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Start-Ups In America

Beware of Geeks Bearing Gifts

A discussion of the startup Industry; yesterday, today and tomorrow

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Stuff You Don't Know Press
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Authors note:

I have spent many years in the fabled Silicon Valley, working with startups and investors to develop new businesses in many different industries. Along the way I have seen a lot, some good and some not so good. I have seen good entrepreneurs and investors, and I have lived through a few really bad ones as well.

While much has changed, much has not. Some things have gotten better and others much worse. What has stayed the same is that it is still very difficult to conceptualize, finance and build a business to maturity in a way that is good for founders, employees and investors.

To a great extent I think that the system today is simply stacked against all of us.

I have come to the conclusion it could be much easier and much more effective if we simply did a few things a bit differently. Enclosed in this paper is a little of what I think!

Stuff You Don't Know Press

Startups Create Most Jobs
about 3 million per year

Introduction

America has long been a land of invention and innovation. Having lived through the PC revolution, I can see that we have been blessed with massive change to the U.S., and the world, due to both technological innovation and a business climate that supported risk capital investment. For the past thirty years or so, this engine of change has been based on the entrepreneurial startup business industry. In more recent history, the engine has showed signs that it no longer may be what it used to be. Some have said, as early as 2012, that it is fundamentally and forever broken. Yet, from the pace of young entrepreneurs going out seeking to start businesses in order to once again change the world and make a whole lot of money, one would never know there is a problem. You'd never know, that is, unless you actually looked a little bit below the surface.

Entrepreneurs trying to raise money in order to start a business are faced with numerous pitfalls, posers, crooks, charlatans and RPRTrs (Right Place Right Timers) all scattered along what is, for many, little more than a boulevard of broken dreams. The mere fact that so many now see their lives as yet another Silicon Valley style rags, to riches story — or more often riches to more riches — are testament to some fundamental shifts that have occurred in America.

There was a time, before the birth of the current startup era that most young people dreamed of a good job, a wife and a family to come home to. We used to believe that working hard and making a living was a great ideal and a key to contentment. Perhaps we set our sights more sedately then. It seems to me, we just didn't expect to get out of school, go found a company using OPM (other people's money) and become multimillionaires in three to five years — or ten to fifteen if we were unlucky. Not so today, particularly where I live near Silicon Valley!

Most young people I meet, believe that they will likely found a company within a few weeks of getting out of school — if they can even be bothered with finishing school in the first place. Some don't even have the slightest clue what this to-be-founded company will do. They believe they will cobble together a business plan within a few weeks to a month and go hit the VCs (that's venture capital companies for those of you living under a rock for the past 20 years) and raise a few million. Then, it's just a matter of time — BOOM — it'll be huge: Just like Mark (as in Zuckerberg), or Steve (as in Jobs), or Sergey (as in Brin), or some other such "entrepreneur," etc.

To say the odds are not stacked in their favor would be a bit of an understatement. But, you would not know this either to hear entrepreneurs talk or to see so many so called investors throw so much money down the proverbial drain. Let's look at a few facts.

According to the National Venture Capital Association, about 20% of start-up companies backed by VCs are successful. That means that roughly 80% fail to deliver expected returns. The NVCA further parses the data to say about 40% outright fail and 40% continue and provide moderate returns. Other sources provide a much starker analysis indicating that on average as many as 75 - 90%[1, 2, 3] fail in two to three years. Yep, that's right, FAIL, in two to three years. When these guys go down the drain they will have lost, on average, about $2.6–5 million[4], most taken from VCs. About 10% of these guys end up considered as a success. And of those that succeed, about 5% grab the golden ring and become Jeff Bezos's, Mark Zuckerberg's, etc. The

1 The Venture Capital Secret: 3 out of 4 Start-Ups Fail, Debora Gage, Sept. 20, 2012, Wall Street Journal
2 90% of Tech Startups Fail [Infographic] by Glen Dalakian II, February 7, 2013, http://www.wamda.com/2013/02/90-percent-of-tech-startups-fail-infographic
3 Kim Luu, Editor of Money and Risk, Adviser to small businesses. http://www.quora.com/What-percentage-of-start-ups-fail
4 Author's analysis of CrunchBase data set as of October, 2014.

rest build decent businesses, grow and thrive, at least for a time, until some other twenty something with a lot of ambition, and someone else's money, comes along to change the world yet again. Just ask AOL, Compuserve or many others.

Now if you, and some other guy, form a company in your garage and don't get VC money for a while, like Steve Jobs did, Mr. Hewlett and Mr. Packard did, and a number of other guys also did, your longevity will be better. Yes, that's right, I said better. You see only 65% of these companies fail in two-three years. And when they fail they take about $1.1–3.3 millions of other people's money, mostly from "angel" investors,[1] right down the drain along with them.

Now, instead of starting your own company let's, for the sake of argument, say you go out and purchase a franchise. I don't mean specifically a Mc Donald's, or a Jiffy Lube. You can purchase from 1,000s of different kinds of franchises. Most are only moderately good business models. And most of the people who go buy one of these franchises are not of the "best and brightest", from "the best schools" types. And more importantly, these guys usually buy the franchise with their own cash and credit. Now, how likely do you think these geniuses are at crashing and burning in the two-three year window? Based on the author's own experience and data, surprisingly, only 45% of these guys will fail. The U.S. Department of Consumer Affairs reported that less than 5 percent of franchises fail[2] — although, the author's experience believes this percentage is suspect. Most of them will go on to build successful lifestyle businesses. Some will grow to own more than one territory and make very good money. If these guys fail, often they lose whatever they paid for the franchise and what they spent to build out the locations and inventory. Typically, this is in the $100,000–500,000 range for one location[3]. Most of the money comes from their own pocket, friends and family and sometimes the bank.

If you talk to people around here, they'll tell you, often with a very dramatic air, a tone of impending doom, and the conspiratorial in-leaning nature of one who is

1 Author's analysis of CrunchBase data set as of October, 2014.

2 Five Reasons Franchises Fail, http://www.allbusiness.com/buying-exiting-businesses/franchising-franchises/2204-1.html

3 How Much Does a Franchise Cost? By Don Daszkowski – Daszkowski estimates the typical franchise fee is $20,000–50,000. But he does not estimate startup costs. From the authors experience the combined costs for low end franchises can be between $100,000 to 500,000. Most established franchisors will want a commitment for more than one location and their up-front requirements can top many millions in cash reserves to qualify.

about to impart keen knowledge, that staring a business today is really tough. They will say,

> *"You know it's not like the old days — you know three years ago when I founded my last company. You know the fourth one I founded, the one that really, really, really almost made it."*

This sounds reasonable to the uninitiated but I submit this is just more bovine scatology. In fact, I submit it has been tough to start a "successful" business since Moses came down off the mount with the 10 commandments, and his little known brother Shepp realized he could print them up and sell them cheap to the public and make a few shekels on each one. Doing so would allow him to get a small upscale ark of his own, get his wife a new hair comb and a new toga, and maybe line up a couple of Bathshebas on the side.

1 shekel

What has changed, is the ready access to really stupid money. To a great extent the VC backed entrepreneurial startup era was little more than a modern version of the great western gold rush of 1849. Like that historical time period, there were many more losers than winners. We all remember, names like John Sutter, James Marshal, Sam Brannan, Levi Straus, Philip Armour, John Studebaker and Henry Wells and James Fargo. These guys constitute the big winners from the Gold Rush period. You may note that only one on the list actually made their money by discovering gold — James Marshal. The rest made it off the gold hunters and the gold industry. This provides a very surprising analogy for the Venture Capital industry in some not so flattering ways[1].

While we are on the subject of the Gold Rush; if you look at the effect the large influx of gold had on the U.S. economy then you will see the same pattern in the "Gold Rush" that ushered in the big boom of Startups over the past 30 years. When we got off the gold standard in 1974 — because we were basically out of cash as a nation — we began a rapid, and baseless, expansion of our currency. In 1974, before the start of this period the U.S. economy had about $500 billion of currency in circulation (CinC). By 2009 we had an estimated $16 trillion CinC. Today, some estimates — the

1 If you're interested in more of the background of these real gold rush giants go to http://cpacowboy.wordpress.com/2009/10/27/17/

government no longer reports the real number — put the CinC amount at over $17 trillion. Now that, my friends has been a "Gold" Rush. But unlike the real Gold Rush (note no quotes) this new cash has been decidedly valueless. It has been based not on tangible goods and measurable, indexed output. It has been based on so called FIRE economics. FIRE stands for Finance, Investment and Real Estate, largely an intangible and highly leverage-able value system.

This has been the economic engine that has fueled our economy for 50 years. It is the engine that fueled the speculative high-risk, high-loss, startup business industry. This new printed money came into the economy through lending and the stock market. VC's have been the prime conduit to startups. One needs to look at this industry closely. Take a look at how many companies have failed. Look at the few that have succeeded. Recognize that of those that we have thought succeeded big, because they were able to go public, many of them have not increased their value in many, if any, tangible ways. In light of this look, do we really think that the startup industry has generated real tangible gains, or has it been little more than a shell game, a Ponzi scheme? Recent economic events indicate there have been some fundamental issues in our economy for a while. Perhaps, the issues we face across our economy and in the startup industry are more deep seated than we are willing to admit. Perhaps, the only reason we have had this "startup boom" is because the money we used to generate it has been decidedly valueless to start with. Have we been kidding ourselves all along? I don't know, but I do think it's a really interesting question that could help explain a whole lot of things!

VC's Created Most Startups
or has this really been true?

Vulture Capitalist

Venture Capital

Long associated with Silicon Valley, you would think that the very idea of venture capital was born of this era. It was not. The Wallenbergs, Vanderbilts, Whitneys, Rockefellers, and Warburgs were notable investors in private companies in the first half of the 20th century. In 1938, Laurance S. Rockefeller helped finance the creation of both Eastern Air Lines and Douglas Aircraft, and the Rockefeller family had vast holdings in a variety of companies. Eric M. Warburg founded E.M. Warburg & Co. in 1938, which would ultimately become Warburg Pincus, with investments in both leveraged buyouts and venture capital. The Wallenberg family started Investor AB in 1916 in Sweden and were early investors in several Swedish companies such as ABB, Atlas Copco, Ericsson, etc. in the first half of the 20th century. This was the real beginning of what we call venture capital today.[1]

Modern venture capitalists bear a strong resemblance to the people that made their money during the gold rush. Very few of today's VCs have really ever run a successful business — other than their investment business. The good ones are either excellent at spotting trends, recognizing talent and networking resources or they were very, very, lucky at least once. Many of these so called VCs have shown that they

1 Wikipedia, http://en.wikipedia.org/wiki/Venture_capital

were more simply lucky, than have shown that they have been good at much of anything other than occasionally at investing.

VCs ruled the roost here in the valley for many years. Money just seemed to flow to venture funds. A long time investor once told me, "You know for the past few years, just about any idiot could become a VC and make money!" And historically there have been many such idiots. In the early years, there were a handful of smart and lucky investors who found and helped create opportunities in Fairchild Semiconductor, Digital Equipment Corporation, Apple Inc., Genentech and Cisco to name a few. As a result of these successes a number of others who saw this success, and happened to have some excess cash, figured how hard can this be? Soon, there were many cash hungry young wannabe startup owners finding ready access to risk capital and founding companies in the tech, and later the Internet and biotech industries. IPOs were the liquidity event of choice and the rising market and steady influx of new cash from the new American debt driven economic engine funneled through VCs fueled development of another similarity to the Gold Rush period — the selling of "Snake Oil."

Unfortunately for the stock investing public, tech startups and the Internet formed that basis of a "New Snake Oil." Everyone was "investing." No one wanted to miss the perceived money train. There were VCs happily advertising that their key to success was to find two guys with a business plan, fund them and take them public. While preferably, it'd be nice if one was a sales guy and the other was an engineer, this wasn't really necessary. Everything became just a time and money calculation. If the product didn't work well, no problem just throw more money. If the founders were less than capable, no problem, we can get new management. If the public is not quite ready for the product, not much of a problem either because we will get this puppy public in eight to twelve months and get our money, and our returns, out before anyone can figure this out.

There were a few things that could be real problems. Recognition that there was no perceived market for the idea or product was often a show stopper, although there have been a few companies that have overcome this issue also. I could name a few right now still trading on NASDAQ, but you probably can as well.

In their heyday, VCs cared only about one thing — liquidity. Rightly or wrongly,

they rapidly rationalized that the only thing they needed to ethically worry about, was their limited partner's investment and the sufficient return on those funds. If the company failed after going public, that was not the VCs concern. The legal principal of "Caveat Emptor"[1] ruled the day, still does, and since most of these VCs were lawyers it was just fine with them. A whole bunch of these guys made a whole bunch of big money. A number of their companies, often run by young kids with no experience, no skinned knuckles and no lessons learned hard in life — or from actually running their own businesses — made millions alongside of them.

This new breed of businessman, now called an entrepreneur, who were lucky enough to grab one of the golden rings, then went on to become the next generation of venture capital investor. These people made their money more from being in the right place at the right time than from any real insight and learning that comes from working over time to actually develop a market or gain understanding of how to really build a business, deal with the difficulties of bootstrapping, cash flow, employees, growth and development. They did not learn these lessons because they made their money by gaining liquidity through their VCs, and very cooperative investment bankers, long before they would have had to learn these lessons and actually demonstrate that their fundamental business model really worked! They got rich and the people who bought these over-hyped and often overpriced IPOs got sold new snake oil. Yes, there were some notable exceptions that have gone on to have sustainable, if not always successful businesses. We remember their names, just like the names from the Gold Rush list above. The losers have been lost to history, and unfortunately to our memory as well.

1 Caveat Emptor is a Latin expression meaning let the buyer beware. It is a common tenant in current legal doctrine. http://en.wikipedia.org/wiki/Caveat_emptor

We have met the enemy and *he is us! - Kauffman Report*

Venture Capital is Broken

In May 2012, the world of venture capital was turned on its head. Established in the mid-1960s by the late entrepreneur and philanthropist Ewing Marion Kauffman, the Kauffman Foundation, based in Kansas City, Mo., is among the largest private foundations in the United States with an asset base of approximately $2 billion[1]. The report titled, WE HAVE MET THE ENEMY… AND HE IS US, summarized an analysis of the lessons from twenty years of the Kauffman Foundation's Investments in Venture Capital Funds. The authors summarized their results as illustrating "the triumph of hope over experience." The 48th page of the report has one of the most appropriate quotes summarizing the state of venture investing that I have ever seen.

"A STRANGE GAME. THE ONLY WINNING MOVE IS NOT TO PLAY. HOW ABOUT A NICE GAME OF CHESS? "
–Joshua (the supercomputer) from the movie War Games

1 From the Ewing Marion Kauffman Foundation website, http://www.kauffman.org/

The above quote is, in effect, just what the Kauffman Foundation announced, that they were no longer going to play the game and would stop being a limited partner in most of the funds that they had been a mainstay in for years. The following excerpt represents a bit more from their summary statement.

- Venture capital (VC) has delivered poor returns for more than a decade. VC returns haven't significantly outperformed the public market since the late 1990s, and, since 1997, less cash has been returned to investors than has been invested in VC. Speculation among industry insiders is that the VC model is broken, despite occasional high-profile successes like Groupon, Zynga, LinkedIn, and Facebook in recent years.
- The Kauffman Foundation investment team analyzed our twenty-year history of venture investing experience in nearly 100 VC funds with some of the most notable and exclusive partnership "brands" and concluded that the Limited Partner (LP) investment model is broken.
- Limited Partners—foundations, endowments, and state pension fund—invest too much capital in under-performing venture capital funds on frequently mis-aligned terms. Our research suggests that investors like us succumb time and again to narrative fallacies, a well-studied behavioral finance bias. We found in our own portfolio that:
- Only twenty of 100 venture funds generated returns that beat a public-market equivalent by more than 3 percent annually, and half of those began investing prior to 1995.
- The majority of funds—sixty-two out of 100—failed to exceed returns available from the public markets, after fees and carry were paid.
- There is not consistent evidence of a J-curve in venture investing since 1997; the typical Kauffman Foundation venture fund reported peak internal rates of return (IRRs) and investment multiples early in a fund's life (while still in the typical sixty-month investment period), followed by serial fundraising in month twenty-seven.
- Only four of thirty venture capital funds with committed capital of more than $400 million delivered returns better than those available from a publicly traded small cap common stock index.

- Of eighty-eight venture funds in our sample, sixty-six failed to deliver expected venture rates of return in the first twenty-seven months (prior to serial fund-raises). The cumulative effect of fees, carry, and the uneven nature of venture investing ultimately left us with sixty-nine funds (78 %) that did not achieve returns sufficient to reward us for patient, expensive, long- term investing.[1]

Since this report surfaced, many VCs have been in significant decline and others have embraced rapid change. The role of venture capital, as it used to be performed, in fact, the underlying business model has, and continues to, undergo significant change. Kauffman found a number of important reasons for the decline in the performance of venture capital. One notable issue that was brought forward in the report is the time to liquidity. While at the beginning of the venture capital craze liquidity was targeted at five years for most funds. The report quotes Ray Rothrock[2] who now believes that liquidity time horizons should be considered as being closer to thirteen to fifteen years. The ramifications to investment from this new time horizon are significant. For investors and entrepreneurs, if the time horizon gets significantly beyond five years then companies will clearly be beyond a development stage — listed as: Discovery, Validation Efficiency or Scale according to the Startup Genome report. They will be at an ongoing business growth point — defined as: Profit Maximization or Renewal stage. Their actual numbers, as opposed to their projected numbers, will become the basis for valuation. Reality can often a problem when it comes to liquidity valuations. History shows that perception often beats reality, unfortunately!

Startups will need much more capital to survive as they make the twists and turns required to get to the Promised Land — liquidity. The changes to assumptions that are necessary in all businesses (called pivots in the new industry parlance) will cost more money as time goes on. The likelihood of them ever getting to these later stages with enough robustness to warrant a significant liquidity valuation goes way down: meaning the cost of capital becomes much higher. Looking at some of the statistics from above about company failure rate, one would think this kind of dynamic would cause the whole thing to break! Well for the most part it did, and it does! That's

1 The Kauffman Foundation's Report: WE HAVE MET THE ENEMY… AND HE IS US. http://www.kauffman.org/~/media/kauffman_org/research%20reports%20and%20covers/2012/05/we%20have%20met%20the%20enemy%20and%20he%20is%20us.pdf

2 Ray Rothrock's bio, http://investing.businessweek.com/research/stocks/private/person.asp?personId=80933&privcapId=23721

why the Kauffman Foundation commissioned the report.

Of Angels and Demons

You can't always tell which is which!

Angel Investors

For those entrepreneurs who are not granted the ability to breathe in the rarefied air of venture capital, there are so called "Angel" investors. Angel investors represent individuals who are willing to put capital at increased risk in order to get higher returns — instead of taking lower risk and investing in public market securities. In the early days, individual angel investors made some great discoveries and a lot of money right alongside the VCs — often co-investing in deals. There are many legitimate angel investors still around today. The problem is that there are also a lot of posers, charlatans and wannabes as well.

Legitimate angel investors are those that know what they are doing and have the financial basis to be in a deal for the long haul. They understand business, have significant experience in the areas that they invest. They typically have strong networks of resources they can bring to bear on a problem in one of their portfolio companies, are patient, are active — in a good way — and understand the risk they are taking when they make an investment of this kind. While these investors often do sit on the boards of the companies they invest in, they are also more interested in having a good experienced board member than they are having their own posterior occupy a seat. They recognize what it takes to make a company successful and they

work hard to help make those things happen. In essence, they take this investing thing seriously. It is either their job or it is their avocation. It is never their "hobby."

Today's entrepreneurs see many more of the other kinds of Angel investors than they do of the legitimate kind. These investors are the ones that entrepreneurs need to be wary of. More often than not, they encompass the bulk of the investors that today's startups find. There are a number of problems with these kinds of angel investors. They tend to think they know a lot about everything because they once made a lot of money at something quickly — see RPRTrs. They tend to demand a board seat because ***they*** are investing 0.01% of the total cash need for the company over its life and only if ***they*** sit on the board will ***they*** be assured that ***you*** will get the guidance that ***you*** need because only then will ***they*** be assured that ***they*** will be there to impart the required wisdom from ***their*** vast experiences in ***their*** one success. (Yes, this may be a snarky, sarcastic comment but, none the less, is likely representative) As you will see in the section that follows, *Why Startups Fail*, these kinds of investors do not often help a company succeed, to put it politely. One more thing to keep in mind, sometimes the less desirable angel investors tend to collect in swarms.

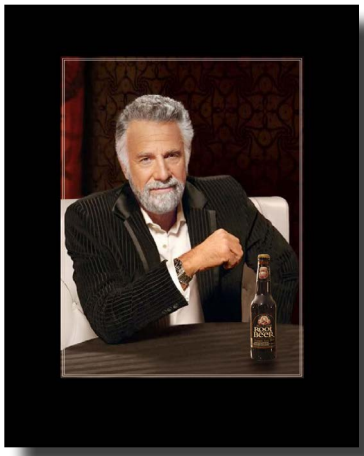
Angel Groups

Over the past twenty years or so we have seen the rise of Angel Groups. They deserve some special consideration here. The original premise of an Angel Group was collective mind-share. The concept that if you get a bunch of experienced people in a room, the collective intelligence of the whole will be greater than the sum of its parts. This concept can seem to make logical sense. Once again, if we stay at the surface, this is a reasonable and valid assumption. For a number of years, angel groups have provided a haven for angel investors to come together and lower the risk profile of the companies they invested in by collective screening and due diligence.

There is one big point to keep in mind relating to this concept of collective intelligence! As a friend of mine put it so succinctly, "If collective intelligence actually worked, then you need to explain to everyone why the U.S. Congress and all governments are so inept!" Collective intelligence in angel groups will provide value when the actual collective intelligence covers the areas that are key to the investment. If the deals are largely in Biotech or in areas requiring specific expertise like particle

physics or finite mathematical analysis, a room full of people, most of whom have a successful background in real estate investment are not likely going to do much good, in fact history shows they can do much worse.

Historically, there has been value to the entrepreneur from pitching angel groups. They provide a convenient place to see a lot of investors at once. If you can get traction with a couple in the room, a number of others may also follow along and the crowding phenomena can help bring what may have normally been $25,000 to $50,000 in investment up to a few hundred thousand. The alternate is also quite true, and perhaps more common. If you get a few people in the room, they may, or may not, know much about your business or market-space. That lack of knowledge may not stop them from having an opinion in order to tear your dream asunder.



He once went to an angel investor's group meeting.
His mere presence immediately doubled the entire portfolio value of all the group's members!
He is . . . the Smartest Guy In The Room! — ***Stay profitable my friends!***

There is a common issue that can occur in angel groups that can be referred to as "The Smartest Guy in the Room syndrome." This is where one or two people in the room go after an entrepreneur and his business idea. They will try to find anything that the entrepreneur may not be prepared to answer in order to prove to the group that they, the questioner, is TSGITR. When this happens, the entrepreneur can engage the questioner in a show down of who is smarter, in that case, even if the entrepreneur wins they'll usually lose. The alternate scenario is the entrepreneur can make some kind of a statement like, "That is a tremendously valuable point. I'd like to chat with you more after the presentation and get your feelings on a number of other very interesting points," in which case the entrepreneur may pull this out of the toilet per-

haps one out of five times.

Angel groups fall into two distinct categories; those that charge companies to pitch, and those that do not. For many years, much has been made about companies that charge "pitch fees." I have seen many companies go through angel groups who charged pitch fees. I have taken a number of clients over the years through groups who charged pitch fees. For the first eight to ten years, in some cases, I felt the pitch fees were worth the investment: that is if the entrepreneur had access to the necessary funds to pay the fees — typically a couple thousand dollars.

While some groups were worth it, there were many more groups charging pitch fees that were not worth it. These were typically characterized by groups of investors who came together for lunch — conveniently paid by the pitch fee — and the entrepreneur was invited to give his or her pitch during the lunch. This kind of "let's have a pitch–you buy us lunch–bunch" really was mostly composed more of people interested in a free lunch and social gathering than they were at investing. Often this was a colossal and expensive waste of money and time by the entrepreneur. Fortunately, most of these groups have disappeared over the past few years — but not all have!

The better angel groups were characterized by good screening — they did not collect fees unless the company was deemed likely to get some funding, they ran structured presentations, not associated with a free meal — the presentations followed the same format so apples-to-apples comparisons could be drawn by the investors, they had some private time for only the investors to interact and frankly discuss the company — entrepreneurs were not allowed in the room, they provided written feedback to the entrepreneur, they had structured due diligence — often based on people signing up to potentially invest and volunteering to participate in the due diligence, there was a structured report format and written guidance to the due diligence process, there were time frames established for the various steps in the investment process — so the entrepreneur was not kept hanging and wasting time unnecessarily, entrepreneurs were charged a one-time fee, and there were a high percentage of real investors, as opposed to posers, sponsors and solicitors, in the group. When this was the case, these groups were a reasonably good deal. Times have changed!

From my own experience in a few of these groups, about 85% of the companies that paid to pitch got some funding. Most received enough to make the amount of the pitch fee they paid a reasonably small percentage expense for the funds raised — less than 8% was a good guideline. For the most part, the time frame for the entire process, to move from initial call to successful funding, was about ninety days. The quality of the due diligence was good, to very good, people volunteered and they worked hard to get a good result. Finally, there were a high percentage of real investors willing to take a calculated risk and invest. Sadly, those days are also gone.

Today, the amount of companies actually getting funding has dropped, the time it takes to get funded has become interminable, the due diligence is terrible, no one wants to volunteer for DD and if some do, you can figure six months in order to see a partial report. Few, if any, are really interested in making an investment. The entrepreneur is sure to be hit for fees multiple times during the period. The entire process has become more of a billable event, or series of billable events than a valid funding process. As a result of the drive for more billing, the screening processes have become quite suspect. The more companies that clear screening, the more charges the group's owners can levy. Overall, if the entrepreneur does raise money, they will have a very difficult time raising follow on funding from upper tier investors. Many top tier investors share the feeling that if the startup had a reasonable business idea, they would not have taken this kind of money in the first place. I have had a number of VCs and upper tier investors tell me that if there is group angel money in a deal — often tied to a specific group — they will not consider investing, as these investors are very difficult to deal with and it is just never worth the aggravation and expense. There is one study out of George Washington University that found 58% of venture capitalist respondents said that angel involvement "sometimes" or "mostly" made a company unattractive. There was criticism of this study, but the authors experience lends more credibility to the issue than the reported data suggests. VCs do participate in angel deals. Sometimes the VCs themselves participate as angels. Regardless, this is a potential issue one should consider as either an entrepreneur or investor.

The biggest problem for many angel groups is their angel investors have now been around for a while. The people that originally joined have now had years of experience in making these kinds of high-risk investments. They have come to realize exactly what high-risk means! They have learned that while the idea that angel groups were supposed to be a form of VC lite, the reality is that this did not hold true

for the returns and the risk for the angels was much higher as well. Many found that if they invested in ten deals, four or five outright failed, four or five just held on and required additional investment from them — or they have been diluted to almost nothing — and perhaps one, maybe two if they were really lucky, were successful. Often in this one "success" they were again significantly diluted in follow-on funding because they simply did not have the resources or risk tolerance to increase their investment. As a result, they made some money, but not the big money they expected.

My advice to entrepreneurs today is, if you can't get a VC in forty-five days go see the recognized individual angels, avoid the angel groups that make you pay. If you don't have any indication of access to the amount of money you need to raise within ninety days, go do something else. Failing at a venture may not always considered a bad thing in this crazy business as you will see later on when we discuss the "Start-Up Genome Report. If an angel group wants to charge you pitch fees? RUN AWAY, RUN AWAY, RUN AWAY!

The Land of the Lost

Everything here wants to eat you!

Facilitators

There are a number of people out there who purport to help startups raise money. They present as "consultants". They indicate they can get you "connected" with their network and help you find money. The "consultants" want you to pay them to do so. Most entrepreneurs, starting their first company, don't have any money to pay. So, the entrepreneur offers equity. The "consultant" comes back with a deal that is often part equity and part fees, to be paid when the funding comes in. Both are not only bad deals for a variety of reasons they are also likely illegal. The only person that can receive some form of compensation, contingent or otherwise, for the investment of money in a company is one that is licensed as a broker dealer.

"Danger, Will Robinson"
- B9 Robot from Lost in Space

There are large pitfalls for a company participating in such a fundraising scheme, typically jail is not the worst one. What is worse, is that equity sold through a contingent fund raising deal, not through a licensed broker dealer, is then subject to a perpetual recall. Meaning that if the investor finds out that you raised the money in this fashion, then anytime in the future, should the investor want the money back plus interest,

then they can unwind the equity investment and you will need to give the money and interest back. This is usually a huge problem. So don't do it.

There is another problem with you working with people that can "help" you raise money. If you're an entrepreneur you need to ask yourself, in one of those rare moments of sober, realistic reflection, some questions. (I can hear a few of you say "Yea! Right! Like those moments ever exist in a startup!") Would I go to my friends and push them to invest in such an admittedly high-risk deal if it was not mine? Would I put my friendship and business relationship at risk, just to make a small amount of money? Would I feel good about getting my friends to invest and taking some of their money and putting it in my pocket for just telling them about the deal? Would my friends even want to agree to let me have some of their money just because I told them about a deal? If the answer to any of these questions is something other than NO then you're clearly delusional. This alone is reason enough that no one should do something like this in the first place.

The converse of the former scenario is the entrepreneur who calls a so called expert and says something like the following…

> *"I was referred to you by your good friend, Whantshisname, he said you could help me 'cause he says you're the biggest and brightest genius on the planet in this area and all the other areas I need help with. He thinks what I have is fantastic and while he himself is too busy right now to help, he's convinced if you take a second, you will find it to be just as true as he does. Now, I don't have any money but if you'll help me, I'm sure you will see that you will make a lot of money. We expect to raise $500K in a bridge loan in the next 30 days, figure out a business plan, where you could really help us, go raise $5 million and have a liquidity event in three to five years. So, I'll give you some equity, and I'll agree to pay you your "normal" consulting rate as soon as we raise the $500K. By the way how much do you charge?"*

I have gotten way too many of these calls over the years. I don't do these deals. First, because of the pesky issue of legality mentioned above — thank God for the law. Second, because I can't, and wouldn't, even if I could, endorse a deal to people I have been friends or in business with for many years. If I did, given the success statistics mentioned above, I wouldn't still be friends or in business with most of these guys. No credible mentors or consultants would either. All that most are willing to do, if anything, will be to read and critique your plan and model. If we then agree it has a snowball's chance, then we will send to a couple of people we know. If any show

interest, then we may send to some more reviewers. If they don't reply, don't like it, or they raise a number of tough questions, we likely won't do much more. We all know you don't have any money, and only a few of us are willing to provide you real mentoring — that means free stuff — instead of consulting — stuff we expect to get paid for.

Syndicators

Another apparent rising avenue for entrepreneurs looking for funding are through deal syndication. These syndicates sometimes bring a group of investors together and then put the collective money in a pot that can be used for a variety of deals that get funded by the management of the syndication. Sometimes they come together and agree that they will look at deals as a group and if they all agree to do a deal then they will put their money together in a specific fund structure for that specific deal — each individual deciding what they will invest individually. Both of these structures can work. They can be a good deal for the entrepreneur because the collective investment is usually represented by one, appointed individual. Sometimes the person doing the syndication, at least, has some background in structuring deals and often has a broker's license. There is sometimes a slightly higher level of professionalism in these deals. The cost of the documentation of these deals is born by the investor, not the entrepreneur.

Syndicates may be good for entrepreneurs but they are often not as good for investors. Investors bear additional costs that they normally would not in typical angel deals. The proceeds of a success are often split and whatever you can negotiate in a liquidity event — and you are almost guaranteed to be negotiating with much bigger players in the deal by then — you will be subject to the will and sharing of the group. The basic structure of many syndicated deals does not overcome the deficiencies of angel investing enough to offset the additional expense. One more thing to remember! Sometimes, the syndicators are just really bad investors. Other times, they are just really good "Snake Oil" salespeople. But instead of the entrepreneur they have a different target — the investor.

Financing Predators

Unfortunately for the entrepreneur out seeking funding, they will be beset by many predators that are feeding in this specific business ecological niche of startups and investors. Startups that receive their initial funding from VCs tend to be somewhat insulated from the charlatans and crooks. When VC backed startups need help, VCs either have

staff or a vetted Rolodex of providers to assist. However, the angel funded entrepreneur is at significant predation risk and sometimes those funded by angel groups are at an even higher risk of predation from within the membership of the group.

Some predators actually show up on the newly funded's doorstep, and in some cases show up during the funding process of angel groups including law firms, accounting firms, recruiting firms and other angel group sponsors. Sometimes these so called resource or sponsor members are only a part of the group in order to prey on the startup. They seldom, if ever invest in a deal. This is not to say that some of these individuals or companies are not willing and able to provide real value — many can and sometimes they do. For every legitimate entity looking to truly help, there are dozens of others who provide little value and often get way too much in compensation and equity for what little they bring.

Predators are not limited to "professionals" and mentor/consulting members of angel groups. They can include suppliers and general vendors. Some of these entities specialize in attracting start-ups as customers. They bet that the entrepreneur is naive and may not have good counsel. In one recent, and particularly egregious example, a founder was convinced to pay a supplier what amounted to $10,000 each for a device that the founders, if they had taken the time to do 10 minutes worth of Internet searching, could have purchased directly from the manufacturer for only $389.00. While this is an out-lier, it is not as far out of the mix as you would expect. Starting a business, dealing with all the issues, raising money, and finding trusted investors, vendors and help is a daunting task. Some believe that there is a better way. Today, we have recently seen the rise of Incubators, Accelerators and other kinds of location driven assistance based businesses. Once again, entrepreneurs and startups are the target and sometimes they have been sucked right in to some bad deals.

Incubators

In what's now the "Old Days," my partners and I provided incubation services many years ago before it was de rigueur, but we never did it like its being done today. Marketing hype aside, most incubators provide space, access to some equipment, technology and sometimes access to some in-house mentor-ship. Once again, the rule of "let the buyer beware" goes in spades for most of these entities. While the

space charge is significantly less than having to lease a regular building or office suite for a monthly fee, it is overpriced and exorbitant for the amount of space provided by most incubators.

You can lease a small office suite for between $1.20 and 3.00/ft^2/mth in the San Francisco area. So if you take a 1,000 ft^2 office suite you pay $1,200–3,000 per month. Of course, there are a number of other costs you will bear including heat/light/power, telephone/Internet, insurance etc. Typically, the space that you get in an incubator is the space you occupy, sitting in one chair, at a folding table or bench, an area of about 3 ft^2. The average charge is for this space is $600.00 in San Francisco. This equates to $66.66 per ft^2 per month. Now, while very expensive for the young entrepreneur struggling with cash flow this doesn't appear to be a bad deal. There are the added benefits, often real and tangible, of being with others who are trying to do the same thing and access to a, at least partially vetted, network of "professionals" and "consultants" who are there to help. Some even offer access to mentors on staff and "entrepreneurs-in-residence." Although the latter can be of questionable value. Still one needs to be wary of incubators. They often extract some equity in the venture as well as the cash payments. They likely will not provide significant long term value to the company and may not significantly increase viability in the critical two to three years phase.

I list Incubators as predatory, because they are. They do provide a relatively expensive service per use but it is rationalize-able because the options cost more in aggregate under the more traditional start up model. There are some examples of really good incubators but they are few and far between today. There are some other options that do, or could, exist that would provide more benefit, at less cost and could actually increase the viability of a business beyond the two to three year window. These options are ultimately a better deal for investors and entrepreneurs but they do not yet readily exist.

Accelerators

Accelerators and incubators are often interchangeable. For many the difference in is name only. There are occasions where the "accelerator" has an added benefit of an organized network of suppliers and professionals. In these cases, they provide

more value. It is in a kind of hybrid structure of an accelerator like this that a good solution may lie for both investors and entrepreneurs. We will speak more of this at the end of this paper. Participating in incubators and accelerators can help lower failure rates somewhat, estimated to be at about 50%[1]. Still, be wary as an entrepreneur. For investors, the same warning applies.

Bad Angels

Bad Angels

As surprising as some may find this next statement; some angel groups have evolved, over time, to actually have a more predatory business model than they had before. These bad angels are now almost completely focused on extracting some fee from investors, sponsors, entrepreneurs and any other type of individual or group they come in contact with. Their business model is no longer driven by the value they can bring to an investor or to an entrepreneur. It is now driven by what they can rationalize and sell at every step in their so called investment process. You want to pitch our group, pay a fee. You want to present the result of your due diligence, pay a fee. Want to come to this event at the Big Name Building in downtown Big City, pay a fee. Want to meet with others who have started a business somewhere at our entrepreneur academy, pay a fee — and maybe, or maybe not, these new found mavens have made money. The list goes on and on. And, this is just the charges for the entrepreneur. They also do the same for investors, sponsors, etc. Remember the admonition to Run Away! Good, you're learning! That's another key trait in successful entrepreneurs as you will see later.

No one should be surprised that this is little more than a business for many of the angel groups and their owners. This has been the case for a long time. The issue that I have now is that while in the past there was an equitable trade in value for the entrepreneur and investor for what was paid to the group, today there no longer appears to be equity.

1 This information comes from an internal analysis from an investor group

The Ice Man Cometh
Change happens to everything!

Evolution Taking Hold

The Kauffman Report, had a devastating effect on VCs in particular and the flow of capital in general. Its effect on the availability of funding for entrepreneurs goes beyond the obvious. First let's talk about the VC, the generally knowledgeable professional investor class. After the Kauffman report came out, the things that had long been said between limited partners in private conversation, and largely ignored, finally began to take hold. A few of the larger and more prominent investors began to pull back from venture capital deals alongside of the Kauffman Foundation. Since they were no longer comfortable going along for the poor return ride of the VC deals. A few who had significant resources like the Rogers Family, Eric Schmidt, Mike Maples, David S. Rose, and others have sought out a new improved investor model.

Some have become part of so called "Super Angel" groups. In some cases, these larger investors have developed single source venture funds. Instead of paying the VCs of old a lot of money to manage a fund of other people's money, they have set up their own fund and hired the same people to manage just their money. This appears to be working better for these large investors, particularly when they can put up $50–100 million in new investment money every year. For those managing the fund, the artificial event horizon of the old days is replaced with a more patient and

longer term strategy. Nurturing the company becomes easier, managing the strategic financing becomes more effective, timely and easier. Liquidity options become wider. Also the fund managers and investors have wider latitude. Since it is their money, they can look at any deal in any space they want. They can rapidly set up significant participation in a few emerging technologies that the old model often stymied.

For the entrepreneur, if these super angels, or sole funded, investors pick up their company, they have a much longer term and more strategically active investor. They also often have a much higher caliber and scope of resources available to assure success. This is great for the investors that have a few hundred million to throw around, but what about for the rest of us?

Crowd Funding

We have recently seen the rise of crowd funding platforms. Crowd funding takes on two, or more flavors. The earlier evolution of crowd funding was for accredited investors looking to place a number of smaller investments in a lot of companies in a portfolio. Companies like Angel's List and Kickstarter are examples of these seed funding approaches. Another example of such a structure for growth stage companies is Funder's Club (www.fundersclub.com).

There is another example of crowd funding that is a direct result of the recent JOBS Act[1]. This type of crowd funding is a legislative driven option for up to 500 non-accredited investors to invest. Companies can raise up to a total of $1 million, raised from non-accredited investors in early stage companies[2]. This law provides a series of regulations for the company raising the money to follow that are supposed to provide some protection for the investor. In the author's opinion, they do little to protect anyone, in fact, they are more there to preemptively ascribe blame and help with litigation.

Companies that decide to raise monies under these rules face a wearisome set of conditions and assume a significant liability. They can engage others to facilitate the fund raise. These facilitators, do not have to be licensed broker dealers — so now

1 Jumpstart Our Business Startups (JOBS) Act, http://www.sec.gov/spotlight/jobs-act.shtml
2 For a good summary see http://www.haynesboone.com/jobs-act/.

the "consultants" can legitimately help raise money — but anyone who attempts to do so under these regulations assume the same responsibilities of raising money as a license broker dealer would and they will not have the benefit of insured liability protection. They accept the same liability for the integrity of representations and warranties made by the company and they can also on the hook for a full background check of the company's founders and assume liability for anything not found that later presents a material problem. Not even "consultants" will likely take this bait. And few entrepreneurs should consider taking money from non-accredited investors. More importantly, no one should make investments in startups if they do not qualify as an accredited investor in the first place. Losing seven out of ten times that you invest is just not good odds for people without the ability to lose all of it every time they invest. Entrepreneurs that take money this way are asking for real trouble every time they accept money from non-accredited investors.

The idea behind the JOBS Act legislation was to increase the access to capital for new companies. Like some of the other examples, this sounds nice in principal, but it does nothing to lower the risk to investors, increase the viability of start-up companies or significantly increase the profitability for founders and employees of startups. To understand how to do that we need to take a look at why start-ups fail in the first place.

Sometimes Failure is an Option

As long as you can learn!

Why Start-ups Fail

If Ray Rothrock is correct, and evidence suggests he is, liquidity for investors is now ten to fifteen years, and most companies still fail in two to three years. For investors to return to investing with the same zeal they had years ago, we need to start to figure out how to improve viability. We need to lower the risk profile. To do this we need to understand why startups fail, and how to re-mediate the causes for failure to improve viability. Those who figure out how to do this will find lots of companies seeking their guidance and lots of investors wanting to invest in their portfolio companies. While most gray haired, skinned knuckled veterans of the technology world likely already know the answers, they have also been loath to actually put them down on paper for a variety of reasons. Fortunately, there are others who have risen to the challenge and some recent reports exist. In one exceptional set, called the "Startup Genome Reports," the authors have developed a significant list of the problems and mistakes that startups make and some of the causes for startup failures[1].

You can read these excellent reports for yourself. There are quite a bit of data, and some very good conclusions in them. The author may disagree with the weighting of some of the factors, and he thinks that the results are a bit skewed as a result

1 These reports, and more good information, can be found at http://blog.startupcompass.co.

of the sample demographic but overall the report provides a good understanding of why startups fail. It's not sufficient just to figure out why these companies fail, one also needs to understand what you need to do about it and how to determine what strategy needs to happen and when. Overall, the best way to lower risk is to increase the likelihood for a company to last long enough to figure out the special combination of assumptions and practices that make the business survive. If it can survive to sustainability — although not always the goal of most traditional VCs — the company has much more likelihood of getting to a significant return position. Sustainable businesses can often manage to turn profits over time that will provide a variety of equity extraction options — beyond the fabled and sometimes disappointing "liquidity event."

So what are the lessons that need to be learned in order to increase viability for businesses and returns for investors? Let's start with the Startup Genome Report, A New Framework for Understanding Why Startups Succeed. (March 2012) Here are their summary findings:

- Founders that learn are more successful: Startups that have helpful mentors, track metrics effectively, and learn from startup thought leaders raise 7x more money and have 3.5x better user growth.
- Startups that pivot once or twice raise 2.5x more money, have 3.6x better user growth, and are 52% less likely to scale prematurely than startups that pivot more than 2 times or not at all.
- Many investors invest 2-3x more capital than necessary in startups that haven't reached problem solution fit yet. They also over-invest in solo founders and founding teams without technical co-founders despite indicators that show that these teams have a much lower probability of success.
- Investors who provide hands-on help have little or no effect on the company's operational performance. But, the right mentors significantly influence a company's performance and ability to raise money. (However, this does not mean that investors don't have a significant effect on valuations and M&A)
- Solo founders take 3.6x longer to reach scale stage compared to a founding team of 2 and they are 2.3x less likely to pivot.

- Business-heavy founding teams are 6.2x more likely to successfully scale with sales driven startups than with product centric startups.
- Technical-heavy founding teams are 3.3x more likely to successfully scale with product-centric startups with no network effects than with product-centric startups that have network effects.
- Balanced teams with one technical founder and one business founder raise 30% more money, have 2.9x more user growth and are 19% less likely to scale prematurely than technical or business-heavy founding teams.
- Most successful founders are driven by impact rather than experience or money.
- Founders overestimate the value of IP before product market fit by 255%.
- Startups need 2-3 times longer to validate their market than most founders expect. This underestimation creates the pressure to scale prematurely.
- Startups that haven't raised money over-estimate their market size by 100x and often misinterpret their market as new.
- Premature scaling is the most common reason for startups to perform worse. They tend to lose the battle early on by getting ahead of themselves.
- B2C vs. B2B is not a meaningful segmentation of Internet startups anymore because the Internet has changed the rules of business. We found 4 different major groups of startups that all have very different behavior regarding customer acquisition, time, product, market and team.

In the author's opinion, what is missing from this analysis, are the operational reasons relating to costs and cash. The Startup Genome reports have a built in sample bias. Most of the companies are at one stage or another and have not been tracked as they progressed through various stages. Some of the companies are headed by so called serial entrepreneurs — a term referring to someone who has started more than one company, and a term that, as often as not, could be likened to a serial killer when it comes to investor money since starting companies does not itself lead to successful companies. Remember that the term "serial entrepreneur" is typically self-ascribed. One cannot be sure that any given serial entrepreneur has been successful in his entrepreneurial endeavors. Nor do we really know if they are any better at understanding where they are now or why they failed the first, second or third time around.

According to the Genome report, learning is a key metric but we do not always know that these guys learn just because they started a company regardless of the outcome.

The Genome reports only track companies in what could be described as at the development phases. Therefore, much of the discussion in the reports omit the issues relating to cash flow and management to profitability. Perhaps they believe these are obvious success points, more likely few of the companies have reached these stages in the sample.

While the reports focus much of the reason for failure at "premature scaling" I would simply say they spent way too much money long before they know how to make any. Another way to put it is, that they expected to make large profits and spent accordingly. When the profits were not realized, as they assumed they would be, then the company went out of business. One of the key things that is also necessary for companies to achieve increased viability is to be able to adjust their business model, to pivot in the terminology of the Startup Genome. To be able to pivot requires methods to lower costs in the key services they must have to be viable in the first place. A lower S, G, & A, and lower cost of goods sold go a long way toward improving viability. "Cash is King," I've heard tell by investors — often more than once.

The authors experience taught him that to make a company viable one should attempt to understand why franchisees are so much more viable than other kinds of startups. What it comes down to are some simple things.

- Entrepreneurs that listen and learn are more successful than the other guys
- Having a lower Selling, General and Administrative (S, G, & A) cost than the other guys.
- Having more timely access to needed resources than the other guys.
- Having access to higher value, proven resources and making less fundamental mistakes than the other guys.
- Having access to deeper discounts for common services than the other guys
- Having access to a lower cost, sometimes shared, infrastructure than the other guys

- Having founders that learn helps companies be more successful than the other guys.
- Startups that have helpful mentors and entrepreneurs that learn from thought leaders, have better growth, increased viability and are generally more successful than the other guys.
- Hands-on help from investors has little or no effect on the company's operational performance. But the right mentors and resources at the right time significantly influence a company's performance and ability to raise money making them more viable than the other guys.
- Initial intellectual property itself is not a competitive advantage. Knowing how and where to apply it in the marketplace is what generates competitive advantage

Why is almost every item up there compared to "the other guys?" Because, funding, like whatever the business you're trying to build, is competitive. Whether you are seeking money to start your business, or your business is up and running, you're competing with others. You will compete for funding dollars. You will compete for resources. As a start-up, you will compete for available time from your lawyers and accountants who also have established paying clients to serve. And, when you finally have your business in the market, you are competing with the other guys for customers — in the end it's the customer's money you're trying to get. If you don't recognize this at every point their going to beat you. And, you will be just another serial entrepreneur, starting yet another company, potentially learning from your failures — as valuable as that is.

So can this be done? Can there be some kind of entity that can lower costs, help entrepreneurs make the correct assumptions and structure their business in a better way to provide room for adjustment (pivots). Is there a way to be able to connect with the needed resources at lower cost than my competitors? How can I find the true experts I need, when I need them, so I don't kill my business by fundamental flaws in my structure, assumptions and cost matrix. And can I find good investors that are willing to take a longer more strategic view? The answer is, yes!

There are some options
If we really want to make it better!

What's needed?

We need to develop resource structures that combine access to funding, with access to shared services and qualified mentoring and consulting services. Mentoring, in this example, are services provided for free and consulting are services provided for a fee. We need to develop an infrastructure, an Entrepreneur's and Investor's Center (EIRC) that brings support service companies like, law firms, accounting firms, and other service firms typically in demand for startups, into a structure that helps lower the overall cost of the services in exchange for ready and inexpensive access to the companies within the structure. Companies that provide services to member startups should have some incentive to accrue free hours for a multiple of billed hours to create a ready access pool for mentoring services to startup companies within the structure. Outside companies (suppliers and vendors) that want access to member companies within the structure would gain access through defined partnership programs. Under the terms of these programs, the goods and services purchased could be provided under a group volume purchasing program that lowers the goods cost for members in exchange for ready access, lower contracting costs, larger aggregate volume and other economies of scale. It is estimated that such a structure can lower the cost of goods and services as much as nine to eleven percent. This provides a significant pricing advantage for member companies. Remarkably, it is about the same

margin advantage as most franchises offer.

Some of the benefits to entrepreneurs of such a system are rapid access to qualified, proven expertise, valuable mentor-ship that does not prey on scarce startup capital, better structure of the company with proper checks and balances to spot needed assumption adjustments earlier. Assumptions problems in startup companies are like all diseases, they benefit from early detection and remediation. A good company structure with proper policies, metrics and reporting can provide that. This should be a required service of any good incubator. Developing a mechanism to stimulate, track and monetize volunteer, free goods and services, lower S, G & A, and cost of goods, not only improves the risk profile and fund-ability, it can also improve long term valuations. Any incubator that wants to help extend the viability of startups in its program needs to develop these kinds of additional benefits.

Another Kauffman Foundation Report called, "The Importance of Startups in Job Creation and Job Destruction," published September 9, 2010 like other Kauffman reports finds some very interesting statistics. Here is the summary section for that report.

- It's well understood that existing companies of all sizes constantly create — and destroy — jobs. Conventional wisdom, then, might suppose that annual net job gain is positive at these companies. This study, however, shows that this rarely is the case. In fact, net job growth occurs in the U.S. economy only through startup firms.
- The study bases its findings on the Business Dynamics Statistics, a U.S. government dataset compiled by the U.S. Census Bureau. The BDS series tracks the annual number of new businesses (startups and new locations) from 1977 to 2005, and defines startups as firms younger than one year old.
- The study reveals that both on average, and for all but seven years between 1977 and 2005, existing firms are net job destroyers, losing 1 million jobs net combined per year. By contrast, in their first year, new firms add an average of 3 million jobs.
- Further, the study shows, job growth patterns at both startups and existing firms are pro-cyclical, although existing firms have much more cyclical vari-

ance. Most notably, during recessionary years, job creation at startups remains stable, while net job losses at existing firms are highly sensitive to the business cycle.

- Because startups that develop organically are almost solely the drivers of job growth, job-creation policies aimed at luring larger, established employers will inevitably fail, said the study's author, Tim Kane, Kauffman Foundation senior fellow in Research and Policy. Such city and state policies are doomed not only because they are zero-sum, but because they are based in unrealistic employment growth models.
- And it's not just net job creation that startups dominate. While older firms lose more jobs than they create, those gross flows decline as firms age. On average, one-year-old firms create nearly one million jobs, while ten-year-old firms generate 300,000. The notion that firms bulk up as they age is, in the aggregate, not supported by data.

So what do you think?

Do we want to build a better system, create more jobs and build better businesses?

Conclusion

If we are going to fuel this needed growth in the job market by the creation of new startups, we will need to be able to finance their start and growth. We will need to find investors alternate methods of equity extraction other than the expectation of rapid and large liquidity events like IPO and acquisition. We will need to give investors structures that will lower the risk profile and increase the viability of these startups while at the same time lowering costs and increasing competitiveness.

We need to provide entrepreneurs with access to capital, expertise, and needed services and resources in a structure that assures quality and long term value. We need to provide investors with access to good quality companies that are competitive and have a longer term viability to get to some form of success. We need to help investors rethink their portfolio and returns goals in order to not be focused on the abject gambling mentality of prior angel and venture investments models that required one, or two, out of ten to hit it big in order for it all to be worthwhile. We need to find mechanisms for investors to take a longer term strategic, more organic, views of wealth creation and find contentment with more portfolio companies returning dividend income. Maybe, if we begin to do this, we can get back to where we once again are all content to go off go to work, get married, raise a family and build a good

business for the long term. And, maybe, just maybe, this could work! Imagine what it would be like for more people to be able to find contentment?

If you are interested in discussing more detail about a model for this new kind of startup development infrastructure, please contact the author.

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