VULTURE OR DOVE?

By Dr. Jay Mendell and Henry Sarkis

Entrepreneurs sometimes find with venture capitalists, participation can be synonymous with interference.

Companies that invite investment invite participation. Entrepreneurs are often surprised by the extent to which investors offer "over the shoulder" advice and demand control. Major investors in growing companies expect to join the board of directors, set standards of performance, and watch their money grow.

If you are about to launch a high tech startup company or pursue fast growth of your existing company, ask yourself if you want participation that too often amounts to interference.

It is easy to accept participation if your large investors are people you would want on your board if you didn't have to take them-and if you are as interested as they are in becoming rich quickly. But if you are strongly motivated by the need to run your own company; consider ways to turn over as little control as possible.

As recently as the late 1970s, when hi-tech ventures became chic, venture capitalists were company builders. They "interfered" sufficiently to make winners of Apple Computers, Digital Equipment Corporation, and Federal Express. But these pioneer high tech investors had already learned about innovation firsthand, by founding or working in Fairchild Camera, Hewlett Packard, Honeywell, and National semiconductor.

Today, there is a shortage of investors who can offer both money and topnotch advice. According to Inc. magazine the amount of available venture capital has almost quadrupled in six years. Investment firms are now staffed by a substantial number of young MBAs with no experience in managing innovation and, often, no business experience at all. And the principals of these firms may themselves be former real estate syndicators or financiers with a bias against high tech, high growth, and high risk situations.

Many of the investors expect 10-to-1 returns in two to five years and want to hold their percentage of losers to 10%. They are so intent on watching their money that the founders and employees of the company are left with only a minority interest. One founder, who made repeated trips to the investors, ended up with 2% of his company (through 2% of a growing company is no doubt better than 100% of nothing).

Of course, investors have a legitimate reason to watch their money. Some of the "sexiest" investments, in computers, robotics, and gene engineering, are companies run by scientists with no business background at all. And other entrepreneurs have systematic blind spots in marketing, accounting, or management.

There are entrepreneurs who intend to buy Ferraris, or ski chalets in Vail, or install their new companies in fancy buildings. And there are entrepreneurs who have no legitimate need for an infusion of capital except to show that they are waterwalkers capable of extracting dollars from prestigious investors.

So the investors do have reason to screen candidates carefully in advance and remain in very close control.

Why capitalists? Because there is a fundamental tension between the entrepreneur and the investor. The entrepreneur is biased in favor of satisfying society's needs, creating something genuinely new, building an organization, and maintaining the quality of his or her products and working conditions. It's true that the entrepreneur wants to become rich, an aspiration he shares with the investor. But because the investor may be involved solely to become rich (because his motivation is one dimensional) all advice is apt to be biased in favor of a quick killing.

What can an entrepreneur do to avoid giving up control and having to receive shortsighted advice?

He or she can meet as many investors as possible, by contracting small business investment companies (SBICs) and the venture arms of banks, insurance companies, and big companies. Exxon and G.E., for instance, are among the many large companies who have formed venture capital subsidiaries.

He or she can meet additional potential investors through contacts with stockbrokers (who may have a few high-rolling clients) and accountants and lawyers (who may help prepare a business plan in return for a fee or the promise of future clientele), and by attending meetings of the Enterprise Forum founded by the M.I. T. Alumni Association in several cities. (In Miami, the Forum is sponsored by the University of Miami). The idea is to meet many

potential investors, hoping to find one whose money and advise are right for the company.

The entrepreneur must prepare a business plan including both market and competitive analyses. Accountants and financial consultants may be employed to write the plan and "pitch" it to potential investors. But these financial people may have the same tunnel vision that the entrepreneur is trying to avoid in an investor (the difference being that they give their advice in advance and ask you to pay for it).

What sort of tunnel vision? An obsession with income statement, balance sheet, and cash flow projection, and the arrogance to deny that some of the most successful growth companies succeeded despite apparent weakness in the financial numbers-succeeded because their products were irresistible or revolutionary and their employees 100% committed to success. Numbers are only part of the story:

To attract capital while retaining control, achieve as much as you can before you ask for money: Come to the investors with a working prototype or small group of customers in hand.

Capitalists are not interested in investing in the first few months of a company's growth. The risk is too great and the seed money too small to interest a top investor. (Nobel prize winning scientists may ignore the previous sentence.) To get from concept to startup, the entrepreneur may have to mortgage his or her home, send the spouse back to work, and borrow from relatives.

It is important to demonstrate that the company does not need the money merely to survive. Investors are more likely to part with dollars that are needed to seize an early lead in a developing market or otherwise exploit an external opportunity.

More and more entrepreneurs are choosing indebtedness over equity dilution. Low salaries, long hours, and spartan conditions are required to conserve and extend resources. Or they are growing slowly and carefully, visiting the investment community only when their strategic plan calls for carefully orchestrated growth. This conservatism may be a blessing in disguise, since most companies fail because their growth in size exceeds their growth in management.

Dr. Jay Mendell is Professor of Administration at Florida Atlantic University and Hank Sarkis is vice-president of a large real estate development corporation in Miami. They are the principals of the Silicon Beach Consultancy, Inc., a firm specializing in innovation and strategy.