
Secrets of Success¹

Key Activities -- in launching a new business

1. Evaluating a product idea
2. Obtaining initial financing
3. Hiring and keeping the right people
4. Balancing the demands of research, development, manufacturing, marketing, sales and fulfillment

Winning strategies

1. Recognize -- this kind of opportunity requires a great deal of time and money
2. Hire good people, give them a lot of equity, and trust them to make good decisions
3. Be willing to give up equity to get Value Added Venture Capitalist (VAVC) financing and you will wind up with a smaller piece of a much larger pie = make more money.
4. **Orchestrate your operating decisions** around the rhythm of the business, always keeping a very close eye on the **cash** situation

Hiring the best people is necessary (1) to generate the right operating decisions and (2) to securing the right financing.

- Be wise – hiring all good people makes sense, but doing so right from the outset may drain all of your cash
- **Quit your job** – you will not succeed by giving less than 100% of your time
- Take on a full partner with **different skills** than your own
- Invest heavily in **market research** – know the market, impress potential investors
- **Hire a couple of experienced (and expensive) people** (VP-level). This makes operations run more smoothly, impresses the investors. Give them more equity and less salary – helps the cash situation. They also will show more commitment.
- **Work 80 hours per week.** Do not work 100 hours per week, this leads to burnout.
- Request financing from multiple sources. Do not overvalue the business, especially for friends and family investors, or for inexperienced angel investors. Taking unfair advantage of dumb money will haunt you, later on.

Take VAVC financing anytime you can get it. Good VAVC's make life much easier. You must give up more equity, but you'll get good advice, partnership opportunities will come sooner, later financing problems will be less difficult to solve, and your FINAL valuation at exit will be much higher.

¹ See *Launching a High-Risk Business*, WA Sahlman, HBS, multimedia game, High Performance Systems, Inc., 2001

- After money is in hand, hire a couple more experienced (expensive) people, give them equity, less salary. (So, they want a full salary, and do not care about equity? Hire someone else!)
- **Reduce hours worked to 60** per week. Do not overwork yourself or your team

Take up all **partnership / outsourcing opportunities** – concentrate on what your team does best, based on their track records (not on their egos).

- **Launch product ASAP** – you cannot afford to wait until it is perfect. You must get to market before the competition does. Rely on your own good people to decide when the product is “good enough.”
- Select a “local” market. **Start small** and keep marketing costs within control of your budget. As you generate more revenue, then expand.
- Consider going after two market segments with one product, to keep competition at bay – *if* you can afford it. But do not go for three segments with two products. Focus thy business plan.
- Aggressively build up inventory. You will need extra product supplies at the start of a fast-growing business.
- Once you have one or two VAVC’s on board, you then can take dumb money and seek higher valuations. **Always take as much money as you can.**
- Adjust product pricing -- not too low, because price is difficult to increase later..
- **Start earning revenues!** You no longer are a “start-up” -- you are “early stage.”
- From here out – cash management and growth strategies are the major keys to your future success.
- **Growth strategy** – steady growth, make sure you have enough \$\$.
- Capacity – ordering large amounts of capacity = great way to go bust quickly!

Losing Strategies

- **Spending on everything at once**, rather than orchestrating the spending
 - 1) Spend on development *after* spending on research
 - 2) Spend on marketing only after you have a product to sell
- Save money and equity by **hiring less experienced people ?**
 - 1) Your people will make the wrong recommendations, you will make too many poor decisions, waste your money
 - 2) You will not be able to get VAVC financing. Unimpressive team of rookies.

- **Trying to grow too fast, too soon** – starting out in a large market will drain your cash; it's better to start small and grow quickly.
- **Rely only on revenues** – keep all the equity for yourself? 100% of zero = zero!

Success Recipe

- 1) Hire the right people
- 2) Engage the right opportunities (partnerships)
- 3) Make the right financing deals with the right investors
- 4) Make sure these decision fit the overall business context

Sounds simple? It's just good common sense? Many entrepreneurs do the exact opposite! **YOU are at risk of doing the exact opposite!** ← (Read this again.)

- Before discussing WHY people do the exact opposite, note that: even if you do follow the recipe (What to do), you must know How and When to do it. See p.4.
- Many entrepreneurs share a belief system that prevents them from hearing this advice, and in fact their beliefs encourage them to do the opposite.

Characteristics and experience base – of many wannabe high tech entrepreneurs:

- **Attitude:** Confident, risk-taking, hard working, willing to sacrifice. View themselves as smart, and capable of “figuring it out.”
- **Experience:** Have achieved success, often in a technical area, usually through hard, individual work effort

Belief System of such a person:

- I can, “Do it all, I can figure it out.”
- This venture is “my idea” and “my baby”, so I deserve all the rewards of success.

Consequences of these beliefs:

- **They hire “rookies” to fill key management positions.** “I can direct these people more easily, tell them what to do, and they will argue with me less. They will do my bidding, which is fine, because I can do it all. This is “my baby” and I do not want to share my equity with those who are ‘just managing.’ They did not create the idea, I did.”
- Since I can do it all, **there is no need to outsource or to partner** with any outsiders. We can keep all of the key business functions “in house.” I can keep more of the profits and the equity for myself this way, too.

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- I am loath to become indebted to someone else. **I just need some dumb money** at a high price. My technical background and personality does not really allow me to “bond” with venture capitalists and other “bean counters.” What value can they add, since I can do it all? Venture capitalists will want to give me advice, which I really do not want to listen to. They also will want a big chunk of my equity stake.
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Even if you follow the recipe (What to do), you must know How and When to do it.

- Implementation involves both timing and magnitude:
 - 1) Too little, too late
 - 2) Too much, too soon
- Why do so many entrepreneurs get the timing and magnitude wrong?

Delays

- Seek more financing? It takes 3-6 months, at least. If you wait until your cash is down to a month or two of burn, you are doomed.
- Delay between investing in product development – and a shippable product.
- Delay between spending on marketing / promotion – and resulting impact upon market awareness and sales.
- Delay between investing in new production capacity – and its readiness.
- Delay between hiring employees -- and the time it takes them to become fully productive for the Company.

Causes and Effects are Lumpy, or Not Directly Correlated Over Time

- Running your people at 10% more than their non-burnout pace
 - λ Initially, no adverse effect on anything, total burnout is low
 - λ After a month or two, morale and production collapse – accumulated burnout
- Initially, spending on marketing leads to direct gains in sales growth. Later, gains in sales growth slow down as the market saturates. Later still, doubling the ad budget now does nothing whatsoever.
- Spending on product development at first yields many, new great product features. Over time, freedom to implement new features is less (because of constraints caused by existing features), and then equal spending = fewer and fewer new product features.

Feedback Loops

Once set in motion, a feedback loop has life of its own. “Virtuous” vs. “Vicious” cycles.

Hire good people → Impresses Investors → More financing → Hire more good people (it costs more) → But it impresses investors = More financing

Hire cheap people → Impress no one → Less financing → Cannot afford good people (not enough money) → Hire cheap people = no financing, eventually.

- But, hire only 2 of 4 good people out the outset – otherwise you will run out of cash. Two good people are “good enough” to raise more financing. After financing, you can hire the other two, or even four more.
- Hiring four experienced VPs at the outset = you risk breaking the bank.

Orchestration

- Sequence your Company’s development. Identify what actions, in which order, their timing and their magnitude.
- Don’t hire a salesforce before you have a product ready to ship.
- Add extra capacity before you start a new marketing campaign, or customers will become unhappy with long lead times in receiving products they order.

Other Secrets to Success

1. Get operational fast.
2. Look for quick break-even, cash-generating projects.
3. **Offer high-value products & services that can sustain direct, personal selling.** High gross margin is your friend.
4. Keep growth of additional products or in new segments in tight check, until initial products in the initial segment are selling well.
5. Ingenuity, spontaneity and hustle, creative ideas and a superior capacity to plan in detail, and execute that plan.

THE TWELVE (ALMOST) * SURE-FIRE SECRETS TO ENTREPRENEURIAL SUCCESS

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Venture capitalists are not known for humility, so take note of the following confession:

Venture capitalists are chickens. Compared to entrepreneurs they're spectators in the great game of small business hardball. They would no sooner personally guarantee a corporate bank loan than they would jump off the cliffs of Acapulco. Contrary to popular opinion, however, they are not totally worthless -- they work long hours, sift through more garbage than a trash collector, and have to get used to disappointing 99 entrepreneurs for every one they please. They are veteran roller coaster riders, but never get used to those big drops. They are, above all else, risk reducers -- they prospect in the land of the commercially unfinanceable, and try to differentiate the superstars from the merely enthusiastic. Some of them are pretty good at it, a result of lessons learned, mistakes made, and successes observed.

Over the past 29 years as a venture capitalist, I've screened thousands of entrepreneurs who were certain of their future success. Most were literally kidding themselves. I've backed about 100 of them. I've sat on several dozen boards of directors, and been part of public offerings, mergers, bail-outs and liquidations. My learning curve is still steep, but I do know what I'm looking for, and it's not magic and it's not luck. What it is -- is people with an extraordinarily *rare* set of characteristics, views and practices.

While there is a popular image of a successful entrepreneur as a supremely optimistic person who is inclined to high risk, little could be further from the truth. In the world of small business, optimism is truly cheap and high risk takers die early deaths. What characteristics do then set the exceptional apart from the masses? In my opinion, there are about a dozen of them.

Here, in no particular order, are the dozen entrepreneurial characteristics I seek.

1. They have a sound knowledge of their marketplace. The literal majority of entrepreneurs do no (or next to no) market research. Instead they try one of the following two approaches:

* "The market is there!" I guess that means "take our word for it." We won't.

* "We're part of the \$220 billion electronics industry. If we get just 1/100% of it, we'll be a \$22 million company." While the arithmetic is sound, this is so intellectually offensive that it leads to the immediate conclusion that the team's whole fabric is shallow and rhetorical. Scientific market research is almost never easy, but almost always possible. When I meet a team which has *segmented* the overall market to isolate their specific opportunity, when their claims are anchored to solid, *third party observations*, when I can taste the particular flavor of their objective, I know that they have a dead aim on their target.

2. They have a sound knowledge of their competition. A cavalier dismissal of this threat, manifested in the oft-heard phrase "We have no competition," is a near certain predictor of performance shell shock, later. We insist that the business plans we seriously review feature a *competitive matrix*, i.e., a comparison by relevant features of their product vs. all other logical purchase alternatives. If it isn't as clear as a bell that any fully informed prospective purchaser would be crazy not to seriously consider purchasing the product in question, one knows, at least, that he is looking at a me-too offering with all of the risks that that entails. ← (Good discipline! Editor's note.)

3. They have a sound knowledge of the financial dynamics of their companies. By this, I most decidedly do not mean that entrepreneurs need an accounting degree, or even an intimate knowledge of financial analysis. What I do mean is that they focus on key results areas, such as: gross margins, monthly fixed costs, sales/employee, sales to budget, dollar production/day -- whatever factors drive cash flow and profitability in that particular type of business.

Entrepreneurs exhibiting this characteristic can tell you (without looking it up) what the trend in gross margins has been over the past few months, or what the cash flow impact of a 20% shortfall in revenues would be next month.

The most memorable lesson I ever received in this regard was during the negotiation of an investment in a high volume hog feedlot. A hog feedlot operator buys 40-pound feeder pigs (a commodity), feeds them corn (a commodity) for four months and sends them off as "top hogs" (a commodity) to the slaughterhouse. *Only those few pigs that grow wings are not a commodity.* When I proposed a traditional earnings/loss test as a default trigger (i.e., cause to accelerate our convertible loan to him), the entrepreneur objected, noting "There are times in this business when the state of the commodities markets literally and arithmetically prevents a profit.

And then there are times when even you could make money!" I asked for his suggestion for an alternative measure of performance quality, to which he replied, "Hog/feed ratio" (how efficiently an operator converts pounds of corn to pounds of hog) "and herd death ratio" (what percentage of the herd dies before it gets to market). While I am undoubtedly the only venture capitalist who ever signed an investment agreement with "hog/feed ratio" and "herd death ratio" as the default triggers, I can tell you that this man truly understood the financial dynamics of his challenge!

4. They have a true understanding of the importance of cash flow. Ask any gathering of entrepreneurs whether they understand that cash is life and there will be nods all around. Then ask them whether they also understand that lack of cash is DEATH and the blood drains out of their faces. A fellow venture capitalist I know describes a start-up venture as "a race against insolvency," and he is right. The best entrepreneurs equate cash with blood and part with it only when it stands to directly further their objectives.

5. They have internal loci of control. True entrepreneurs take things personally. When they succeed, they know that they deserved to. When they fail, they know that it was their fault. They don't make excuses for past shortcomings. They describe them as lessons learned. They don't look for places to pin blame. When they first smell failure, they fight like alley cats to turn things around, because they see their performance, however good or bad, as a reflection of themselves.

6. They have inner confidence. I noted earlier that optimism is cheap and it is. Optimism based on reason, however, what might be called "inner" confidence, is rare indeed. It's the difference between "knowing" you'll succeed because you're a part of the \$220 billion electronics industry, and knowing you'll succeed because your new product has nailed the competition right through the heart. It is, quite simply, confidence based on a knowledge of outstanding preparedness.

7. They plan -- and they execute their plans. It has been said that if you don't know where you're going, any road will get you there.² Entrepreneurs don't love planning. Nobody loves planning! Planning is a powerful tool, however, and the best entrepreneurs reduce their pursuit of their strategic objectives down to action plans with detailed budgets, people responsibilities and deadlines, and they monitor the assault on a real-time basis.

8. They inject reality into their attacks. Truly sound entrepreneurs not only recognize that there are risks associated with their endeavors, they have actually thought about them! They'll even *admit* that there are forces hostile to their success out there! And they have taken every possible step to minimize their impact or their potential impact. They have fallback plans, they have fallback cash, and even when everything is going as hoped, they run lean and mean. They rent space, buy used furniture and equipment, and draw a pittance of a salary. They are quite content to delay civilized living and celebrations until they can be paid for out of earnings.

9. They hire smart. They are not intimidated by partners smarter than they. They recruit charismatically, with equity participation as bait. They can charm industry superstars out of Fortune 500 trees onto dusty trails leading to small business wars. When I can look three to five people deep into a young venture and find nothing but talent and adrenaline, I know that I'm probably looking at a winner. When the CEO seems dynamite -- but the lieutenants are quaking yes men, I steer clear.

10. They hit it hard. One of my favorite motivational speakers says that, "It's a dog-eat-dog world out there...for forty hours a week. But when you get out to fifty, there aren't as many dogs. And when you get out to sixty or more, it's downright lonely!" There is no attack more likely to succeed than one executed when the enemy is asleep, or having his second martini. Almost everything is stacked against entrepreneurs. They even the odds with, among other things, sustained, superior effort.

² Quote from fabulous "*Porcocomasas*" case -- from the VC Investments class at Yale SOM.

Anyway, I asked the Wall Street wolf, Jessie Cheshire Livermore, about which way a small investor like me should go -- with my modest trading position in Porco stock.

"Would you tell me please, which way I ought to go from here?" I asked.

"That depends a great deal on where you want to get to," said Livermore.

"I don't much care where," I said.

"Then it doesn't much matter which way you go," said Livermore.

11. They make it fun! There is something special though indefinable in the air at companies run by great entrepreneurs. The pursuit of their dream is punctuated by experiences that produce natural highs. It's clear that everybody there is having a ball. And they work at making it that way. The Friday afternoon beer bashes at Apple Computer in its early years are legendary. I once had an investment in a company that would pit one production line against the other during the short Christmas week, with each allowed off for the holidays as soon as they met normal production for the period. You have never seen people move at such a pace!

12. Maybe most important, they've got fires in their bellies. True entrepreneurs have such a strong achievement orientation that winning each marketplace battle, and ultimately the war, become compulsive needs.

The most graphic example of this that I have ever personally witnessed occurred when I was in Kentucky. The state, led by then-Governor John Y. (Kentucky Fried Chicken) Brown and his wife, former Miss America Phyllis George, hosted a one-day seminar followed by a black tie dinner-dance for the CEO's of "Inc." magazine's 500 Fastest-Growing, Privately-Held Companies. I attended the business program during the day, which ended at 5:00 P.M., and my wife came up to the Lexington Hyatt to join me for this gala affair, which started at seven o'clock.

We were waiting at the elevator when a fellow rounded the corner wearing a tuxedo and scuffed brown shoes. I recognized him from the day program as the CEO of the fastest growing, privately held company in the country during the previous five years, and introduced myself and my wife to him. As we continued waiting for the elevator (almost a thousand people in the hotel were all trying to get to this function at the same time), he suddenly blurted out as he pointed at my cummerbund, "So that's what that is!

It's a belt!" He went on to explain that the state had procured the tux for him and that he had held the "thing" up (demonstrating for us as if he were holding a skunk by the tail) and wondered to himself, "Now whatinthehell do I do with this!"

He then decided not to go back to his room for it since if he kept his jacket buttoned you couldn't tell that he wasn't wearing it, and changing the subject, volunteered, "This is a very nice section of town. Yes we replied, it was the most prosperous retail section in Lexington. "That confirms my experience," he countered, "I sold two of my company's systems after the program." He then tired of waiting for the elevator (demonstrating classical entrepreneurial impatience), bid us good-bye and disappeared down the stairs.

I explained to my wife that subsequent to the end of the five-year period in question, this gentleman's very successful company had gone public, making him personally worth tens of millions of dollars. He was on top of the mountain - yet he had taken advantage of 1-1/2 hours of free time in a strange town to make cold calls on customer prospects! And nailed two of them!

I trust that the moral of this story is obvious. You can evaluate entrepreneurial prospects against the twelve, often complex criteria I have covered... or you can look for guys in tuxedos with brown scuffed shoes and no cummerbund.