 2004, I attended my first trade show. I had borrowed a trade show booth and bartered with the event organizers to give me the booth space for free. Once I arrived, I quickly realized I had nothing to hand out and my Kinko's signs weren't appealing enough for people to even stop and chat.

Other companies had spent tens of thousands of dollars on their spaces; I was the odd man out. But it was hot and everyone was thirsty, so I got creative and bought 100 Vitamin Waters at a nearby CVS. Back on the show floor, I offered them to people in exchange for watching a demo. I ended up making two more trips to CVS and giving away more than 300 Vitamin Waters.

Learning to improvise like that is essential to startup success, and it's hard to learn unless it's forced upon you. Bootstrapping does just that.

It also helps attract talent. If you're bootstrapping, you probably don't have enough cash or cachet to attract high-profile talent. Early on, bootstrapping companies aren't able to hire candidates with tons of experience. Instead, they attract people who are willing to bet on themselves — and on your vision.

What does it mean to ask people to bet on themselves? It means they are crazy enough to turn down a $60,000 salary to work for $8,000 a year in someone's basement because they believe they can turn an idea into a billion-dollar business. The result is a culture able to solve problems with fewer resources, which creates a huge competitive advantage.

Finally, bootstrapping means greater control over both your business and your partners. I became an entrepreneur because I wanted to write my own story. But securing funding while still a budding business naturally limits a company's options down the road. Instead of being able to develop, evolve, and grow into an enduring, profitable business, the company can have a tendency to focus on pleasing and appeasing the funders, which all too often creates a short-term focus or pressure to realize an early exit.

After bootstrapping for a decade, my company, Qualtrics, did raise capital: it has raised nearly a quarter-billion dollars over the past few years. Today, people congratulate us on our success in fundraising, but as entrepreneurs, that's not what we're most proud of. We started with the goal of building something great that would change the world and last for a long time, which is why it has never made sense to me to congratulate people on accepting funding — that is the easy part.

We live in a world of instant gratification. But in the entrepreneurial community, we need to remember to hold out, to take the time to build the business into something actually worth VC funding. Then, when funding comes, you will be able to use the investment to scale quickly, not to figure out what you are trying to do. At that point, you can raise money from funders who function as true partners. Above all, you will control your own destiny.

STARTUPS NEED RELATIONSHIPS BEFORE THEY ASK FOR MONEY

EVAN BAEHR

Many founders fall into the same trap: they focus all their energy and resources on building a product and finding customers, and when they come up for air, they realize that they need to raise outside capital. So they scramble to craft a pitch, find potential investors, and ask for money — and they usually fail. They end up with no money, and, sometimes, no company.

Raising capital is often the hardest and most critical part of launching a business, and it can be very time-consuming. The average outside equity financing round, from the beginning of the roadshow to when the money is wired, takes six months. But getting to that point can take even longer, especially since investors like to fund projects from founders with whom they're familiar. That means you may need to spend twelve months building relationships before you can successfully raise money.

Relationship fundraising, as opposed to transactional fundraising, may be time-consuming, but it's the key to getting funded and building a set of core advisers and investors who will back you for the long term.

Here are some tips to get started:

If you want money, ask for advice.

When I was starting one of my first ventures, Teneo, a nonprofit national civic leadership program, a successful businessman and philanthropist invited me to lunch with several of his friends for a brainstorming session. After an hour of productive conversation about my concept, the host asked me, "Did you achieve everything you wanted to during this lunch?"

A bit flummoxed, I answered, "Yes, yes, thank you for hosting, I learned so much."

He paused. "Well, how about $250,000?"

And that was the first money I ever raised — without even asking for it.

The experience taught me that if you want money, you should ask for advice. When you genuinely seek advice from someone, you are humbling yourself while elevating them to a position of authority, demonstrating your ability to listen well and ask great questions, and subtly letting them know that you're raising capital without directly asking them for it.

For my last company, Outbox, a service that digitally delivered all of your snail mail to you online, we made a list of 20 subjects that we needed help with. They included everything from logistics to warehouses, government partnerships to direct mail. We then created a list of 100 investors and advisers who had expertise in areas that were key to our business, and we reached out to everyone on the list.

Often, we found that these experts were eager to talk about something that was both in their domain of expertise and also new and exciting. We were not pitching investors just because they had money; we were genuinely seeking advice from people who could really help us solve tough problems.

Build trust before you ask for money.

On first blush, the fact that investors only put money into companies of people they know seems like good-old-boy nepotism. And, indeed, there are real problems here along demographic lines. But on a deeper look, at least some parts of it make sense. Investors in early-stage companies are not only evaluating your business acumen; they're assessing your personal characteristics as well. They want to know if they can trust you. Trust is very hard to build in a first meeting, especially if you're asking for money. The challenge is to build rapport with investors before you actually need capital.

To build trust, consider a few ideas.

- **Establish common relationships.** Trust is often translated across common friends. I trust Sally. Sally trusts you. Therefore, I trust you. Be sure to know about common relationships and use them appropriately. After looking up shared relationships on Facebook, Twitter, and LinkedIn, I might say, "I saw we are both connected to Molly from the Balloon Factory. I have to ask, how do you know her?" Sometimes you strike out: "I have no idea who that is," they could say. But often I get a fun story and a chance to build rapport.
- **Be conversationally humble.** Too often, founders are such passionate believers in their own cause that they lose the ability to hear and process fair criticism.
- **Show that you know what you don't know.** If you get a question about your company and you don't know the answer, admit it and own it. "You know, I'm not sure about the patent process timeline in Malaysia — let me check on that and get back to you," might be one way to play it. And above all, never make something up.

Show that you have a plan to figure out what you know you don't know. If there are core gaps in your knowledge that are problematic for your business, identify them and show you have a plan to solve them. "We do know our regulatory strategy for each major city we enter will be very complex; right now we do not have that strategy, but we are interviewing several law firms in the hopes of hiring one."

Show that you are eager to fully hear out someone's criticism, skepticism, and/or fears related to the things you know. Though it is easy to jump in and even interrupt someone when you have stats ready to answer their questions, stay curious and hear them out. You may learn of a new way they are thinking about the issue, and at the least you will communicate to them that you value what they say.

Meet investors when you aren't raising money.

It's true that the most natural time to meet investors is when you're raising money, but there are many other avenues to explore as

well. I have personally sought out top investors in an industry to get feedback on my company. When I reach out, I ask something like, "I'm building a company in the XYZ industry and have really admired your writing and investing in the space. Might you have 30 minutes for me to share what we have learned and get your feedback?"

Disciplined investors are keen to meet with new entrepreneurs often, even if you're not raising capital. In addition to investing, their job is to know the latest in the industry, so use that to your advantage. Treat the meeting as a chance to share with them things you have been learning.

Shy of a formal meeting, consider these three approaches:

- **Offer to help, and actually do it.** I met one of my current investors in Able, a financial technology company that makes the lowest-interest loans online, when he actually reached out to help. He knew that we were not yet raising money, but he wanted to find a way to build a relationship. He was able to make a dozen introductions for us, all just as a fan of what we were doing. Later on, when it was time to raise money, we knew Chris was the kind of guy who did what he said he was going to do.
- **Meet them out of the office.** Many investors, especially younger ones who have a mandate to bring in new deals, go to hundreds of events a year, including happy hours, conferences, demo days, and alumni events. Find ways to identify these events and get invited, and then learn how to get the most out of networking events. Introduce yourself widely. Have something (brief but interesting) to say about yourself. Ask good questions. And then find a way to follow up.
- **Engage with them intellectually, even virtually.** Some investors publish very thoughtful analyses about all kinds of things on Twitter and even blogs. Consider offering a counterpoint or asking a probing question, or track down their email and send them 200 words and some data on how they might refine or add to their argument. Don't hear me wrong: please do not pick fights with investors. But you should start engaging conversations.

When I started out fundraising, I put investors on a high pedestal. They intimidated me. But, after a while, I realized that they weren't much different than me. Many investors have run companies, just as many founders have been investors. The tables can turn quickly and life is long; even in my short career, I have had investors whom I pitched (and told me no) write me months later to ask for an introduction to another investor because they had founded a company and were raising capital.

There's no doubt that relationship fundraising can be an intimidating process, but with practice you'll learn how to be yourself in meetings and begin to build authentic relationships with people. It may take more time than you want, but by forming meaningful relationships rather than just making transactions, your business will be better off in the long run.

STARTUPS CAN'T REVOLVE AROUND THEIR FOUNDERS IF THEY WANT TO SUCCEED

RANJAY GULATI AND ALICIA DESANTOLA

Even when startups have great products and customer interest, they struggle with long-term growth. Often, our research shows, the biggest obstacles are the entrepreneurs themselves. To borrow an analogy from our Harvard Business School colleague Shikhar Ghosh, their firms aren't murdered by the market; they commit suicide because the founders can't or won't adapt to the organizations' changing needs.

Founders tend to use their personal charisma and technical smarts to rally their teams, and that can work while a business is small. But as a venture scales and becomes more complex, more operational and commercial sophistication is required to manage it. Founders may lack the skills and interest to lead those activities effectively — what they typically love is dreaming up and building products. Yet many of them insist on retaining control over all aspects of their business, even those that they don't enjoy, which gets them into trouble.

They may try to rationalize their micromanagement by arguing that every aspect of their venture's success hinges upon their own exacting review. But those who hold on to control too tightly become bottlenecks to organizational action, as all decisions have to pass through them. What's more, as Noam Wasserman points out, they may forgo riches in the process of trying to stay "king." In a recent *Strategic Management Journal* study with a sample of more than 6,000 companies, Wasserman discovered that founders who keep a powerful central role in their startup as it grows — controlling the board or the CEO position, or both — can harm the firm's prospects, reducing pre-money valuation by up to 22%.

Historically, venture capitalists have bypassed founders' limitations and desire for control by swapping in new CEOs who have more professional experience. This practice, euphemistically called "founder redeployment," usually means "founder exit." (That's what the popular HBO comedy series *Silicon Valley* depicted at the end of last season, when fictional investors contemplated whether the geeky but brilliant Richard Hendricks should be replaced as CEO of Pied Piper.) But our interviews with VCs suggest that this practice is becoming less common with the greater availability of capital in recent fundraising markets. As a result, many founders are retaining the CEO role even when investors think they should be replaced.

Still, bringing in a "professional CEO" isn't always the panacea it is made out to be. In many instances, large-company experience doesn't easily translate into leading an entrepreneurial venture. Also, there is a difference between managing scale and getting to scale. While some of these new leaders from the outside are skilled at the former, they may have trouble navigating the turbulent transitions associated with the latter.

Our research suggests that a startup's path to maturity is not quite as definitive as simply asking the founders to leave. Based on a recent sample of more than 2,600 VC-backed technology firms in the San Francisco Bay Area, we found that 45% of founder-CEOs of surviving companies are displaced by the completion of a Series C investment round. That means 55% of them *remain* at the helm while their company scales. Silicon Valley lore offers examples of exceptional founder-CEOs, such as Salesforce.com's Marc Benioff, who were able to lead their companies through an IPO. Founders can be invaluable resources because they provide an arc of continuity from the firm's earliest days to today. In addition to being cultural champions, they can help remind their companies not to shift their attention too far away from product strategy and innovation.

Whether the founder stays or leaves, one thing is clear: in order for a startup to successfully grow, it must be an institution that transcends any one individual. Founders who recognize this bring in partners whose skills complement their own. Together, the leadership team can build out the scaffolds to transition the venture from an organization that revolves around the founder to one that revolves around an independent company brand. We use the term "scaffolds" because the structures and processes that facilitate the scaling must be readily dismantled and rearranged. Otherwise, they are ill-suited to accommodating the firm's rapidly changing needs.

In periods of growth, organizations will always have to figure out how to embrace the new without jettisoning what's valuable about the old. That tension is particularly strong in a scaling startup, and founders can help mitigate it by reimagining their roles, stepping back slightly so their companies can leap forward.

THE LIMITS OF THE LEAN STARTUP METHOD

TED LADD

Advocates of the lean startup method for creating a business advise entrepreneurs, as well as corporate intrapreneurs, to document, test, and refine their assumptions about a new venture's business model via customer conversations and experiments. My recent research on 250 teams that participated in an American cleantech accelerator program during the last 10 years found that while the lean approach can be effective, having a strong strategy is more important than conducting a tremendous number of market tests.

First, the good news: In general, the lean startup method works. We measured success by looking at how teams performed in a pitch competition in front of a panel of industry experts at the end of the accelerator program (a proxy, albeit an imperfect one, for long-term financial performance). Teams that elucidated and then tested hypotheses about their venture performed almost three times better in the pitch competition than teams that did not test any hypotheses.

Now, the bad news: There was no linear relationship between the number of validated hypotheses and a team's subsequent success. In short, more validation is not better. I also found that teams that conducted both open-ended conversations and more formalized experiments with customers actually performed worse in the competition than teams that conducted either one or the other during the early stages of venture design.

One possible explanation for the diminishing and even negative return on customer interaction is an erosion of confidence: too much feedback from customers might cause the entrepreneurs to change the idea so frequently that they become disheartened. Another possibility is that the lean startup method, while efficient compared to the conventional approach of "build it and they will come," still requires time, attention, and resources that are diverted from other projects. At some point, managers run out of patience for continued testing and pull the plug.

Certainly, some ideas deserve to die a quick and early death if they do not generate customer demand. However, the lean startup method might be producing "false negatives," meaning good ideas are mistakenly rejected because the approach does not have a clear rule for when entrepreneurs and intrapreneurs should declare victory, stop testing, and begin scaling production.

David Collis, a professor at Harvard Business School, proposes a solution to this conundrum: the "lean strategy" process, which involves setting clear constraints for which markets and methods are to be considered while testing and refining the business model.

Let me extend his advice by advocating that entrepreneurs should also declare the threshold for making a go/no-go decision. For example, if 50% of customers in the target segment pay a fee for an early prototype, or if testing produces only minor alterations to an already granular and specific business model, managers could decree that some or all major aspects of the business model should be locked into place. (I am now conducting research on these "stopping rules" for entrepreneurs and intrapreneurs who employ lean startup methods.)

In addition, entrepreneurs should ask themselves which aspects of the business model they should consider first. Are all aspects of a business model equally important in the early design phase? In my research with cleantech entrepreneurs, I found that teams that focused their testing on the triumvirate of target customer segment, value proposition, and channel performed twice as well as teams that did not spend much attention on those three categories.

The popularity of the lean startup method is well deserved. But, as is true of any business process, the method must be tailored and employed with reflection and constraints, not blind allegiance. Just like the new ventures it creates, it will improve as researchers and practitioners propose, test, and incorporate refinements.

WHAT MAKES NEW ORLEANS A STARTUP CITY TO RIVAL THE "BIG THREE"

TIM WILLIAMSON

There's a great irony when you consider that the "Big Three" cities for entrepreneurship — San Francisco/San Jose, Boston, and New York — are some of the most difficult places in the U.S. to live on the sort of shoestring budget that startups demand. Nonetheless, they are home to "about half the VC firms and an equal percentage of the U.S.-based companies that they finance," according to a paper published by the National Bureau of Economic Research. This gravitational pull has historically given these cities an upper hand, making it difficult for smaller cities to compete, but as the surge in entrepreneurial activity and migration of talent around the country continues, investors and influencers are starting to look elsewhere for great entrepreneurs.

With nearly every metropolis vying to become the next Silicon Valley, New Orleans would rather become a better version of itself: the next New Orleans.

Prior to Hurricane Katrina, in 2005, New Orleans was a place where too many people accepted that the city's zenith had passed over 150 years ago. After the storm, a group of young entrepreneurs and emerging leaders banded together, first in tragedy, then in rebuilding, and then in reinvention. New Orleanians new and old returned to their city with a newfound sense of urgency, and they began to look at some of those decades-old problems that had dogged the city with fresh eyes, whether in education, transportation, food service, or music. Katrina allowed one of America's most historic places to reimagine itself as a startup city. This quickly attracted entrepreneurial talent eager to find their place in the Crescent City's renaissance. Now, New Orleans is being recognized as a hub of innovation, with a rate of business startups 64% higher than the national average.

Considerable ink and air time have been devoted to analyses attempting to pinpoint the driving force behind the positive momentum, with the conclusions falling predictably into one of two categories: resilience or reform. Yes, both have played a role in making the city a less risky base for businesses. But these factors alone do not explain the dramatic turnaround.

Most established startup hubs have image issues. Millennials in particular see them as either prohibitively expensive, culturally devoid, or both. But New Orleans offers both culture and an affordable cost of living. With world-renowned food and live music scenes, New Orleans is a city of rhythms and rituals, all organized around a unique cultural calendar. It's that lure that brings in eager migrants from all over the country, and when they arrive they find not only the fun-loving and diversity-embracing culture they've heard so much about, but also the newfound energy that's characterized a city determined not to fade into history.

This, coupled with relative affordability, makes it a place people want to call home.

In 2011, demographer Joel Kotkin developed a list of the U.S.'s "biggest brain magnets," cities where college graduates are flocking, and New Orleans ranked at the top. His analysis revealed that the college-educated were looking for affordability, with "many ending up in places with lower housing prices. Areas with the highest-price housing experienced college-educated growth at a rate only 60% of those with more affordable real estate." According to a CNN Money cost of living calculator using December 2015 figures from the Council for Community and Economic Research, the cost of housing in San Francisco is 227% higher than in New Orleans, groceries cost 25% more, and transportation costs 33% more. Similarly, housing in New York is 368% higher, and Boston is 95% higher. College graduates looking to move to an established hub may find that they either cannot afford it or do not want to pay the price to live in those places.

New Orleans recently earned its place as one of the "20 Hottest Startup Hubs in America" in a report from the Ewing Marion Kauffman Foundation. The city's new status is why Lucid, a software company and global data platform that completed more than $100 million of sample transactions in 2015, is in New Orleans, along with Kickboard, a technology company helping to create smarter schools, and Smashing Boxes, a creative technology firm known for creating a lasting experience through bold design and disrupting the status quo.

It doesn't take too many conversations with locals to realize that New Orleans has no interest in becoming San Francisco — but rather than stymying innovation, it's that fierce sense of identity that has driven New Orleans in the post-Katrina era. The city developed a new atmosphere of inclusion and collaboration and a sense of unified purpose in those years, and that same drive is now pushing the city to places it's never been before. It's resilience, yes, but there is something more. New Orleans is a city with the confidence to remain itself even in an increasingly homogenous country.

WHAT IT TAKES TO BUILD A STARTUP INTO A BRAND

MICHAEL J. SILVERSTEIN

When Howard Schultz initially proposed to buy Starbucks from its founders, the chain had three stores; he had a plan to expand to 150 stores. Today Starbucks has more than 22,000 stores and is now opening in Italy — a lifelong dream for Schultz.

When Leslie Wexner opened his first store, he hoped he could expand to a three- or four-store chain to achieve economies of scale. Today he leads an enterprise that has cumulatively created over 10,000 stores. His prize, Victoria's Secret, will generate $8 billion in revenue this year and operates in a dozen countries.

When Brunello Cucinelli bought his first 24 kilograms of cashmere, his intent was to make a few sweaters in his local community in central Italy, earning enough money to get married, start a family, and live a peaceful, humanistic life. Today he has more than 125 stores in the world's most affluent urban locations and a company valued in excess of $1.5 billion.

None of these entrepreneurs had a full vision of where their businesses would ultimately go. But they had energy, curiosity, courage, and a willingness to adapt to new circumstances. They were hungry to provide opportunities for their associates, their investors, their customers, and themselves. Their stories offer valuable lessons on how to build a startup into an iconic brand.

From the outset, all three men viewed themselves as serving in multiple roles: founder, custodian, brand manager, chief financial officer, recruiter, and head of consumer insights. They operated on shoestrings.

They also knew that their prospective customers could not think in abstractions, so they didn't look for definitive feedback. Sure, they wanted a reaction to their product, retail environment, and service delivery. But they were not testing a concept; they were improving their concept with inexpensive live interaction. They knew that consumers change their preferences based on what they see, touch, and experience. Customers cannot envision a new concept. They cannot predict their own behavior. They can only compare against their current frame of reference.

These entrepreneurs knew that you need to make the big leap for consumers. You need to provide them with a reason to buy and a reason to brag to their friends. The lesson: entrepreneurs in the creation phase should expect novel ideas to fall on deaf ears.

For the budding entrepreneur, a good starting point is to create a qualitative understanding of market drivers. You need to get into the head of the consumer and be able to tell her story. It is both art and science. The purpose of this map of users and usage is to define dissatisfactions, hopes, dreams, and fears. Winning solutions respond to the distinct and specific needs of a group of consumers.

Today, Leslie Wexner is CEO, chair, and founder of L Brands, a $25 billion market cap company with two primary brands, Victoria's Secret and Bath & Body Works. In his career, he has created The Limited, Express, Bath & Body Works, Abercrombie, and Limited Too, and has expanded Victoria's Secret from three stores to 1,500. He is a master of all things retail — store operations, design, merchandising, merchandise selection, pricing, promotion, employee engagement, visual excitement, retail as theater, and, most important, invention. He became a master by working every job from housekeeping to purchasing. He is blessed with natural consumer marketing skills, and he can create specialty stores that target narrow segments, fulfill unmet needs, and reach out to adjacent consumer segments.

Victoria's Secret is a dominant provider of lingerie to American women. It has expanded to fragrance, skin care, and a variety of related apparel categories. Its stores are now as large as 58,000 square feet, a celebration of glamour, sex, comfort, and fantasy. VS flagship stores deliver the highest sales per square foot and profits in the specialty store business.

For Wexner, success in business is about anticipation, instinct, insights — and, ultimately, curiosity and experience.

"Entrepreneurs know how difficult it is to create a brand. They understand how fragile their brand's equity is," he says. "We know that the force of gravity is likely to bring you down. We know that success breeds competition. And the most loyal consumer is loyal for about 32 seconds. You can't and shouldn't count on them for their loyalty. Everything changes. So if you don't exercise the change muscle, then you just lose the ability to change. You either go out of business or you evolve into a different position."

Wexner's story is a profile in curiosity, in how a constant search for new patterns and understanding the eye of a merchant can be a path to riches, notoriety, and joy. It's also a story about reinvention — from one category to another, transporting business skills and insights and investing for advantage.

My colleagues and I at BCG also believe that curiosity is the greatest source of ideas, retail revolutions, and insights. A curious mind armed with skill, experience, and knowledge can give birth to a brand revolution. A curious mind does not say to consumers, "What do you want?" A curious mind asks the questions that open up the consumer to talk about her latent dissatisfactions, hopes, wishes, and dreams. A curious mind knows that functional goods sold en masse earn a good return but breakthrough profits come from satisfying emotional needs. A curious mind will draw on all of life's experiences to get to the big "Aha!"

THE BEST ENTREPRENEURS THINK GLOBALLY, NOT JUST DIGITALLY

MICHAEL SCHRAGE

"Born Global" is becoming the new "Born Digital." Social media and digital platforms giving local start-ups global reach increasingly facilitate "born global" start-ups. The "two guys in a Silicon Valley garage" paradigm is surrendering to cross-border collaborations between "two guys in a Noe Valley garage, three female coders in a Pune office park, and a machinist of indeterminate gender with a 3D printer cluster in Nanjing."

In other words, today's innovators don't "go global"—globality is baked into their origins. Innovation isn't merely outsourced to low-cost providers, it's globally networked between peers and partners. People with fundable ideas increasingly seem as comfortable and confident acquiring essential talent and capital from around the world as they do from across the country. Better that gifted group of Estonian coders than the decent but uninspired pride of freelance programmers from Raleigh-Durham.

This globality phenomenon is itself surprisingly global: the Berlin and Beijing startup scenes, for example, appear almost as technologically transnational as Boston's and the Bay Area's. "Ecosystems have become more interconnected and startup teams have become more international," according to one comprehensive 2015 global research survey.

More granularly, the data are tentative but trending: for example, the average proportion of foreign employees within a start-up is 29% for the top 20 innovation ecosystems surveyed. For Silicon Valley, however, that proportion rises to 45%.

Worldwide, the number of start-up offices in those top 20 ecosystems that are second offices outside the initial ecosystem or founding headquarters that were moved rose more than 8.4X (!) from 2012 to 2014.

Even as a Silicon Valley and Berlin and Cambridge and Bangalore have become more entrepreneurially vibrant locally, they've become more global operationally. Essentially, innovators—and their investors—now worry that if they don't go global from the beginning, do they risk starting off behind?

Consider Kaggle, Innocentive and other global competitions designed to bring global talent to bear on provocative problems. Their winners are typically worldwide. Google, LinkedIn, Facebook, Twitter, Skype and Slack make entrepreneurial self-organization around a project or a prototype faster, simpler and cheaper. A "proof of concept" that might have taken six months and a $100,000 to develop can be globally improvised, refined and field tested in a fortnight for only a few thousand dollars.

The real-time benefits of "born global" options increasingly outweigh their costs. Does this frighten IP attorneys? Yes. But speed and agility matter measurably more for many innovators than proprietary software development and patent filings.

A couple of years ago, an Indian data science start-up approached me to hire them for my academic research. While impressed, I didn't need what they had to offer. When they persisted and came back with new computational capabilities, I couldn't resist: "If you can really do this," I observed, "I'd rather hire you to develop this new product I've been thinking about than work on my research."

One of the company's co-founders immediately "got" the idea, and I soon had one of the start-up's best software engineers sleeping on my couch for a week as we sketched out prototypes. We handed off our work to the home office every night. A prototype services was tested both in Indian and American universities.

The project ultimately didn't pan out (it remains a terrific concept) but the experience had a huge impact on the organization and I'm now an advisor to the company.

The essential insight and takeaway, however, is that these informal international innovation improvisations are less exception than expectation. I wouldn't think of running an experiment or writing a paper without first doing a global literature search; today, I wouldn't think of prototyping a start-up concept without first exploring possible collaborators worldwide.

Indeed, assessing an innovator's GQ—the Globality Quotient—has become a standard market test. Whether medical device, new material or novel app, I now push the innovation team's leaders to describe how global their talent, sourcing and testing has been. Almost without exception, the most compelling innovators reflect and respect a "born global" ethos.

THE U.S. STARTUP ECONOMY IS IN BOTH BETTER AND WORSE SHAPE THAN WE THOUGHT

WALTER FRICK

Startup activity can signal a city's economic potential, but it's actually the quality of the startups, not the quantity, that matters.

That's just one of several important findings from a paper released this week by Jorge Guzman and Scott Stern, both of MIT. The paper surveys the landscape of American entrepreneurship, offering an optimistic picture of it and of the U.S. economy's future prospects.

The study's core point is simple. We've long known that new businesses matter to the economy and that it's a small group of fast-growing firms that matter most, because of the jobs and innovation they bring. What Guzman and Stern add is a method for identifying the firms that are trying to grow. A new restaurant or dry cleaner probably won't end up hiring thousands of employees or commercializing new technology. On the other hand, what the authors call "innovation-driven enterprises" — think Facebook or Google — do intend to grow and can have significant economic impact. Guzman and Stern's quality measure seeks to separate the former from the latter.

With this measure of entrepreneurship "quality" in hand, the researchers can map the geography of startup potential, linking it to cities' future growth.

The chart above shows where cities fall according to Guzman and Stern's measure of average startup quality between 2001 and 2003 — more on that in a moment — and compares that to their GDP growth from 2003—2014. "A doubling of entrepreneurial quality predicts an increase of 6.8% in GDP 11 years in the future," the authors report. By contrast, startup quantity is less correlated and not significantly linked once the city's current GDP is controlled for.

The authors say they are not implying that entrepreneurship, even the quality kind, necessarily causes growth. It could also be that "the reason people start firms is that they see opportunities," said Guzman, which would mean measures of entrepreneurship could simply reflect a city's economic strength rather than causing it.

To determine which new firms are likely to grow, Guzman and Stern developed an algorithm that predicts the chances of a startup going public or being acquired for a significant sum. Firms that register in Delaware are more likely to grow, for instance, as are firms that file as a corporation rather than a partnership or an LLC. Firms that apply for patents are also more likely to grow. Firms that are named after their founders are less so.

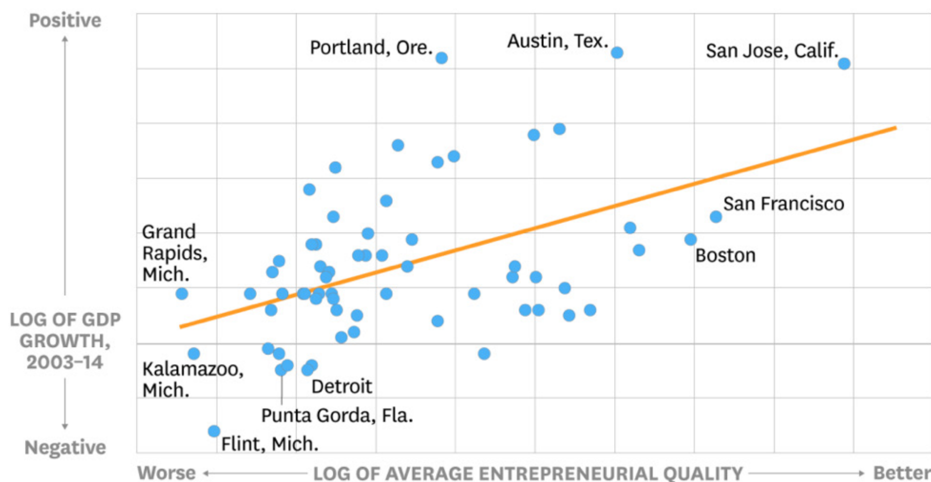
Amazingly, these and other factors can predict a startup's prospects pretty well. Three-quarters of the startups that end up going public or being acquired score in the top 10% by this algorithm, based only on factors available at the time of their founding. The algorithm isn't good enough to distinguish Facebook from MySpace, so it won't help venture capitalists do their work. But by applying this algorithm to business registration records, the researchers can get a reasonable measure of the entrepreneurial quality of a city, state, or nation.

In addition to predicting growth, the researchers' measure of startup quality challenges two common economic arguments. The first is that American entrepreneurship is in decline. That's true as measured by the number of new businesses, but Guzman and Stern's measure shows that America's entrepreneurial potential has increased since the Great Recession and that in 2014 it was almost as high as its 2000 peak. In some places, including the Bay Area, it's at record highs. (Guzman and Stern's data is restricted to 15 states but includes the major U.S. startup hubs.)

The second bit of pushback concerns the argument, put forward by economists such as Larry Summers and Robert Gordon, that America is facing a period of slow economic growth. "Our index does say there's been a steady growth of [quality] entrepreneurship," Guzman said, and he sees this as reason for optimism. Whether or not startups directly cause economic growth, they seem to predict it, so the high number

The Quality of a City's Startups Predicts Its Future Economic Growth

The higher the EQI, the higher the average quality of startups in a city.



NOTE DATA IS LIMITED TO CENSUS-DESIGNATED METROPOLITAN AREAS IN 15 U.S. STATES.
SOURCE "THE STATE OF AMERICAN ENTREPRENEURSHIP," BY JORGE GUZMAN AND SCOTT STERN, 2006

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of growth-oriented startups in recent years may be cause for confidence in the future of the American economy.

The challenge, as FiveThirtyEight's Ben Casselman explains in his coverage of the research, is that quality startups don't seem to be as likely to grow as in the past. The number of startups that the algorithm scores as quality is high, but the likelihood of a successful IPO or acquisition hasn't kept up. This could be a function of funding availability and the IPO market, or it could reflect something darker about the U.S. economy, perhaps that incumbents are more protected from competition than they used to be. In a companion policy paper, Guzman, Stern, Catherine Fazio, and Fiona Murray urge policy makers to take this drop in growth events seriously by focusing on the problems startups face when trying to scale.

The good news is that the potential is there. America is producing fewer new businesses than it once did but plenty of the ones that matter most. The trick is to make sure that they grow.

GREAT COMPANIES STAY TRUE TO THE SPIRIT OF THEIR FOUNDERS

JAMES ALLEN

Companies still run by their founders have a certain magic. That's not just a hunch — among public companies since 1990, returns to shareholders were three times greater at firms where the founder is still part of the management team. In an upcoming book and in a recent article in *Harvard Business Review*, my coauthor Christopher Zook and I identify the qualities of "the founder's mentality" and show how all organizations, even those whose founders have long retired, can harness its vitalizing effects. We believe that a company's best hope to sustain profitable growth is to stay true to the characteristics that great founding management teams naturally possess.

The founder's mentality has three components: It requires that companies view themselves as business insurgents, fighting on behalf of an underserved customer; that they have an obsession with the front line, where the business meets the customer; and that they foster an owner's mindset, which keeps them fast, bold, and infused with a deep sense of responsibility for long-term results. As part of our research to understand these attributes, we interviewed scores of founders and ran dozens of workshops with leaders of the Founder's Mentality 100 (a network of fast-growth, mostly founder-led companies). Almost all of the founders we interviewed provided useful lessons, but three CEOs in particular exemplified each of the qualities that make the founder's mentality so powerful.

Robbie Brozin and the insurgent mission

In 1987, a Portuguese audio engineer named Fernando Duarte took a friend, South African entrepreneur Robbie Brozin, to a small take-out restaurant in a suburb of Johannesburg. Brozin found the chicken there so delicious that he made a radical move: He bought the restaurant, renamed it Nando's, in honor of Fernando, and made plans to expand. In the years since, Nando's has become one of the most successful chicken restaurant chains in the world, with more than 1,200 restaurants in 23 countries.

What's the secret to Brozin's success in a world with no shortage of chicken joints? He and his employees rally around an insurgent mission. Every day they make a conscious choice to be world-class at the few extraordinary capabilities that make it possible to deliver a better product or service to customers. Great founders focus ruthlessly on these capabilities — and they accept that they cannot be world-class at everything, only the things that truly matter.

This "spikiness" is the key to staying competitive, but it isn't easy. To make everybody happy, to serve every need, to hedge every bet, many CEOs spread resources around democratically as their companies grow — and they lose the spikiness on the cost sheet that is the telltale sign not of profligacy but of focus. The result is a slide into mediocrity.

Brozin knew exactly where to spike Nando's resources: on its amazingly tasty chicken. It was his love for that chicken, after all, that got him into the business in the first place. Everything else — even the industry norm of speedy service — was secondary. "In our industry, all the talk was about fast, cheap food," he told us. "I remember folks telling me that if we couldn't cook our chicken within three minutes, we were doomed. But we rejected that thinking. We argued that the quality of our chicken would be remembered long after the wait was forgotten."

The lesson for other companies: Neither your customers nor your employees want you to do everything well. Declare war on "functional excellence" programs that consume money and management time, and refocus resources on the few capabilities where you must be amazing. Seize control of your strategy and budget processes, which too often are designed to ensure every bureaucrat holds on to last year's resources, and demand a real discussion of where you must redeploy resources. Focus is undemocratic. Embrace that truth, and refuel your insurgency.

M.S. Oberoi and the frontline obsession

Successful founders understand the economics of customer loyalty. In their early days they know every customer by name. Keeping that up becomes impossible as they grow, but nevertheless they remain obsessed with making sure that someone is looking out for every customer at all times.

Few business leaders have developed this attention to the front line as effectively as M.S. Oberoi, the founder of the Oberoi Group, a chain of luxury hotels in India. Oberoi obsessed about every detail in his hotels that might affect the customer experience. Even in his eighties he kept visiting his hotels to make sure employees were getting everything right, and in doing so he established a culture by which all employees shared in his obsession.

Poornima Bhambal, the assistant manager of the front office at the Oberoi Udaivilas, in Udaipur, described for us the company's empowerment program, which encourages all employees to do what it takes to delight customers and even gives them access to small amounts of money in order to do so. "We love to surprise and delight guests with little gifts and niceties," Bhambal said, "and the empowerment program allows this to happen."

One example, related to us by Vikram Oberoi, a grandson of M.S. Oberoi who now serves as the group's CEO, was what happened when the staff at one hotel discovered that an American family occupying two rooms was taking all the toiletries — twice a day. This seemed a bit much to the housekeeping staff, and the manager's first instinct was to go to the family and politely point out that they probably had enough toiletries.

But instead, says Oberoi, after some coaching, "He created a basket of soaps and shampoos and oils used at the hotel's spa, and wrote a note that was signed by the housekeeping staff. The note said, 'We notice you like our toiletries and wanted to give you a supply you can take home and share with friends.' The family loved

this. They wrote us after, saying that we were the most fantastic hotel and that they would tell all their friends to visit. That's a wonderful business result from the investment of a box of lotions!"

Of course, everyone can recite the mantra customers first. But it is striking how few organizations are actually set up to deliver that promise. You can't put customers first unless you also put the people who serve those customers first. And you also can't put customers first until senior leadership meetings are filled with the voices of the customers and front line. Check your last executive committee meeting agenda. Did customers drive the agenda? Was the focus to empower the front line and reorient center activities to help your front line do their job better? Or was the agenda designed to serve the needs of the senior leadership, as they reported out their activities and demonstrated how busy they are? At most founder-led companies, CEOs spend all their time in the field and very little behind their desks. Why? They know which voices they need to listen to.

Galip Yorgancioglu and the owner's mindset

Leaders with a strong founder's mentality also have what we call an owner's mindset: They think about every expense as if it were their own money (which it often is) and hate any sort of bureaucracy that slows the company down. Their bias is toward action. One leader who exemplifies this is the CEO of Mey, a leading spirits company in Turkey that makes raki, the country's national drink. Once a government monopoly, the company was privatized, in 2004, and bought by a set of construction entrepreneurs, for $292 million. Two years later, they sold it to TPG, for about $810 million. In 2011, TPG sold it to Diageo, for about $2.1 billion — not a bad value-creation story. The first employee those original entrepreneurs hired was Galip Yorgancioglu, who remains CEO today.

Yorgancioglu has been passionate about maintaining an owner mindset at Mey, especially as it moved from private equity to corporate ownership. "If our team thinks like owners, we know we can retain our speed and agility," he says. One way he maintains that speed is with a Monday meeting where his leaders can get together and rapidly solve issues. "One of the hardest things to do culturally is to make everyone understand that conflict is OK. I want my supply chain team fighting to rationalize, to look for scale benefits. And I want my marketing guys fighting for new variants, new products. My job is to make sure that we address the conflicts that inevitably arise when our people are doing their job."

Embracing conflict, he explains, keeps Mey agile. "The whole company knows that we'll deal with the issues that come up each Monday, so they raise any issues that are stopping them from taking action. It's a social contract, and if we do it right, it ensures that we move faster than our competitors."

As Yorgancioglu notes, speed is a competitive asset. But too many companies lose sight of this and fall victim to the growth paradox: Growth creates complexity, and complexity kills growth. While Yorgancioglu's meetings are designed to rapidly resolve conflict and eliminate problems, too many companies have meetings that add new processes, new analysis — even new meetings. As companies lose the elements of the founder's mentality illustrated above, they lose the antibodies to complexity. Ask yourself: How's your company's immune system holding up?

HOW CFOS CAN TAKE THE LONG-TERM VIEW IN A SHORT-TERM ECONOMY

JOE SINFIELD AND ALASDAIR TROTTER

Investors are increasingly seeking firms with long-term growth strategies, rather than ones focused on managing short-term earnings to boost the stock price. This, in turn, is triggering a shift in the perceived role of the CFO — from bean counters to planters of seed corn.

No one has done more to spotlight the contrast than Laurence Fink, the CEO of BlackRock. As head of the world's largest asset manager, with $4.6 trillion in holdings, Fink in February sent a letter to the CEOs of all S&P 500 companies that essentially cut the Gordian knot of short-termism. Companies have been paying sharply higher dividends and buying back their shares much more aggressively, he says, in order to please people like him. Fink is essentially saying: Stop it! Invest more of that capital in growing the company. Do away with the game of quarterly earnings guidance, and instead articulate to investors your "strategic framework for long-term value creation."

Backing this up is another group of asset managers who have committed $2 billion to invest in a newly created S&P Long-Term Value Index, a subset of companies doing things right. "We are trying to use the index to change corporate behavior," said Mark Wiseman, chief executive of the Canada Pension Plan Investment Board, the lead investor in the initiative. Wiseman has helped start Focusing Capital on the Long Term, a new institute that also counts Barclays and Unilever as founding members.

Redefining the CFO role. For CEOs, creating and communicating long-term growth strategy is easier said than done. After all, it's the CFO who typically sets expectations about growth to investors and then allocates resources to ensure their organizations deliver. CFOs know exactly the role that their company plays in their investors' portfolios. So if the organization is going to invest in longer-term growth, this could increase the stock's beta — both in downside risk and upside reward.

That's why the CFO needs to take charge of telling that growth story to investors while clearly communicating the higher beta. Knowing how to frame and tell this story is critical for a CFO wishing to manage the natural tension between inspiring and scaring investors.

Some leadership teams have served as guiding examples of how to overturn short-termism and reorient their enterprise. In 2010, when Mark Bertolini, CEO of Aetna, began articulating a strategy to invest billions to transform from a healthinsurance company to a health care company, analysts grumbled. "If you don't like our strategy," he told them. "Then get out of our stock." Many did. But the shareholders who left were replaced by ones who believed in the long-term strategy.

Similarly, Corning Inc. under the leadership of current CEO Wendell Weeks articulated a strategy 15 years ago of moving beyond core markets in glassware to create a future "world of displays" that positioned it for the coming ubiquity of smart phones, tablets, and televisions.

In 2012, John Deere CEO Samuel Allen began releasing long-term, aspirational revenue targets for 2018. The company continues to prioritize that five-year horizon and keep its eye on big goals — not just selling more tractors each month but helping the world double food production by 2050.

In successful cases like these, CFOs have had to reorient their roles as the "gate-keeper" of a company's finances. If the long-term view of the organization is going to have a chance, the CFO's "approval," whether explicit or implied, is precisely what provides other executives the right to explore entrepreneurial ventures.

Given what we can learn from these and other leaders who have wrestled with short-termism, we have distilled a set of five principles for how entrepreneurial CFOs can become champions of long-term growth:

Highlight today's threats and the resulting opportunities to change your business. Don't worry about scaring people off. Investors will appreciate that you understand the evolution of the industry and markets in which you currently compete or might compete in the future, and that you have a strategic perspective on the implications of emerging trends, technologies, and new competitors.

Paint a compelling future vision of your industry ecosystem grounded in emerging customer needs. Don't just say that the future is uncertain, and that you will act when it gets here. It is the responsibility of a forward-looking leader to share a point of view about the role the company might play in specific scenarios. Communicate how customers are changing, and how your organization can address those needs in the future.

Demonstrate the need to invest in non-core initiatives today to create that future. As one CEO told us: "By the time the writing is on the wall, everyone can read it." For the long-term view to have a chance, the CFO must embrace a bold new vision rather than downplay the short-term risk. Investing in a portfolio of long-term initiatives today is essentially a call-option on the growth of tomorrow. CFOs must be clear that it's cheaper and less risky to make future investments today than it is to let opportunities pass by and be forced to make it up later via expensive acquisitions.

Commit to achieve a new growth business of specific and aspirational scale. While not every organization needs to lay out specific revenue and earnings targets as far as five years into the future, it should be recognized that without some firm target, it is impossible to address the related questions of "how much growth is needed, and by when?" and "how much should we invest?"

Manage expectations on the pace and challenge of experimentation. The leadership team should publicly commit to achieving its vision — yet communicate that it's flexible

on the details of how it will achieve it. Larger investments may follow, but only when the organization finds opportunities where they have both a strong competitive advantage and the ability to scale. As one CEO put it to us, "I need to be two steps ahead of my investors, but not 10."

As we stress, the CEO can't stand alone in taking those steps. Successful firms of the future are the ones that are investing in portfolios of long-term, non-core ventures.

That's why it's so essential for the entrepreneurial CFO to embrace a bold new vision and share that growth story to investors. Some analysts and investors might not like it at first, but the investors you want are the ones who share your vision for the future and are willing to stick with you on the long journey.

THE TWO TRAITS EVERY ENTREPRENEUR NEEDS

JIM DOUGHERTY

What are the most important attributes you need if you want to successfully launch a new business?

Narrowing it down to just a handful of characteristics and behaviors is difficult — there are so many one needs to succeed as an entrepreneur.

But if I had to choose just two, the ones that nearly every successful entrepreneur I've encountered has exemplified, I'd pick focus and tenacity.

I learned the importance and challenge of focus early, when I served as CEO of a startup called Intralinks. The company makes digital workspaces for large financial transactions. When I took over for the founders, it had $3 million in annual revenues and was losing $18 million a year. At that point it had seven different products, and it was on the verge of going out of business.

The lack of focus was one reason why.

The first thing I did was figure out which of the seven products we could shut down, and why this made sense strategically. One of our products involved loan syndication. It provided a solution for a very complicated process, one involving dozens of entities and hundreds of participants. We decided to shut down the other six products and focus on this one, since it solved the biggest problem.

When I sat with the team to explain the decision, I told them it is really hard to be best in class at one thing — and it's impossible to be best at seven things. By trying to do so many things, we were unlikely to succeed at any. The team took some time to absorb the difficult message, but eventually they understood and bought in.

The board of directors, mostly VCs who'd never run a company, were aghast. They felt shutting down possible options for revenue at a time when the company badly needed it was insane. I argued that making choices and achieving focus was essential. Ultimately, they agreed.

This focused behavior is particularly hard for certain types of entrepreneurs. Many of these people are super-creative, get bored fast, or are comfortable juggling lots of balls. These types of entrepreneurs need to be sure they have more focused people around them as cofounders, directors, or advisers.

Tenacity is the other most important entrepreneurial virtue. Albert Einstein is credited with saying insanity is defined as doing the same thing over and over again and expecting different results. Well, sometimes that is exactly what's required to successfully launch a venture. Ross Perot referenced this when he said, "No doesn't mean no — just 'not now.'"

Later, Intralinks decided to try to IPO. By then we were growing very fast, from $3 million in revenue in 1999 to $20 million in 2000. We went on a public road show in August 2000. Stock markets were tanking as the dot-com bubble was bursting. We did the standard 75 or so presentations to investors. We settled in at JPMorgan, in lower New York City, to "price" — that is, to work with our bankers to settle on the price per share at which our stock would open trading. We decided not to price due to falling markets: we had a book, but it wasn't considered strong enough to withstand the selling that would occur. So we decided not to IPO. It was a hard decision — I'd been planning to personally ring open the NASDAQ market the next day. Now we had to stay private, at least for a while.

After that, one bank stepped forward to lead another private round of funding. We made another 50 presentations to investors, but due to a conflict that bank had to drop out. Another bank came forward, another 50 presentations — and then one of that bank's clients decided to make a bid to buy us, forcing that bank to drop out. (The buyout didn't happen.)

We then found an amazing VC firm named Rho Capital. After eight months and more than 215 presentations we closed on a $50 million round. Were we insane for taking 215 meetings and hearing "no" after almost every one of them? No, we were simply exhibiting tenacity, which is what it takes to succeed as an entrepreneur.

HOW DECISION MAKING EVOLVES AS A STARTUP GROWS

BRIAN HALLIGAN

As I approach the 10-year anniversary of HubSpot, the marketing and sales software firm of which I'm CEO, I've been reflecting back on the decisions I've made — both right and wrong. There has been a fair share of both. I've also been considering how my decision-making process has evolved as the company moved from an early-stage startup to a growth-stage scale-up. Understanding my own evolution in decision making and the tools I use today may help spare other scale-up leaders some unwanted headaches.

Flip-flopping will cost you

In startup mode, I changed my mind all the time. Most decisions didn't impact many people, so I didn't hesitate to change course often. This became very problematic in scale-up mode: every time I changed my mind it impacted hundreds of employees and typically involved retooling lots of processes and systems. Over time, I learned that the cost of changing your mind becomes huge as your startup scales up.

Optionality will also cost you

A closely related bad behavior is not making up my mind and keeping my options open. It's hard to see at the time, but optionality has a hidden tax. Here's an example. In the startup days of HubSpot, we argued for years about which target persona to pursue. Target personas go beyond the demographics and psychographics normally associated with target markets. Personas focus more on the specific needs, pain points, and buying process of your ideal prospects and customers. In HubSpot's case, we were toggling between focusing on marketing manager types at midsize businesses and focusing on small business owners wearing multiple hats, including marketing.

I just didn't make the call. My indecision meant the marketing and product teams had to serve multiple personas — and ended up creating middling solutions for each of them. Once we ripped off the Band-Aid and decided on one persona, the marketing and product teams could focus their efforts and craft the perfect solution. We delighted customers more, and our close and growth rates went through the roof.

As the company has grown, I've learned to listen carefully to all the inputs, engage in healthy debate with my team, take my time, make a decision, and "sail the ship." Sailing the ship means that decisions are final. We put the sails up, send the boat out of the harbor, and there's no turning around. I tell my team that I've heard their point of view and if someone disagrees, I'm sorry, but we're ready to sail. The worst thing that can happen is people continuing to debate the issue when they're on the losing side. It's not always easy, but you need to make final decisions and not field arguments from the losing side.

Fast vs. right

In startup mode everything comes at you quickly, and you tend to react fast. If you're a manager and make a wrong decision, you just roll it back. Simple. In scale-up mode, however, you have a choice: You can do things fast or you can do things right. There's always a balance, but in scale-up mode you need to shift toward doing things right more often than doing things fast.

If you do everything fast in a scale-up, you end up with "shortcut debt" — a close cousin to "tech debt." (For the non-IT types, this is a phrase commonly used to refer to the extra development work that arises when code that is easy to implement in the short term is used instead of applying the best overall solution.) Shortcut debt will leave you in the same predicament. If you take the easy way out the first time around, you're left spending time cleaning up messes that never should have occurred. And what if too much shortcut debt racks up? It cripples your ability to manage. Your whole team will be too preoccupied with having their fingers in the dam, holding back the water.

Stop making uninspired compromises

Nothing kills a scale-up like the uninspired compromise. The more managers sitting in the room with strong opinions and good arguments, the more likely you are to come up with an uninspired compromise. Everyone might be happy, but uninspired compromises tend to be conservative by nature.

In the early days it is just you and your cofounder making the big decisions. It is relatively easy to convince one other human being who likely sees the world in a similar way to make a risky, bold, counterintuitive call. As your company scales, there are a lot more people around the table weighing in on those decisions. If you did your job and hired well, those people are a diverse group who were hired based on varied experience and brainpower, and they likely have strong convictions and the ability to convince others. It is infinitely harder to convince those 10 people from varied backgrounds to make a risky, bold, counterintuitive call than it was to convince your cofounder. What you can find yourself doing is making compromise after compromise — and before you know it you are making the same decisions your competitors are making, you're building the same product your competitors are building, you have the same culture your competitors do, and you and your competitors have the same mediocre results.

As CEO, it's your job to make the right decision, not the most popular decision. There have been plenty of times during HubSpot's scale-up period that I've left a meeting with some disappointed managers; I feel it as soon as I step out of the room. But uninspired compromises feel much worse. Once decisions are made, it's important to communicate them clearly to the rest of your team. Again, the key to this principle is having a culture of healthy debate and people rallying around the decision — whether they're advocating for it or not.

Focus on the three duties of a leader

Stop me if you've heard this one before, but I find myself using it a lot these days. It's the bus analogy, and it goes like this:

A leader has three responsibilities, all of which can be illustrated by a bus trip. First, the leader needs a clear set of directions in mind about where the bus is headed. Second, the leader needs to know whom to pick up and whom to leave at the bus stop along the way, a concept the management writer Jim Collins made famous. The people on the bus need to be excited about the direction and ready to work together en route. Some will hop off along the way, and that's normal. Third, the leader needs to make sure there is enough gas in the tank (cash in the bank account) to get to the destination.

The bus trip analogy is a back-to-basics approach to decision making that I try to use when I look at HubSpot and the leaders on my team. If you stick with the bus analogy, it'll help you with any micromanaging tendencies that most CEOs, including myself, have.

Adopt a martian's point of view

Sometimes you get so wrapped up in your own guardrails, your company's set of assumptions, or your industry's conventional wisdom that you can lose sight of the forest for the trees. When I'm in a meeting and feeling like I'm stuck in my company's or industry's box, I take an unconventional approach.

I ask: "What if a Martian landed in the room right now and was faced with this decision? What would she say?" More often than not, asking what a total outsider might do — someone with zero knowledge of conventional wisdom or company history — can help pull a discussion out of the weeds and help to make the right decision. At HubSpot, that means solving for long-term enterprise value, not for short-term goals or what an investor wants to hear.

FOUNDER-LED COMPANIES OUTPERFORM THE REST — HERE'S WHY

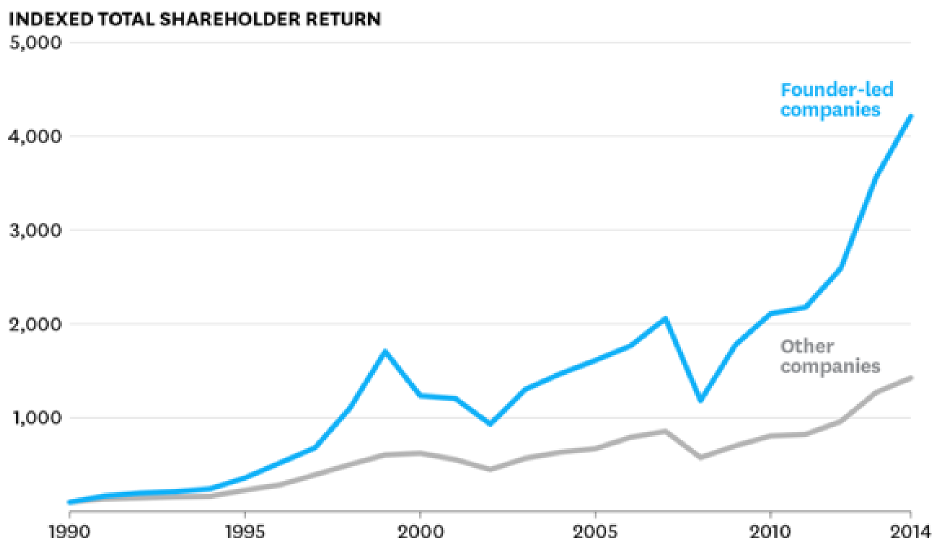
CHRIS ZOOK

A recent study by three professors at Purdue's Krannert School of Management is part of a growing mountain of evidence of the superior and more lasting performance of companies where the founder still plays a significant role as CEO, chairman, board member, or owner or adviser. Specifically, the study found that S&P 500 companies where the founder is still CEO are more innovative, generate 31% more patents, create patents that are more valuable, and are more likely to make bold investments to renew and adapt the business model — demonstrating a willingness to take risk to invent the future.

This begs the question, why?

When the founder is still involved, why are companies more innovative? Why are they able to increase value at a higher rate, willing to make bolder investments, and able to maintain more loyal employees?

Over the past decade, we at Bain & Company have been studying the deep roots of the most adaptable and sustainably successful companies. We started with the observation that profitable growth is becoming more challenging, and that only one in 10 companies achieve it over a decade. We confirmed this observation by developing a database of all public companies in the global stock markets and tracking their performance over 25 years. We found that the companies most successful at maintaining profitable growth over the long term were disproportionately companies where the founder was still running the business (such as Oracle, Haier, or LBrands), was still involved on the Board of Directors (like Four Seasons Hotels and Resorts), or, most importantly, where the focus and principles of how to operate that the founder had originally put in place still endured (as at IKEA or at Enterprise Rent-A-Car).



To find out why, we went out into the field. We did a series of interviews with executives and founders around the world, and analyzed another 200 founder-led companies with the help of an expert who knew each company well. What we found surprised us. Three sets of hard-edged practices and underlying attitudes, tracing back to the way the founder had set up the company, emerged consistently. In other words, how founders built their companies on the inside, from the start, influenced their companies' success on the outside, for a long time.

We call these company practices "the founder's mentality." They are not vague cultural notions that are hard to pin down and take forever to change. Rather, they are grounded in concrete actions and an approach to business that can be studied and emulated with rapid results. And that is good news for all companies: most of the practices that produce this successful performance are observable, learnable, and useable by all leaders immediately.

The first is the unique, spiky feature, or capability that gives a business special purpose. We call it business insurgency. My co-author James Allen refers to this as waging war on industry norms on behalf of underserved customers, as Netflix did for video rentals, or to create a new market entirely, as Google has done, following its mission to organize all of the world's information.

Many businesses lose this sharp sense of purpose as they grow. This is why only 13% of employees worldwide feel any personal engagement with their work at all. And engagement matters. Our research shows that engaged employees are 3.5 times as likely to solve problems themselves and invest personal time in innovation as unengaged workers. Imagine if all were engaged!

Lose this clear purpose and your company becomes directionless and uninspiring — especially to the millennial generation.

The second element of the founder's mentality is a front line obsession — as the founder had. It shows up in a love of the details and a culture

that makes heroes of those at the front line of the business and gives them power.

An example I love is how M.S. Oberoi, founder of Oberoi Hotels, role modeled this for the next generation of leaders. He scrawled responses on customer comment cards even at the age of 94 when he could barely see and had to hold the cards an inch away from his eyes.

Lose this deep curiosity for what is going on at the front line, and your company loses its instincts. At the extreme, your company becomes an out-of-touch bureaucracy where power shifts to corporate offices and to people who may never have served a customer or made a product.

The third element is an owner's mindset, the fuel that propelled the rise of private equity, whose essence is dialing up speed to act and taking personal responsibility for risk and for cost.

This has been central to the success of AB InBev, the $50 billion world leader in beer. The company states at the top of its list of principles that "we are a company of owners and act like one" and translates that idea into minute detail throughout the whole company.

Lose the owner's mindset and your company becomes complacent, slow to act and decide, and risk averse. Leaders can easily turn into custodians and then into bureaucrats, and bureaucrats are especially vulnerable today.

Our research shows that companies that maintain the founder's mentality as they age are four to five times more likely to be top quartile performers. For instance, an index of Fortune 500 companies in which the founder is still deeply involved performed 3.1 times better than the rest over the past 15 years.

Some of the most successful venture capitalists, like Andreesen Horowitz have been quite vocal about their strong preference for investing in businesses where the founder is the CEO. In fact, most of the great tech firms — just think of Oracle, Intel, Microsoft, Apple, Dell, Google, Amazon, Facebook, and so many others — had founder CEOs, often for a long time. In his blog, Ben Horowitz lists three reasons his VC firm prefers founder CEOs: founders have the moral authority to make the hard choices, they know the detail of the business and have better instincts, and they have a long-term perspective on investments and building a company that lasts.

The implication for today's business leaders? Cultivate a founder's mentality as a key strategic asset, and talk about it, measure it, monitor it, and reward it. We believe it is the most important indicator of the health of a company on the inside — which is almost always where the deep root causes of failure to perform on the outside reside. The founder's mentality is an indicator of a company's readiness to act quickly, to adapt to change, to retain the ground-level instincts of a founder, and to innovate to invent — and not fight the future.

HOW UNICORNS GROW

FROM THE JANUARY—FEBRUARY 2016 ISSUE

Seven years ago Uber didn't exist. Five years ago it was limited to San Francisco. Today it offers rides in more than 65 countries and at this writing is valued at more than $50 billion. Along the way the company has amassed an impressive war chest to fund its expansion and ward off competitors: It has raised more than $8 billion from private investors.

The meteoric rise of Uber and other "unicorns"—private, venture-backed companies valued at a billion dollars or more—feels unprecedented. But is it? And does that matter?

Research from Play Bigger, a Silicon Valley consultancy that works with VC-backed start-ups, confirms that they really are growing faster in recent years, at least as measured by market capitalization. It also examines whether raising lots of private capital prior to an IPO is an important determinant of future success and looks at the best time for these companies to go public.

The researchers began by exploring speed. They took the market capitalizations of 1,125 firms started in 2000 or later and divided each by the number of years since founding; the result is the "time to market cap." A company founded five years ago that's worth $2 billion, for example, has a greater time to market cap than a company founded 10 years ago that's worth $3 billion. For firms that have gone public, market cap is the total value of outstanding shares; for private firms, it's the valuation assigned by VCs during the most recent round of funding. (Private valuations are less precise, but they're arguably the best approximation of value creation.)

The results were even more dramatic than the researchers expected. Firms founded from 2012 to 2015 had a time to market cap more than twice that of firms founded from 2000 to 2003. In other words, today's start-ups are growing about twice as fast as those founded a decade ago.

Because the data doesn't go back to the dot-com era, it's not clear whether today's start-ups are getting big more quickly than those of the 1990s. Some of the VCs with whom Play Bigger shared its research suggested that the data merely reflects a bubble. They believe that investors are overpaying for equity in unicorns, thereby inflating their market caps. In November the *Financial Times* reported that Fidelity Investments had written down its stake in Snapchat—reportedly valued at $15 billion at its last fund-raising, in May—by 25%. Also that month, the mobile payments company Square filed for its IPO at a price range that put the firm's worth significantly below its private valuation, which was $6 billion in 2014.

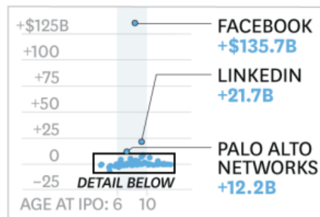
Play Bigger founding partner Al Ramadan believes that although a bubble may be part of the explanation for today's fast growth, fundamental forces are also at work. "Products and services get discovered and adopted at a speed never seen before," he says. "Word of mouth today—through Facebook, Twitter, Tumblr, Pinterest, and so on—is just so fast, and it's the most effective means of marketing." Moreover, the launch of the iPhone, in 2007, not only opened up opportunities for products and services but also created a new way to rapidly distribute software, through the Apple and later the Android app stores.

"Get big fast" has been a start-up mantra since the 1990s. Many VCs try to grow their companies quickly in order to raise as much capital as possible; having a cash hoard, the thinking goes, gives a start-up greater flexibility and more power to fend off potential rivals. But another piece of Play Bigger's research sounds a cautionary note in this regard.

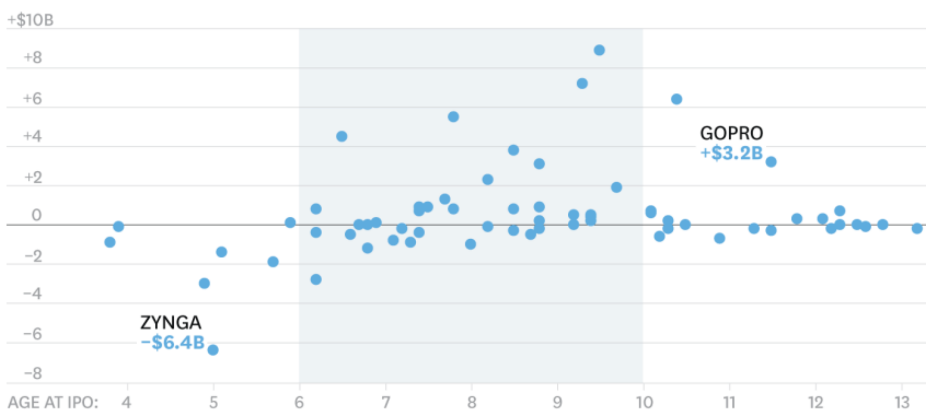
Specifically, the researchers looked at the 69 U.S. companies in their sample that have raised venture capital since 2000 and subsequently gone public. They wanted to know whether the amount raised prior to IPO predicted growth in market cap after IPO—a proxy for long-term value creation. They found no relationship.

Finding the IPO Sweet Spot

In a study of the 69 U.S. firms that have raised venture capital since 2000 and later gone public, those whose public offerings occurred six to 10 years after launch saw greater increases in market cap following their IPOs.



CHANGE IN VALUE SINCE IPO



SOURCE PLAY BIGGER. MARKET CAP CHANGES ARE AS OF 6/30/2015
FROM "HOW UNICORNS GROW," JANUARY–FEBRUARY 2016

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"Candidly, we did not expect this result," says Play Bigger founding partner Christopher Lochhead. "There's a lot of belief in Silicon Valley that the amount raised really matters."

If money raised doesn't predict long-term value creation, what does? The research points to two interesting correlations. The first is the age of the company at IPO. "Companies that go public between the ages of six and 10 years generate 95% of all value created post-IPO," Ramadan says.

It's difficult to interpret the finding that company age at IPO predicts value creation, because companies today are not just getting big faster but also staying private longer. And it's not clear whether the link between firm age and growth in market cap is causal. Are the strongest companies coincidentally all going public at about the same time? Or is there something intrinsic about companies that go public very early or very late that inhibits their ability to create value post-IPO? Play Bigger plans to explore the relationship in future research.

One possible interpretation of the IPO "window" is that many unicorns are missing their chance—staying private too long. Start-ups have been in no rush to go public, preferring to take advantage of plentiful private capital from hedge funds, mutual funds, and corporate VC firms. Public investors want to see some upside, so if unicorns remain private through too much of their growth phase, they may never conduct a successful IPO. And in some cases investors may wish they'd pushed companies to go public sooner, so as to realize returns while the firms were still growing rapidly. The privately held company Jawbone, for instance, founded in 1999 and once seen as a leader in wearable devices, has seen its market share decline and no longer ranks among the top five vendors in the category, according to the market research firm IDC. In November it announced that it was laying off 15% of its staff.

The researchers' last finding is more qualitative. The group scored the companies in its sample on the basis of whether they were trying to create entirely new categories of products or services in order to fill needs that consumers hadn't realized they had. They looked at whether firms are articulating new problems that can't be solved by existing solutions and whether they are cultivating large and active developer ecosystems, among other criteria. They found that the vast majority of post-IPO value creation comes from companies they call "category kings," which are carving out entirely new niches; think of Facebook, LinkedIn, and Tableau. Those niches are largely "winner take all"—the category kings capture 76% of the market.

"We hear all the time, Oh, this is going to be a huge market, room for lots of players," says Lochhead. "But that's actually not true."

Tech start-ups are in a race to define new product categories, and the pace has quickened. Simply raising more money isn't enough to win that race—and going public too soon or too late may limit long-term success. Even for unicorns, the path forward can be a challenge.

IN SEARCH OF THE NEXT BIG THING

FROM THE MAY 2013 ISSUE

Marc Andreessen knows both sides of the start-up game. As freshly minted university graduates in the 1990s, he and his partners went hat in hand to venture capitalists in Silicon Valley to fund their new project, the breakthrough web browser Netscape Navigator. Within 18 months the enterprise had gone public and Andreessen had become a symbol of the internet generation. Now he's a cofounder and partner of Andreessen Horowitz, a Menlo Park venture capital fund that's trying to make smart bets on tech start-ups in a climate much icier than the one during the dot-com boom. In this edited interview with HBR's editor in chief, Adi Ignatius, Andreessen talks about the complex challenges entrepreneurs now face and an investment opportunity that slipped away.

HBR: How would you characterize the best entrepreneurs you work with?

Andreessen: We aim for a trifecta in the people we want to back. We're trying to find a product innovator who is entrepreneurial and wants to start a company, and who also has the bandwidth and discipline to become a CEO. When people like that actually deliver and work hard for 10 years, the results are miraculous. If they fall down on any of those three fronts, generally it's a casualty.

Do all those skills really have to reside in one person?

It's hard to pair a product innovator with a business partner—or to partner the founder with an outside CEO—and have them get anywhere. We work with our companies when they absolutely have to do this, but it's very challenging.

Can entrepreneurs be taught? Or are the skills innate?

We think CEOs can be taught, so we specialize in training innovators to become CEOs. We don't spend a lot of time trying to teach CEOs to be innovators.

To what extent is the start-up business still hungover from the last boom and bust in tech stocks?

It's a really big deal, especially for anybody over age 35. It's similar to what happened after the Great Depression: Not until the 1950s did people really start focusing again on the stock market. Everybody's hypersensitive about another bubble. The minute anything starts to show even a little bit of life, they say, "Oh, my God, it's another bubble!"

Are you saying that the general view of the market is irrational?

Yeah, it's irrational. The rational thing is to focus on the future, not the past. But current attitudes are very much based on what happened in the past.

What's the view of Andreessen Horowitz?

Obviously, we see opportunity. We started our firm in 2009, after probably the worst 10 years ever in venture capital. But given the history of these things, this is probably a good time to get in.

Do you see the danger of a new bubble out there?

It's in the nature of venture capital and start-up investing that there are always stupid investments. The problem is that you never know which ones are which. I get these things as wrong as anybody else. But if you're afraid to make any investments that might be stupid, you'll never get any big winners—because the big outlier winners tend to look crazy at the start.

One symptom of the hangover is that fewer start-ups are doing IPOs. What does that mean for investors like you?

In a sense it's good for me. As venture capitalists, we have a 13-year lockup on our money, so we take "long term" seriously. I tell our entrepreneurs, "If you build a big successful independent company, at some point you almost certainly will go public."

In the meantime, how do you prepare them for that moment?

I tell them they shouldn't even think about going public until they've built what I call a fortress. You build a company that's so big and powerful and well defended that it can withstand the pressures of being public. Our entrepreneurs are therefore almost completely focused on the substance of what they're doing—as opposed to what happened in 1999, when everyone tried to take companies public in two years on the basis of a lot of hype.

Ah, the good old days.

One of the local VCs had two mottoes in 1999. One was "Grow big or go home." The other was "Forget details, just do deals." The second one got them into trouble because some of their companies had very little substance. They were largely just press releases on their way to an IPO.

So walk us through getting to an IPO today.

We take companies through what we call the parade of horrors—all the stuff that happens to a public company. We take them through Sarbanes-Oxley, financial disclosure, patent laws, antitrust. We talk about what hedge funds do, and the intersection between hedge funds and fair disclosure.

What role do hedge funds play in all of this?

Hedge funds are much more powerful than they used to be. Market manipulation is never prosecuted, so they can lie about you all they want. On the short side, they target companies that aren't fully funded. If you have liquidity exposure on your balance sheet and you have to raise money at some point in the future, they'll try to kill you. And they can make it into a self-fulfilling prophecy, where it's impossible for you to raise money. So we talk a lot about what it means to have a strong balance sheet, to ensure you never get into that situation.

How much cash should a start-up have on hand?

Generally, you want to have at least two years' worth of cash on the balance sheet in case

your revenue goes to zero. This is the tech industry—sometimes that actually happens.

In this brutal environment, how important is it for start-ups to retain their founders?

We always want control to rest with the founders. Anything else can be intensely dangerous, because of the ease with which people can mount proxy fights and all this other stuff. Large tech companies will often move to take over start-ups with no intention of actually buying them, just to screw up their business for 18 months.

Man, I'm glad I'm on the East Coast.

It's like World War III out here. [Laughs.]

If IPOs are so hard to pull off, are most of today's start-ups looking to sell out to bigger fish?

If somebody comes in here and says his goal is to sell his company, we won't invest. There are plenty of other venture capitalists who will fund him. For us, companies that are built to be independent are the most attractive. As for companies that are built to be sold, most acquirers are pretty smart and can smell that. It's ironic, but it's very hard for such a company to actually find a buyer.

Back in 1995, you took Netscape public after just 18 months. Now you're on the board of Facebook, which had its own noteworthy IPO. Can you talk about the difference in IPO expectations?

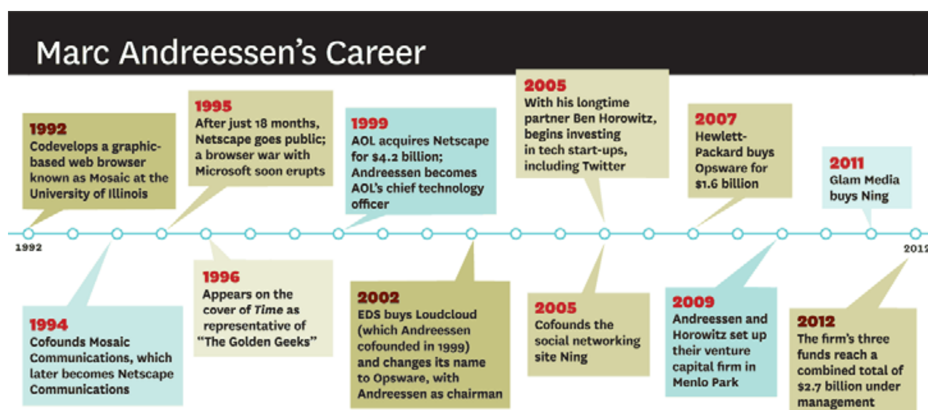
Netscape was a different era. There was no Sarbanes-Oxley, no reg FD [regulation fair disclosure]. Hedge funds were a tiny percentage of the market. Short sellers were small and unsophisticated. And there were more long investors who really understood what it was like to invest in a small company and see it develop. There was also the expectation that you took things public quickly. I can't really talk in detail about Facebook. But in my opinion, Facebook went public when it had become a fortress. The company had built itself into a position of strength in all the areas that make it safe to be public.

How has the lean start-up model changed the game?

It's a direct reaction to "Forget details, just do deals." Back in 1999, entrepreneurs were guided to do a fast start-up: Get the most basic, rudimentary product on the market as soon as you possibly can, and then hype the s— out of it. Sell the s— out of it. Try to generate as much noise as you can and as much hype as you can and get the big IPO first-day pop. And then hope that in the fullness of time you'll grow into all the promises you've made to everybody. Or, the cynics would say, you can sell out quickly. A lot of these companies had terrible products.

And now?

The new start-up methodology is basically a complete 180 on that. It says the only thing that matters is getting the product right—developing a product that people want and use and love and will pay for—before you do all the other stuff. That is a tremendously healthy move, because it centers these companies on the substance of what they're building.



Is there any downside to that kind of focus?

It can be taken too far. A large number of founders are terrified of actually getting into a market. They use this approach as an excuse to never think about sales and marketing. In my view, they're in complete denial about what it takes to actually build a company and build a business.

So what do you do? A guy comes in with a great product and no interest in the rest of it...

We administer a beating. [Laughs.] We basically say, Look, we understand. A 28-year-old who has built a great product and comes in here is not going to have much experience in sales and marketing. We explain that a lot of products are being sold and marketed out there. If you don't take sales and marketing seriously, nobody is ever going to know about you. Nobody is ever going to buy the thing. You're going to end up losing. But if you want to take it seriously, here are the things we can do to help you.

What are you looking for when you invest in a tech start-up?

I define a tech start-up as a new company whose value is the innovation it's bringing to the world. It's not the value of the product it's currently building but the value of the products it's going to build in the future. So it's worth investing in a technology company only if it's going to be an innovation factory for years to come.

You've written that "software is eating the world," that digital innovation is transforming virtually every industry. Where are we in that process?

It's a long-term thing. Only recently have we become a world in which everybody has a computer and we're really there with the smartphone. Now is the time when a number of industries that historically have not been much affected by technology are all of a sudden in a position to be transformed by it.

What are some examples?

The book industry is an obvious one. First Amazon came for the book distribution business. It turned that into software—the Amazon website. Now it's turning the book itself

into software. We look at industries like real estate, agriculture, education, financial services, health care, retail. And we think now is a good time to create the kind of state-of-the-art software companies that will really transform them. Ironically, a lot of these companies are actually replays of ideas that were tried and failed in the dot-com era.

You've talked about having launched some big ideas that didn't fly because they were ahead of their time.

We launched Loudcloud in 1999, and basically Amazon Web Services is what Loudcloud would have been if it had launched in 2006 instead of 1999. The technology wasn't ready. Reid Hoffman started a social networking company in 1997 called SocialNet.com, long before Facebook or LinkedIn [which Hoffman cofounded in 2003] existed. For 20 years people laughed at the Apple Newton and said it proved that nobody had any interest in a tablet. And then along came the iPad. A lot of ideas that failed in the dot-com era were actually winners. They were just too early.

Does access to the cloud and big data improve the odds of success for new companies, by allowing their business models to rely a bit more on science and a bit less on art?

Yeah, I think so. The best of the companies we're seeing now are unbelievably good at analytics. They have this incredible closed loop where they analyze data and feed the numbers directly back into the process virtually in real time, running a continuous improvement loop. But none of this is a shortcut to success. That still involves a lot of art. For that matter, it's still hard to get the science right.

What have you learned about developing the art part of the process?

The best founders are artists in their domain. They operate instinctively in their industry because they are in touch with every relevant data point. They're able to synthesize in their gut a tremendous amount of data—pulling together technology trends, their companies' capabilities, their competitors' activities, market psychology, every conceivable aspect of how you run a company. A large number of tech companies that failed did so when they brought in a new CEO and the company stopped innovating and sold out. It's very hard to transplant a founder's skill set to someone coming from the outside.

Are VCs actually any good at finding great companies?

Research shows that there is a very high correlation between the top VC firms and persistent returns. These firms are good at what they do, but we believe that only a very small part of that is because they're smart. It also has to do with the persistence of the deal flow. It's a buyer-driven market for capital. And the best entrepreneurs want to raise money from the top firms, because they want the positive signaling effect—which is especially important for recruiting top talent. As a consequence, most second- or third-tier firms don't have the option of funding great companies. It doesn't matter how good the picker is. He'll never get to see the deal.

You've made some good bets—on Twitter, Facebook, Skype, and others. Is there one bet you missed out on that you wish you hadn't?

Square [an electronic payment service] is our great white whale. We've passed on every single round and we've regretted it pretty much every time. But we're proud of our results so far. Our first fund has returned 2x already, with a lot more companies still to mature—which has allowed us to raise the other funds very quickly.

You've developed a strong philanthropic focus. Is the next generation of investors thinking about social investment?

No. [Laughs.]

So much for my hopes for the next generation.

Many younger entrepreneurs have a social mission or a philanthropic agenda. They start early. Investors, not so much.

HOW TO WRITE A GREAT BUSINESS PLAN

WILLIAM A. SAHLMAN

w areas of business attract as much attention as new ventures, and few aspects of new-venture creation attract as much attention as the business plan. Countless books and articles in the popular press dissect the topic. A growing number of annual business-plan contests are springing up across the United States and, increasingly, in other countries. Both graduate and undergraduate schools devote entire courses to the subject. Indeed, judging by all the hoopla surrounding business plans, you would think that the only things standing between a would-be entrepreneur and spectacular success are glossy five-color charts, a bundle of meticulous-looking spreadsheets, and a decade of month-by-month financial projections.

Nothing could be further from the truth. In my experience with hundreds of entrepreneurial startups, business plans rank no higher than 2—on a scale from 1 to 10—as a predictor of a new venture's success. And sometimes, in fact, the more elaborately crafted the document, the more likely the venture is to, well, flop, for lack of a more euphemistic word.

What's wrong with most business plans? The answer is relatively straightforward. Most waste too much ink on numbers and devote too little to the information that really matters to intelligent investors. As every seasoned investor knows, financial projections for a new company—especially detailed, month-by-month projections that stretch out for more than a year—are an act of imagination. An entrepreneurial venture faces far too many unknowns to predict revenues, let alone profits. Moreover, few if any entrepreneurs correctly anticipate how much capital and time will be required to accomplish their objectives. Typically, they are wildly optimistic, padding their projections. Investors know about the padding effect and therefore discount the figures in business plans. These maneuvers create a vicious circle of inaccuracy that benefits no one.

Don't misunderstand me: business plans should include some numbers. But those numbers should appear mainly in the form of a business model that shows the entrepreneurial team has thought through the key drivers of the venture's success or failure. In manufacturing, such a driver might be the yield on a production process; in magazine publishing, the anticipated renewal rate; or in software, the impact of using various distribution channels. The model should also address the break-even issue: At what level of sales does the business begin to make a profit? And even more important, When does cash flow turn positive? Without a doubt, these questions deserve a few pages in any business plan. Near the back.

What goes at the front? What information does a good business plan contain?

If you want to speak the language of investors—and also make sure you have asked yourself the right questions before setting out on the most daunting journey of a businessperson's career—I recommend basing your business plan on the framework that follows. It does not provide the kind of "winning" formula touted by some current how-to books and software programs for entrepreneurs. Nor is it a guide to brain surgery. Rather, the framework systematically assesses the four interdependent factors critical to every new venture:

The People. The men and women starting and running the venture, as well as the outside parties providing key services or important resources for it, such as its lawyers, accountants, and suppliers.

The Opportunity. A profile of the business itself—what it will sell and to whom, whether the business can grow and how fast, what its economics are, who and what stand in the way of success.

The Context. The big picture—the regulatory environment, interest rates, demographic trends, inflation, and the like—basically, factors that inevitably change but cannot be controlled by the entrepreneur.

Risk and Reward. An assessment of everything that can go wrong and right, and a discussion of how the entrepreneurial team can respond.

The assumption behind the framework is that great businesses have attributes that are easy to identify but hard to assemble. They have an experienced, energetic managerial team from the top to the bottom. The team's members have skills and experiences directly relevant to the opportunity they are pursuing. Ideally, they will have worked successfully together in the past. The opportunity has an attractive, sustainable business model; it is possible to create a competitive edge and defend it. Many options exist for expanding the scale and scope of the business, and these options are unique to the enterprise and its team. Value can be extracted from the business in a number of ways either through a positive harvest event—a sale—or by scaling down or liquidating. The context is favorable with respect to both the regulatory and the macro-economic environments. Risk is understood, and the team has considered ways to mitigate the impact of difficult events. In short, great businesses have the four parts of the framework completely covered. If only reality were so neat.

The People

When I receive a business plan, I always read the résumé section first. Not because the people part of the new venture is the most important, but because without the right team, none of the other parts really matters.

I read the résumés of the venture's team with a list of questions in mind. (See the insert "Who Are These People, Anyway?") All these questions get at the same three issues about the venture's team members: What do they know? Whom do they know? and How well are they known?

What and whom they know are matters of insight and experience. How familiar are the

team members with industry players and dynamics? Investors, not surprisingly, value managers who have been around the block a few times. A business plan should candidly describe each team member's knowledge of the new venture's type of product or service; its production processes; and the market itself, from competitors to customers. It also helps to indicate whether the team members have worked together before. Not played—as in roomed together in college—but worked.

Investors also look favorably on a team that is known because the real world often prefers not to deal with start-ups. They're too unpredictable. That changes, however, when the new company is run by people well known to suppliers, customers, and employees. Their enterprise may be brand new, but they aren't. The surprise element of working with a start-up is somewhat ameliorated.

Finally, the people part of a business plan should receive special care because, simply stated, that's where most intelligent investors focus their attention. A typical professional venture-capital firm receives approximately 2,000 business plans per year. These plans are filled with tantalizing ideas for new products and services that will change the world and reap billions in the process—or so they say. But the fact is, most venture capitalists believe that ideas are a dime a dozen: only execution skills count. As Arthur Rock, a venture capital legend associated with the formation of such companies as Apple, Intel, and Teledyne, states, "I invest in people, not ideas." Rock also has said, "If you can find good people, if they're wrong about the product, they'll make a switch, so what good is it to understand the product that they're talking about in the first place?"

Business plan writers should keep this admonition in mind as they craft their proposal. Talk about the people—exhaustively. And if there is nothing solid about their experience and abilities to herald, then the entrepreneurial team should think again about launching the venture.

The Opportunity

When it comes to the opportunity itself, a good business plan begins by focusing on two questions: Is the total market for the venture's product or service large, rapidly growing, or both? Is the industry now, or can it become, structurally attractive? Entrepreneurs and investors look for large or rapidly growing markets mainly because it is often easier to obtain a share of a growing market than to fight with entrenched competitors for a share of a mature or stagnant market. Smart investors, in fact, try hard to identify high-growth-potential markets early in their evolution: that's where the big payoffs are. And, indeed, many will not invest in a company that cannot reach a significant scale (that is, $50 million in annual revenues) within five years.

As for attractiveness, investors are obviously looking for markets that actually allow businesses to make some money. But that's not the no-brainer it seems. In the late 1970s, the computer disk-drive business looked very attractive. The technology was new and exciting. Dozens of companies jumped into the fray, aided by an army of professional investors. Twenty years later, however, the thrill is gone for managers and investors alike. Disk drive companies must design products to meet the perceived needs of original equipment manufacturers (OEMs) and end users. Selling a product to OEMs is complicated. The customers are large relative to most of their suppliers. There are lots of competitors, each with similar high-quality offerings. Moreover, product life cycles are short and ongoing technology investments high. The industry is subject to major shifts in technology and customer needs. Intense rivalry leads to lower prices and, hence, lower margins. In short, the disk drive industry is simply not set up to make people a lot of money; it's a structural disaster area.

The information services industry, by contrast, is paradise. Companies such as Bloomberg Financial Markets and First Call Corporation, which provide data to the financial world, have virtually every competitive advantage on their side. First, they can assemble or create proprietary content—content that, by the way, is like life's blood to thousands of money managers and stock analysts around the world. And although it is often expensive to develop the service and to acquire initial customers, once up and running, these companies can deliver content to customers very cheaply. Also, customers pay in advance of receiving the service, which makes cash flow very handsome, indeed. In short, the structure of the information services industry is beyond attractive: it's gorgeous. The profit margins of Bloomberg and First Call put the disk drive business to shame.

Thus, the first step for entrepreneurs is to make sure they are entering an industry that is large and/or growing, and one that's structurally attractive. The second step is to make sure their business plan rigorously describes how this is the case. And if it isn't the case, their business plan needs to specify how the venture will still manage to make enough of a profit that investors (or potential employees or suppliers, for that matter) will want to participate.

Once it examines the new venture's industry, a business plan must describe in detail how the company will build and launch its product or service into the marketplace. Again, a series of questions should guide the discussion. (See the insert "The Opportunity of a Lifetime—or Is It?")

Often the answers to these questions reveal a fatal flaw in the business. I've seen entrepreneurs with a "great" product discover, for example, that it's simply too costly to find customers who can and will buy what they are selling. Economically viable access to customers is the key to business, yet many entrepreneurs take the Field of Dreams approach to this notion: build it, and they will come. That strategy works in the movies but is not very sensible in the real world.

It is not always easy to answer questions about the likely consumer response to new products or services. The market is as fickle as it is unpredictable. (Who would have guessed that plug-in room deodorizers would sell?) One entrepreneur I know proposed to introduce an electronic news-clipping service. He made his pitch to a prospective venture-capital investor who rejected the plan, stating, "I just don't think the dogs will eat the dog food." Later, when the entrepreneur's company went public, he sent the venture capitalist an anonymous package containing an empty can of dog food and a copy of his prospectus. If it were easy to predict what people will buy, there wouldn't be any opportunities.

Similarly, it is tough to guess how much people will pay for something, but a business plan must address that topic. Sometimes, the dogs will eat the dog food, but only at a price less than cost. Investors always look for opportunities for value pricing—that is, markets in which the costs to produce the product are low, but consumers will still pay a lot for it. No one is dying to invest in a company when margins are skinny. Still, there is money to be made in inexpensive products and services—even in commodities. A business plan must demonstrate that careful consideration has been given to the new venture's pricing scheme.

The list of questions about the new venture's opportunity focuses on the direct revenues and the costs of producing and marketing a product. That's fine, as far as it goes. A sensible proposal, however, also involves assessing the business model from a perspective that takes into account the investment required—that is, the balance sheet side of the equation. The following questions should also be addressed so that investors can understand the cash flow implications of pursuing an opportunity:

- When does the business have to buy resources, such as supplies, raw materials, and people?
- When does the business have to pay for them?
- How long does it take to acquire a customer?
- How long before the customer sends the business a check?
- How much capital equipment is required to support a dollar of sales?

Investors, of course, are looking for businesses in which management can buy low, sell high, collect early, and pay late. The business plan needs to spell out how close to that ideal the new venture is expected to come. Even if the answer is "not very"—and it usually is—at least the truth is out there to discuss.

The opportunity section of a business plan must also bring a few other issues to the surface. First, it must demonstrate and analyze how an opportunity can grow—in other words, how the new venture can expand its range of products or services, customer base, or geographic scope. Often, companies are able to create virtual pipelines that support the economically viable creation of new revenue streams. In the publishing business, for example, Inc. magazine has expanded its product line to include seminars, books, and videos about entrepreneurship. Similarly, building on the success of its personal-finance software program Quicken, Intuit now sells software for electronic banking, small-business accounting, and tax preparation, as well as personal-printing supplies and on-line information services—to name just a few of its highly profitable ancillary spin-offs.

Now, lots of business plans runneth over on the subject of the new venture's potential for growth and expansion. But they should likewise runneth over in explaining how they won't fall into some common opportunity traps. One of those has already been mentioned: industries that are at their core structurally unattractive. But there are others. The world of invention, for example, is fraught with danger. Over the past 15 years, I have seen scores of individuals who have devised a better mousetrap—newfangled creations from inflatable pillows for use on airplanes to automated car-parking systems. Few of these idea-driven companies have really taken off, however. I'm not entirely sure why. Sometimes, the inventor refuses to spend the money required by or share the rewards sufficiently with the business side of the company. Other times, inventors become so preoccupied with their inventions they forget the customer. Whatever the reason, better-mousetrap businesses have an uncanny way of malfunctioning.

Another opportunity trap that business plans—and entrepreneurs in general—need to pay attention to is the tricky business of arbitrage. Basically, arbitrage ventures are created to take advantage of some pricing disparity in the marketplace. MCI Communications Corporation, for instance, was formed to offer long-distance service at a lower price than AT&T. Some of the industry consolidations going on today reflect a different kind of arbitrage—the ability to buy small businesses at a wholesale price, roll them up together into a larger package, and take them public at a retail price, all without necessarily adding value in the process. Taking advantage of arbitrage opportunities is a viable and potentially profitable way to enter a business. In the final analysis, however, all arbitrage opportunities evaporate. It is not a question of whether, only when. The trick in these businesses is to use the arbitrage profits to build a more enduring business model, and business plans must explain how and when that will occur.

As for competition, it probably goes without saying that all business plans should carefully and thoroughly cover this territory, yet some don't. That is a glaring omission. For starters, every business plan should answer the following questions about the competition:

- Who are the new venture's current competitors?
- What resources do they control? What are their strengths and weaknesses?
- How will they respond to the new venture's decision to enter the business?
- How can the new venture respond to its competitors' response?
- Who else might be able to observe and exploit the same opportunity?
- Are there ways to co-opt potential or actual competitors by forming alliances?

Business is like chess: to be successful, you must anticipate several moves in advance. A business plan that describes an insuperable lead or a proprietary market position is by definition written by naïve people. That goes not just for the competition section of the business plan but for the entire discussion of the opportunity. All opportunities have promise; all have vulnerabilities. A good business plan doesn't whitewash the latter. Rather, it proves that the entrepreneurial team knows the good, the bad, and the ugly that the venture faces ahead.

The Context

Opportunities exist in a context. At one level is the macroeconomic environment, including the level of economic activity, inflation, exchange rates, and interest rates. At another level are the wide range of government rules and regulations that affect the opportunity and how resources are marshaled to exploit it.

Examples extend from tax policy to the rules about raising capital for a private or public company. And at yet another level are factors like technology that define the limits of what a business or its competitors can accomplish.

Context often has a tremendous impact on every aspect of the entrepreneurial process, from identification of opportunity to harvest. In some cases, changes in some contextual factor create opportunity. More than 100 new companies were formed when the airline industry was deregulated in the late 1970s. The context for financing was also favorable, enabling new entrants like People Express to go to the public market for capital even before starting operations.

Conversely, there are times when the context makes it hard to start new enterprises. The recession of the early 1990s combined with a difficult financing environment for new companies: venture capital disbursements were low, as was the amount of capital raised in the public markets. (Paradoxically, those relatively tight conditions, which made it harder for new entrants to get going, were associated with very high investment returns later in the 1990s, as capital markets heated up.)

Sometimes, a shift in context turns an unattractive business into an attractive one, and vice versa. Consider the case of a packaging company some years ago that was performing so poorly it was about to be put on the block. Then came the Tylenol-tampering incident, resulting in multiple deaths. The packaging company happened to have an efficient mechanism for installing tamper-proof seals, and in a matter of weeks its financial performance could have been called spectacular. Conversely, U.S. tax reforms enacted in 1986 created havoc for companies in the real estate business, eliminating almost every positive incentive to invest. Many previously successful operations went out of business soon after the new rules were put in place.

Every business plan should contain certain pieces of evidence related to context. First, the entrepreneurs should show a heightened awareness of the new venture's context and how it helps or hinders their specific proposal. Second, and more important, they should demonstrate that they know the venture's context will inevitably change and describe how those changes might affect the business. Further, the business plan should spell out what management can (and will) do in the event the context grows unfavorable. Finally, the business plan should explain the ways (if any) in which management can affect context in a positive way. For example, management might be able to have an impact on regulations or on industry standards through lobbying efforts.

Risk and Reward

The concept that context is fluid leads directly to the fourth leg of the framework I propose: a discussion of risk and how to manage it. I've come to think of a good business plan as a snapshot of an event in the future. That's quite a feat to begin with—taking a picture of the unknown. But the best business plans go beyond that; they are like movies of the future. They show the people, the opportunity, and the context from multiple angles. They offer a plausible, coherent story of what lies ahead. They unfold possibilities of action and reaction.

Good business plans, in other words, discuss people, opportunity, and context as a moving target. All three factors (and the relationship among them) are likely to change over time as a company evolves from start-up to ongoing enterprise. Therefore, any business plan worth the time it takes to write or read needs to focus attention on the dynamic aspects of the entrepreneurial process.

Of course, the future is hard to predict. Still, it is possible to give potential investors a sense of the kind and class of risk and reward they are assuming with a new venture. All it takes is a pencil and two simple drawings. (See the insert "Visualizing Risk and Reward.") But even with these drawings, risk is, well, risky. In reality, there are no immutable distributions of outcomes. It is ultimately the responsibility of management to change the distribution, to increase the likelihood and consequences of success, and to decrease the likelihood and implications of problems.

One of the great myths about entrepreneurs is that they are risk seekers. All sane people want to avoid risk. As Harvard Business School professor (and venture capitalist) Howard Stevenson says, true entrepreneurs want to capture all the reward and give all the risk to others. The best business is a post office box to which people send cashier's checks. Yet risk is unavoidable. So what does that mean for a business plan?

It means that the plan must unflinchingly confront the risks ahead—in terms of people, opportunity, and context. What happens if one of the new venture's leaders leaves? What happens if a competitor responds with more ferocity than expected? What happens if there is a revolution in Namibia, the source of a key raw material? What will management actually do?

Those are hard questions for an entrepreneur to pose, especially when seeking capital. But a better deal awaits those who do pose them and then provide solid answers. A new venture, for example, might be highly leveraged and therefore very sensitive to interest rates. Its business plan would benefit enormously by stating that management intends to hedge its exposure through the financial-futures market by purchasing a contract that does well when interest rates go up. That is the equivalent of offering investors insurance. (It also makes sense for the business itself.)

Finally, one important area in the realm of risk/reward management relates to harvesting. Venture capitalists often ask if a company is "IPOable," by which they mean, Can the company be taken public at some point in the future? Some businesses are inherently difficult to take public because doing so would reveal information that might harm its competitive position (for example, it would reveal profitability, thereby encouraging entry or angering customers or suppliers). Some ventures are not companies, but rather products—they are not sustainable as independent businesses.

Therefore, the business plan should talk candidly about the end of the process. How will the investor eventually get money out of the business, assuming it is successful, even if only marginally so? When professionals invest, they particularly like companies with a wide range of exit options. They like companies that work hard to preserve and enhance those options along the way, companies that don't,

for example, unthinkingly form alliances with big corporations that could someday actually buy them. Investors feel a lot better about risk if the venture's endgame is discussed up front. There is an old saying, "If you don't know where you are going, any road will get you there." In crafting sensible entrepreneurial strategies, just the opposite is true: you had better know where you might end up and have a map for getting there. A business plan should be the place where that map is drawn, for, as every traveler knows, a journey is a lot less risky when you have directions.

The Deal and Beyond

Once a business plan is written, of course, the goal is to land a deal. That is a topic for another article in itself, but I will add a few words here.

When I talk to young (and old) entrepreneurs looking to finance their ventures, they obsess about the valuation and terms of the deal they will receive. Their explicit goal seems to be to minimize the dilution they will suffer in raising capital. Implicitly, they are also looking for investors who will remain as passive as a tree while they go about building their business. On the food chain of investors, it seems, doctors and dentists are best and venture capitalists are worst because of the degree to which the latter group demands control and a large share of the returns.

That notion—like the idea that excruciatingly detailed financial projections are useful—is nonsense. From whom you raise capital is often more important than the terms. New ventures are inherently risky, as I've noted; what can go wrong will. When that happens, unsophisticated investors panic, get angry, and often refuse to advance the company more money. Sophisticated investors, by contrast, roll up their sleeves and help the company solve its problems. Often, they've had lots of experience saving sinking ships. They are typically process literate. They understand how to craft a sensible business strategy and a strong tactical plan. They know how to recruit, compensate, and motivate team members. They are also familiar with the Byzantine ins and outs of going public—an event most entrepreneurs face but once in a lifetime. This kind of know-how is worth the money needed to buy it.

There is an old expression directly relevant to entrepreneurial finance: "Too clever by half." Often, deal makers get very creative, crafting all sorts of payoff and option schemes. That usually backfires. My experience has proven again and again that sensible deals have the following six characteristics:

- They are simple.
- They are fair.
- They emphasize trust rather than legal ties.
- They do not blow apart if actual differs slightly from plan.
- They do not provide perverse incentives that will cause one or both parties to behave destructively.
- They are written on a pile of papers no greater than one-quarter inch thick.

But even these six simple rules miss an important point. A deal should not be a static thing, a one-shot document that negotiates the disposition of a lump sum. Instead, it is incumbent upon entrepreneurs, before they go searching for funding, to think about capital acquisition as a dynamic process—to figure out how much money they will need and when they will need it.

How is that accomplished? The trick is for the entrepreneurial team to treat the new venture as a series of experiments. Before launching the whole show, launch a little piece of it. Convene a focus group to test the product, build a prototype and watch it perform, conduct a regional or local rollout of a service. Such an exercise reveals the true economics of the business and can help enormously in determining how much money the new venture actually requires and in what stages. Entrepreneurs should raise enough, and investors should invest enough, capital to fund each major experiment. Experiments, of course, can feel expensive and risky. But I've seen them prevent disasters and help create successes. I consider it a prerequisite of putting together a winning deal.

Beware the Albatross

Among the many sins committed by business plan writers is arrogance. In today's economy, few ideas are truly proprietary. Moreover, there has never been a time in recorded history when the supply of capital did not outrace the supply of opportunity. The true half-life of opportunity is decreasing with the passage of time.

A business plan must not be an albatross that hangs around the neck of the entrepreneurial team, dragging it into oblivion. Instead, a business plan must be a call for action, one that recognizes management's responsibility to fix what is broken proactively and in real time. Risk is inevitable, avoiding risk impossible. Risk management is the key, always tilting the venture in favor of reward and away from risk.

A plan must demonstrate mastery of the entire entrepreneurial process, from identification of opportunity to harvest. It is not a way to separate unsuspecting investors from their money by hiding the fatal flaw. For in the final analysis, the only one being fooled is the entrepreneur.

We live today in the golden age of entrepreneurship. Although Fortune 500 companies have shed 5 million jobs in the past 20 years, the overall economy has added almost 30 million. Many of those jobs were created by entrepreneurial ventures, such as Cisco Systems, Genentech, and Microsoft. Each of those companies started with a business plan. Is that why they succeeded? There is no knowing for sure. But there is little doubt that crafting a business plan so that it thoroughly and candidly addresses the ingredients of success—people, opportunity, context, and the risk/reward picture—is vitally important. In the absence of a crystal ball, in fact, a business plan built of the right information and analysis can only be called indispensable.

LEADERSHIP LESSONS FROM GREAT FAMILY BUSINESSES

A HARVARD BUSINESS REVIEW WEBINAR FEATURING CLAUDIO FERNÁNDEZ-ARÁOZ

PRESENTER

CLAUDIO FERNÁNDEZ-ARÁOZ
Senior Advisor, Egon Zehnder

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OVERVIEW

Family-owned businesses are an important engine in today's global economy: Worldwide they account for around 80% of all companies. In the United States these companies employ 60% of workers and create 78% of new jobs. But family businesses also face many challenges. Only 30% last into the second generation and just 12% are viable into the third.

But family businesses that succeed long term offer valuable lessons for all firms. The Family Business Leadership Study conducted by Egon Zehnder and the Family Business Network-International discovered that exemplary family businesses apply five elements of success. The leaders of these companies understand their organizations' unique "family gravity," have a structured leadership succession process, utilize a defined corporate governance process, understand what is needed in family business leaders, and manage the integration process for new leaders.

CONTEXT

Claudio Fernández-Aráoz shared insights from an analysis of 53 leading family businesses. Adopting the lessons learned will increase firms' chances of long-term success.

KEY TAKEAWAYS

Strong leadership differentiates enduring family businesses from vulnerable ones.

Family businesses are powerful, but vulnerable. In the United States, one third of Standard & Poor's 500 companies are family controlled. More than 60% of large corporations in East Asia and Latin America, and 40% of the 250 largest firms in France and Germany, are family owned. Yet, success is often fleeting. The mortality rate of family businesses is high:

- Only about one third (30%) of family businesses last into the second generation.
- Only 12% endure into the third generation.
- Just 3% exist in the fourth generation and beyond.

To understand the role of leadership in family businesses, Egon Zehnder and the Family Business Network-International interviewed 53 leading family firms around the world. Details of the study are provided below.

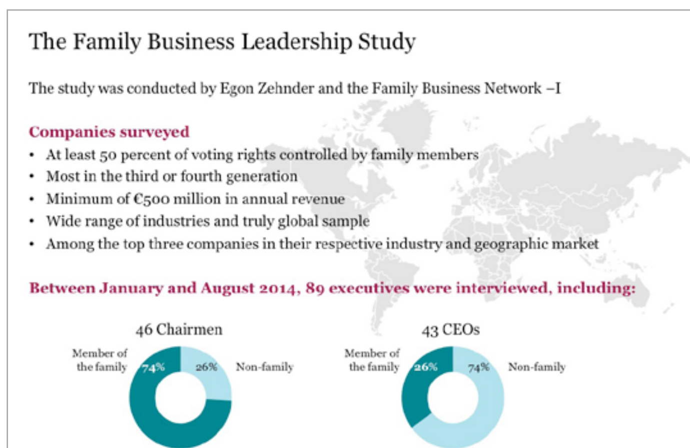

FIGURE 1: THE FAMILY BUSINESS LEADERSHIP STUDY OF SUCCESSFUL FAMILY FIRMS

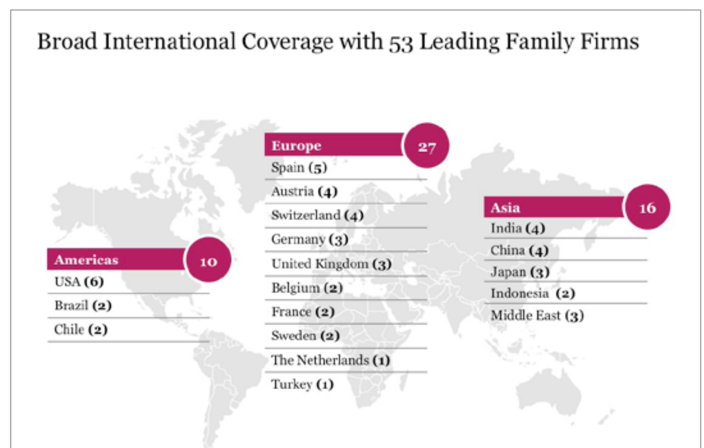

FIGURE 2: THE FIVE KEY ELEMENTS OF SUCCESS AMONG FAMILY BUSINESSES

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> "Great family businesses take a long-term perspective and develop talent from within. This is a best practice that all firms should consider adopting."
>
> CLAUDIO FERNÁNDEZ-ARÁOZ

Through this study, the Family Business Leadership Study identified five elements of success in exemplary family businesses.

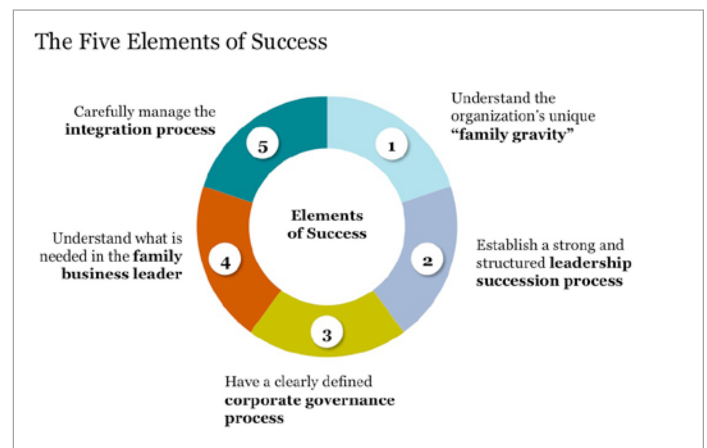

FIGURE 2: THE FIVE KEY ELEMENTS OF SUCCESS AMONG FAMILY BUSINESSES

Element 1: Successful family businesses understand their unique "family gravity."

For most family businesses, leading family members are the central point of attraction in the company. Their strong personalities create gravitational power and illustrate the corporate identity. Leading family members carry and shape the succession process and management of non-family talent. If non-family top executives don't find their orbit in this system, succession fails. It is important to understand three elements of family gravity:

- *The nature of the gravity.* This is characterized by the non-negotiable values and legacy of the family business, such as customer focus, integrity, or quality.
- *The strength of the gravity.* This is defined by how firmly the family's identity is linked with the company and how much cohesion exists among family members.
- *The transmission of the gravity.* This is determined by the written and unwritten rules of family and business governance that determine how decisions are made.

Element 2: They establish a strong and structured leadership succession process.

Effective succession processes have three phases:

- **Phase 1:** Discussion and commitment by shareholders. This includes exploring possible paths of succession, examining the company's position and goals, securing family alignment on firm strategy and investment, translating company goals into a profile of the next leader, and developing and executing a succession process.
- **Phase 2:** Identification, evaluation, and selection. This phase should begin as early as four years before the planned succession. A pool of internal and external candidates is identified. Two lists are created: a long list with candidates who meet all requirements and a short list with the six to eight most desirable candidates. One or two finalists are identified and contract negotiations ensue.

3. Board Governance

The costs of poor governance are real

- One-quarter of the non-family executives interviewed report **having had governance concerns** when they considered joining the family business.
- Non-family members must be able to count on **professionalism and independence**

Of the firms we studied:

Governance by ...

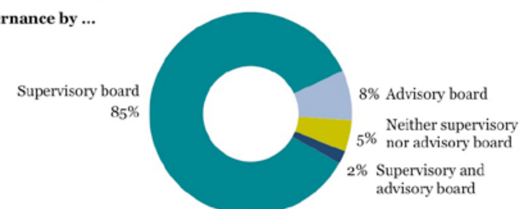

FIGURE 3: TYPES OF GOVERNANCE AT SUCCESSFUL FAMILY FIRMS

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> "Without a clear separation between ownership and management, family businesses can't attract and retain great talent."
>
> CLAUDIO FERNÁNDEZ-ARÁOZ

- **Phase 3:** Integration and development of the successor. Integration includes establishing an agenda for the first six to twelve months, as well as analyzing and selecting the top management team. After twelve months, 360-degree feedback is gathered, and if necessary, a development plan is created. Performance is evaluated again after two years, and the company decides whether the leader's contract will be renewed.

In high-performing family businesses, a hierarchy of talent sources is used for succession. The first tier is composed of family members, followed by internal candidates, and then external candidates. Ideally, a CEO is never hired from outside the company.

Element 3: Exemplary family businesses have a clearly defined corporate governance process.

Poor governance is costly. One quarter of non-family executives had governance concerns when they joined a family business. Non-family members must be able to count on professionalism and independence. The predominant governance form among the firms in the study was a supervisory board.

Element 4: They understand what is needed in the family business leader.

The study found that outstanding family businesses assess leadership in three areas:

1. **Shared values.** Shared values are essential as family members select senior leaders. Cultural fit is very important for success.
2. **Key competencies.** Beyond traditional business competencies, leaders must possess three competencies that are specific to family business:
    - *Family business awareness.* This is the ability to translate the organization's values, traditions, and history into how the business is run.
    - *Ownership dynamics.* This is the ability to mentor next-generation family leaders and act as a trusted advisor on ownership and governance issues as they relate to the family's legacy.
    - *Sustainable entrepreneurship.* This is the ability to manage both the commercial and social impact aspects of the business to allow the family business to be sustained in ways that are true to the family's values.
3. **Potential.** Since the business world is constantly changing, it is also important that family business leaders also show "potential." Individuals with potential exhibit four characteristics:
    - *Curiosity.* They seek new experiences and are open to learning and change.
    - *Insight.* They gather and make sense of information, enabling them to identify new opportunities and threats.
    - *Engagement.* They use emotion and logic to communicate a persuasive vision and connect with people.
    - *Determination.* They fight for difficult goals and bounce back from adversity.

The research found that non-family leader relationships fall into one of three archetypes:

- *Counterparts.* Counterparts work as equal partners and create their own momentum within the business, while preserving the family's values.
- *Governors.* Governors are pragmatic leaders who leave strategy to the family. They have leeway for implementation within well-defined boundaries.
- *Stewards.* These managers are subordinate to the family, but add significant value by executing the family's vision in an effective, professional manner.

Element 5: They carefully manage the integration process.

The finish line is integration of new leaders into the organization, and not simply succession. Exemplary family businesses consider three dimensions of integration:

1. *Organizational alignment.* The new candidate is affirmed quickly. He or she is provided with mentoring and knowledge transfer from the outgoing leader or senior decision makers.
2. *Family bonding.* Family and non-family executives get to know the new leader through many formal and informal opportunities.
3. *Stakeholder acceptance.* Family decision makers must send strong signals that the successful candidate has their full support. Any poorly defined roles or boundaries must be addressed.

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CARRYING ON A STRONG LEGACY

SPONSOR'S PERSPECTIVE

Ensuring that a family business' legacy continues from generation to generation—or what Claudio Fernandez-Araoz calls "family gravity"—is vital to the long-term success of the enterprise. The themes that illuminate family gravity often are defined by the business' founder. Working these foundational principles into a succession plan establishes the family's identity and the non-negotiable values of the business.

As a family-owned business that began in 1889, Northern Trust has worked with generations of family-owned businesses and has come to understand how great family businesses thrive. Our experiences are consistent with the findings of Fernandez-Araoz's research—leadership succession and an effective governance process are key components to the successful transition of a family business from one generation to the next.

Kevin Harris, managing director in Northern Trust's Family Business Group, advocates a succession planning process that addresses the following three questions:

- How will ownership be transferred to the next generation?
- How will the leadership and management be transitioned?
- Is there a proper governance structure in place to support decision making at both the business and family levels?

Ownership succession addresses who the future owners will be and the mechanisms by which company shares will be transferred. Given a reasonable planning horizon, business ownership can be transferred over time in a manner that minimizes the impact of income and estate taxes and provides the liquidity necessary to pay those taxes.

Management succession explores the current and future leadership of the business and the transition strategies needed to navigate to the next generation, whether or not that leadership is a family member, an existing non-family executive or an outside hire. We have found using a board of directors (or an advisory board) can help facilitate a management transition. A board can have a significant impact on the ease of transition to a new leader, planned or as a result of death or disability, as it can provide continuity and assist in mentoring the new leader.

Governance succession addresses how business decisions will be made with input from the family. Developing a family governance structure creates a framework that allows family members to work together with open communication toward a shared vision. Effective governance requires appropriate connectivity between the family (in many cases a family council) and the business (ideally the board of directors).

Time Must Be Devoted to the Planning Process

Harris cautions that succession planning requires multiple streams of integrated planning to be successful and achieve the desired results. All of the planning around ownership, management succession and governance must be coordinated and mesh with the family's core values and beliefs. As Fernandez-Araoz notes, planning takes time and should be started years in advance of a transition. Businesses that have a blueprint for the future are not only less likely to fail, but they are also more likely to retain their value, now and in the future.

About Northern Trust

Northern Trust is a premier wealth management firm founded more than 125 years ago on the principles of service, expertise and integrity. With offices in 19 states and Washington, D.C., and 20 international locations, we have worked with generations of families and their advisors, offering fresh perspectives and creative thinking, backed by leading-edge technology and customized solutions. To learn more about our business owner services, visit northerntrust.com/business.

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