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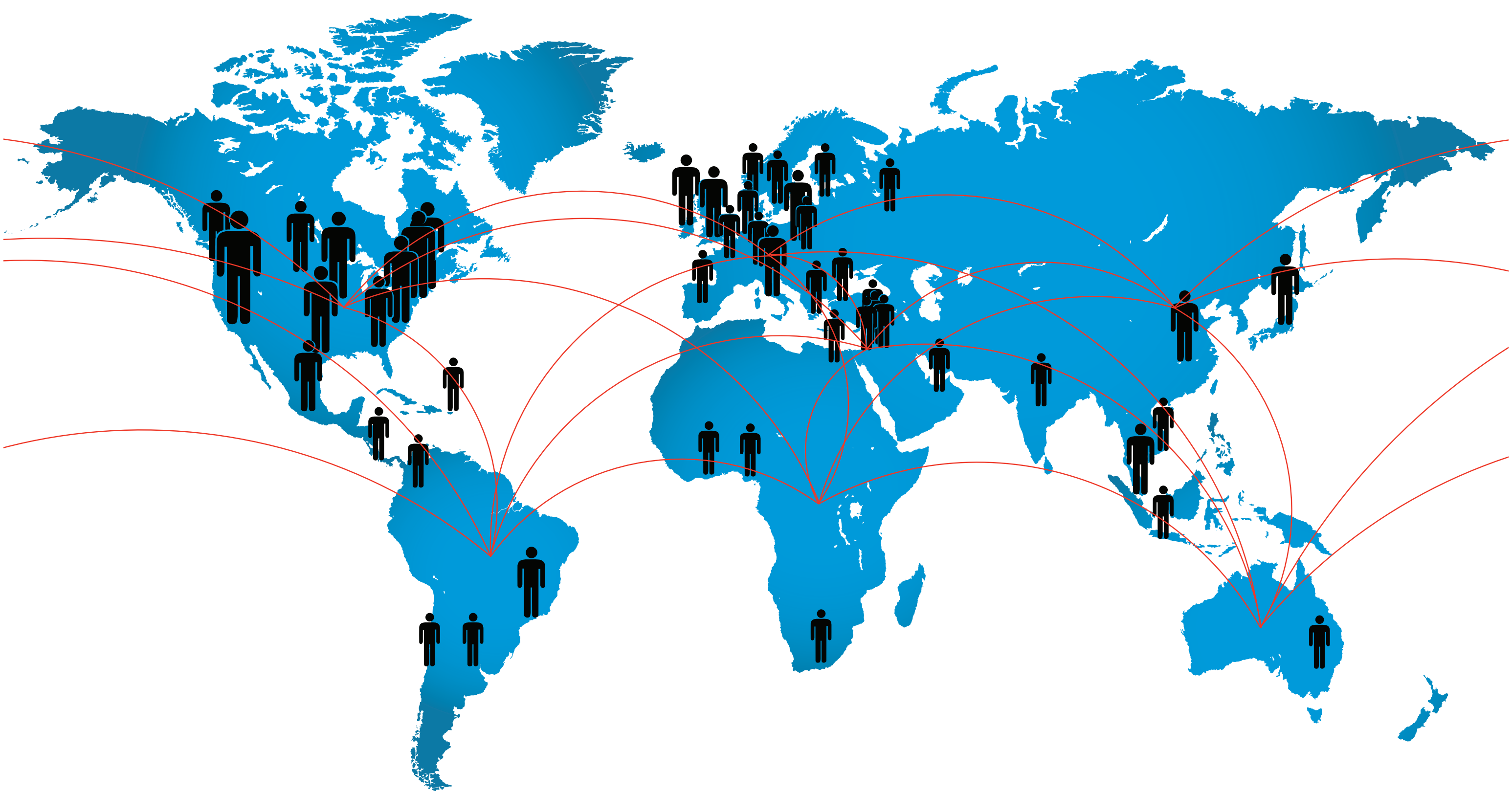

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Phil Wickham

Managing Editor
Anna F.Doherty

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Leslie F. Peters

Production and Design
Anna F. Doherty
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Kauffman Fellows on the Science of Capital Formation

Phil Wickham

Charter Class

Conceived in 1993, the idea of the Kauffman Fellows Program was controversial from the start: prevailing wisdom said that what happened inside venture capital was a "black art"—it could not be understood scientifically and it certainly could not be taught. The Kauffman Foundation visionaries who started the program believed otherwise, and we have proven them right many times over.

This June, we celebrate our 20th birthday. It's been a period of reflection for Kauffman Fellows as an organization, looking back at riding the Internet bubble up, spinning out to independence from the Kauffman Foundation, and surviving first the crash of the Internet and, later, the global financial system. Reviewing our two decades, we can see that the skills and networks of the 400+ Kauffman Fellows in the world have been accelerated through their engagement with the program, to the benefit of entrepreneurs around the world. In this article, I share a model for our understanding of the science of capital formation, with the intention of opening a dialogue with industry participants around the world.

Two Questions about Kauffman Fellows

In my seven-year tenure as CEO, I get asked two questions more than any others. The first evokes the history of Kauffman Fellows, and that history provides the answer to the second question.

"Why? Why did the Kauffman Foundation create this program?"

The answer to "Why?" stems from Mr. Kauffman's focus on the role of the capital food chain in the United States. Capital had to be available for startups at all stages of growth—at the laboratory and university level, through the angel gap, and into growth mode. Capital is also needed to function in alignment with the entrepreneur's vision. Mr. K also observed that the biggest and most exciting growth stories were associated with the top venture capital funds. At that time, the next generation of investors in those funds were often recruited from banking and consulting, bringing with them the transactional mindset that was critical to success in their previous fields, but that ran against the culture and needs of a startup.

The Kauffman Fellows Program was designed to bring a new cadre of leadership to the venture capital field—one that better reflected the entrepreneurial community and society as a whole. This outcome would help the Kauffman Foundation better codify venture capital best practices; give the venture funds new talent with a structured, accelerated training; and prove that scientists, doctors, operators, women, and under-represented minorities could contribute and thrive in the venture capital industry.

The founders of the program relate how Mr. K believed that if the Kauffman Fellows Program could help optimize the cornerstone of the capital food chain—venture capital—we would then go on to leadership roles across the entire food chain. These two decades have proven him right. We have spawned educational, government, corporate, and entrepreneurial leaders including the following:

- Thomas Darden (Broad Superintendent Academy; Co-founder, Reliant Equity),
- Winslow Sargent (Chief Counsel for Advocacy at the SBA, an Obama appointee),
- Azita Sharif (Founder/CEO of Daedalus Software, BINDS),
- Risa Stack (Head of new business creation at GE; partner at Kleiner Perkins),
- Jens Eckstein (CEO of SR One, TVM Capital),
- Jana Nieto (Former Assistant Undersecretary of the Economy, Mexico; head of innovation, 3M, Latin America),
- John Pacifico (CEO of ORTHOCON, Abyrx; Founder/Chairman of Kairuku; partner at Canaan Partners),
- Jeff Stein (Founder/CEO of Trius Therapeutics; Sofinnova Ventures), and
- David Lowe (CEO of Aeglea Biotherapeutics; partner at Skyline Ventures).

"What is your distinctive contribution to the ecosystem?"

At Kauffman Fellows, we focus on the health of the "capital food chain," that is, the stakeholders who practice the art and science of "capital formation." Few people really have a working model for these terms. To the novice, capital is seen as money; however, while financial capital is certainly an important type of capital for a startup, it is only one among many equally important forms of capital.

To clarify the developmental biology of a startup, it helps to consider it like that of a child. A new human is conceived, incubated, birthed, and brought to independent adulthood (hopefully). Capital is to a startup what nutrients are to a child—and what we "feed" a child goes far beyond just food and water. We nurture our children with safety, education, physical fitness, health care, discipline, and stimulation, among many others. Providing the best nutritional food chain for a child involves deep expertise for each of the child's stages of life. The skillset of an obstetrician varies from that of a pediatrician, a preschool teacher's challenges contrast starkly with a middle-school teacher's, and a 5-year-old and a 14-year-old are coached differently in tennis or soccer.

Extend this metaphor to the birth and development of a new startup; we argue that new companies also consume a spectrum of capital "nutrients," and that the best outcomes are attained when these nutrients are administered by experts at each stage of growth. This range of experts includes advisors, lawyers, accountants, laboratory managers, technology licensing officers, accelerator advisors, angel investors, seed investors, venture investors, venture banks or lenders, corporations, mezzanine investors, investment bankers. These stakeholders, along with stock exchanges and institutional capital, comprise the capital food chain.

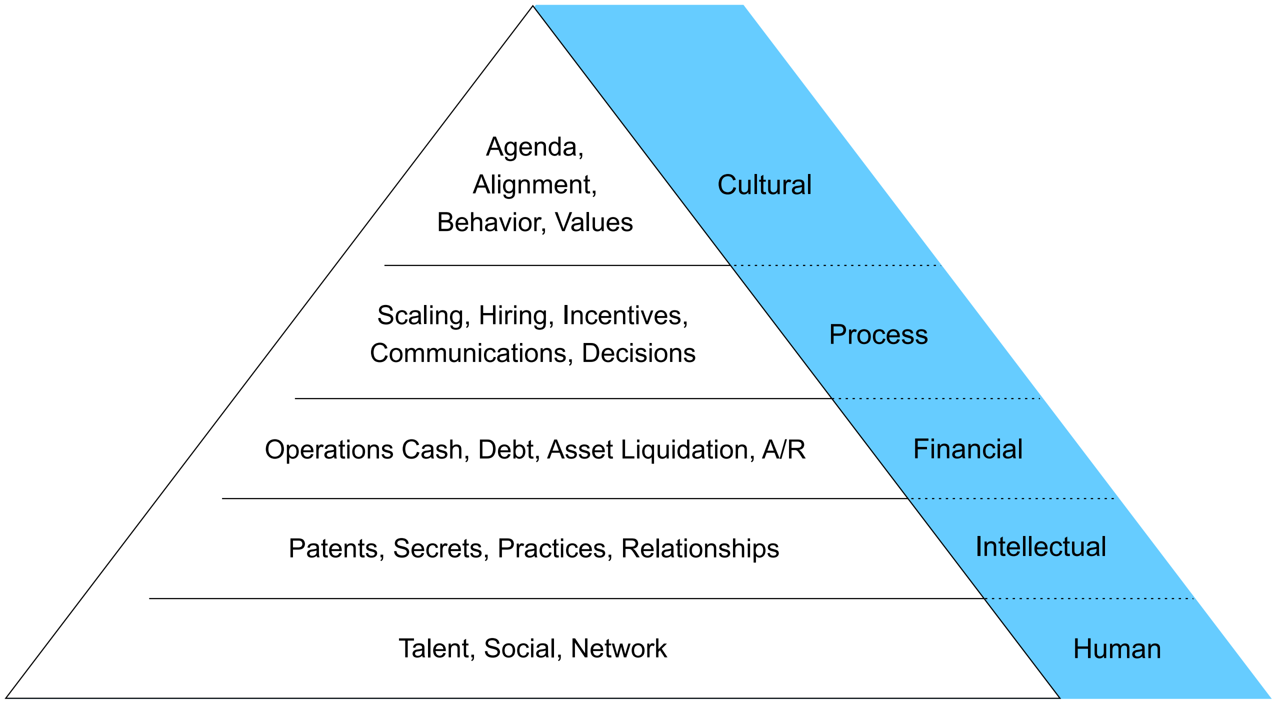

Figure 1. The Startup Capital Hierarchy of Needs: (At Least) Five Types of Capital for Success. Author's figure, drawing on psychologist Abraham Maslow's hierarchy of needs (see footnote 1).

This chain works best when it defaults to the needs and vision of the entrepreneur. Mapping, building access to, and mobilizing all of the different forms of capital on behalf of entrepreneurs is the practice of the science of capital formation.

An Introduction to Shadow Capital

These observations raise the question of what are the different forms of capital (i.e., startup nutrition) that companies require for optimal health? In the rest of this article, I share a rough draft of observations we have made over the years. This is a working model, and one we welcome feedback on.

Channeling U.S. psychologist Abraham Maslow,[1] we have developed what in effect is a "startup capital hierarchy of needs" (figure 1). Resting on a base of societal challenges sits a pyramid of at least five types of capital. In concert, these different types of capital are equally important to optimize a new company's chances for success.

[1] NetMBA, "Maslow's Hierarchy of Needs," 2010, http://www.netmba.com/mgmt/ob/motivation/maslow/.

While all five are needed, the majority of media, entrepreneurs, and venture capitalists focus only on financial capital. We have coined the term *shadow capital* to describe these other valuable-but-often-overlooked startup nutrients.

Human Capital

In volume 1 of this journal, I laid out a working definition of innovation as the systematic, sustainable delivery of a solution to a market in need.[2] To deliver that solution, one must build a remarkable new organization—remarkable because it has to go against the prevailing wisdom of the time, and because it has to last. Innovation (and new organizations) begins with human capital: essentially the founding team, including advisors

[2] Phil Wickham, "A Note on Innovation, Capital Formation, and the Role of the Society of Kauffman Fellows," *Kauffman Fellows Report* 1 (2010):3-6, http://www.kauffmanfellows.org/journal_posts/a-note-on-innovation-capital-formation-and-the-role-of-the-society-of-kauffman-fellows/.

and investors. Human capital can also be defined one layer deeper as the characteristics of those people: factors such as IQ and EQ (emotional intelligence), as well as complimentary skillsets, preferences, values, and character traits in particular.

Companies like Google are legendary for their recruiting and integration of new talent so that new employees both meet the standards for the job in the moment but also fit in with the original culture of the company. This selection and onboarding process should extend beyond employees, to all new investors, partners, and advisors. Investors make funding decisions they must live with, but with the right skills they can also help with optimizing the founding team's dynamic and ensuring that new talent for growth is accessed, identified, filtered, and integrated in a systematic way.

Intellectual Capital

To address a market in need, a startup team will build their solution around intellectual capital: individual expertise, trade secrets, patents, technology trends, and business model innovation and practices. The deeper and more sophisticated the blend of intellectual capital, the greater the sustainable competitive advantage over time. Pivoting is mistakenly thought to happen only when a door closes on a possible market, but it is just as likely to happen when intellectual capital comes together in a surprising way and opens up unforeseen opportunities (think Post-its, Kevlar, Viagra). Investors can help with access to past patterns of success across hundreds of companies.

Financial Capital

The most commonly known type of capital, financial capital, is more than just funding—fueling a startup with cash is an art form. Timing, amount, and type of financing must be considered; it is common to see a mix of equity, operating debt (venture debt), asset lending, and accounts receivable lines. Entrepreneurs have to weigh the costs of capital, the risks of taking on too much venture equity (which has to be repaid first upon an exit), the possibility of raising conservatively and confronting challenging conditions later, and the balance of the lower cost of debt against the cash burden of interest payments. At Veeva, for example, Emergence Capital and Gordon Ritter (Mentor, Class 15) helped management run extremely lean on equity to achieve an IPO in 2013 ($4M in venture investment; $4.4B in valuation[3]). On the other hand, Gilt Groupe is an example of perhaps too much capital and too many ideas intoxicating a young company, to its detriment.[4]

Process Capital

The best founding teams are laser-focused on bridging the gap between the societal problem (the "market") and the IP (the product or service that will make them successful). However, scaling the organization to enable big success requires process capital, which is not always the most exciting for executive leadership: hiring, accounting/audit, 409a valuations, litigation, incentive structures and compensation, copyrights/trademarks, branding, and internal and external communications. With these kinds of challenges, investors can often help the most, both with pattern recognition and wisdom as well as access to the best lawyers and specialist hires or consultants.

Cultural Capital

Culture is the highest and most powerful form of startup capital, but for many it is the most elusive. Scott Kriens (co-founder of The 1440 Foundation) relayed to our Fellows that, in his experience in growing Juniper Networks as CEO for over 12 years, a trust-based culture is marked

[3] Ari Levy, "Veeva IPO Generates 300-Fold Return for Emergence Capital," *Bloomberg* 16 October 2013, http://www.bloomberg.com/news/articles/2013-10-16/veeva-ipo-generates-300-fold-return-for-emergence-capital-1-.

[4] Jillian D'Onfro, "Four Years Ago Gilt Groupe Was the Hottest Startup in New York — Here's What Happened," *Business Insider*, 21 February 2015, http://www.businessinsider.com/gilt-groupe-story-2015-2.

by its "generative" energy. A culture lacking in trust is, in contrast, "toxic."[5]

Culture should be designed, executed, managed, and protected—when it is ignored, an arbitrary culture just happens. In practice, an arbitrary culture is never what management hopes for. Facebook is renowned for dropping in a "culture team" from headquarters for up to 18 months in a new office, to ensure that the right culture is established through the hiring and onboarding of new employees.

About Fellows: Developing Smart, Connected Capitalists

Kauffman Fellows identifies emerging leaders in venture capital and accelerates them to positions of global authority.

We identify potential Fellows using a multi-layer design process that moves through credentials, proven skills, appetite for and success with calculated risk, and most importantly, ethical and behavioral traits. As we develop Fellows, we want them to see the capital-formation process laid out in figure 1 as a framework for developing and applying their most critical tools as venture capitalists.

We accelerate them by first helping them to achieve an extremely deep understanding of their individual "powers and passions" (thanks to Lisa Solomon[6]), and then mapping those powers to unique and exciting VC "white spaces" where high-potential entrepreneurs are underserved. The global peer network of the Kauffman Fellows Society becomes a trading platform for the key currencies to help Fellows help accelerate new fund ideas and execute them. Our most traded currencies are typically insights, opportunities, and resources.

I have heard VC legend Dave Marquaurt say, "Entrepreneurs distinguish themselves by how they build, VCs by how they buy." There is no doubt this is true, but since success in the modern world of venture capital depends so heavily on brand within the entrepreneurial world, one has to believe that a class of investors plays a material role in supporting entrepreneurs to build success. Success requires more than fulfilling the adage, "first, do no harm."

The earlier the stage of human development, the more critical the mix, dosage, and timing of nutrients. We encourage Fellows to see capital as an array of different types of inputs that nourish startups. We encourage them to focus on how and when to provide particular nutrients, and to strive daily to increase their expertise in and access to capital in all its forms. As with humans, capital formation is most important at the earliest stages of startup life.

Adding Value as a VC

Our view of the world is that everything begins with the founding entrepreneurial team. They feed off a base of societal challenges and become motivated to address a particular challenge by turning a problem into a market. To create that market, they must develop a solution to the problem and people must be willing to pay for the solution, use it, and (hopefully) promote it to others.

We tend to discourage a belief that Fellows can add value in product or service developments and iterations—that is the domain of the startup team. The simple adage prevails that "if you, the investor, can actually help your founding team with product or service issues, you have backed a bad team."

Another dynamic in capital-formation that cannot be ignored is the atmosphere (commonly called "the ecosystem") in which entrepreneurs operate. This ecosystem can include government factors such as tax structures, regulatory processes, immigration policies, and law

5 For some of his thoughts on corporate culture, see Alan Weissberger, "Juniper CEO Scott Kriens Thoughts on Leadership and Corporate Culture Transformation," *Viodi View*, 21 January 2008, http://viodi.com/2008/01/21/leadership/.

6 http://lisakaysolomon.com/about-lks/.

enforcement. It can also include social forces such as media bias, religious influences, and family or community prejudices.

Investors, often through larger organizations, can have a material impact on government policy and regulations. Through the NVCA, Kate Mitchell[7] worked with the JOBS Act to convince the SEC to lighten regulatory oversight of smaller venture funds.[8] VCs can also help and encourage the media to better tell and celebrate the stories of successful entrepreneurs as a way to educate society and inspire future generations. However, this sort of broader regulatory or media push is a side effort best left to those, like Kate, who have achieved many years of success in the industry and are working to have bigger impact.

Developing This Model Further

This analysis leaves me asking questions that I will continue to work on. The first is the existential question: do investors really add any value post-investment, and are there clear limits if they do? From there, I wonder whether the management and investors in the great successes in Silicon Valley would agree with this analysis. Did they mobilize all these forms of capital in the right ways, and did that contribute to their eventual success? Conversely, could we as an industry reflect on high-potential disappointments and find discrete examples where there was a key capital "hole" that contributed to an unnecessary and costly failure?

Finally, if this is a useful framework for the business of venture capital post-investment, could Kauffman Fellows fluent in this approach use it in the "buy" process and as a framework for due diligence?

I look forward to following up on these questions with experts in the Kauffman Fellows Society and elsewhere. Whether you agree or disagree with this model, we want to know about it.

Phil Wickham

Phil is President and CEO of Kauffman Fellows and a co-founder of Sozo Ventures, a $150M fund focused on leading IT companies targeting global expansion. Phil was a Charter Class Fellow and helped to found the Kauffman Fellows Program spinout from the Kauffman Foundation. Previously, he was a General Partner at JAFCO America Ventures and Copan. His investments include Twitter, Ikanos, Web Methods, Com21, Lotame, Square, Palantir, ServiceMax, MongoDB, and Pley. He holds a BSME and an MBA. phil@kfp.org

7 Kate was a Kauffman Fellows Mentor for Class 11 and volume 2 author; see Kate Mitchell, "Venture Capital 2011: How the Past Informs the Future…Today ," *Kauffman Fellows Report* 2 (2011):10–14, http://www.kauffmanfellows.org/journal_posts/venture-capital-2011-how-the-past-informs-the-future-today/.

8 James Freeman, "Kate Mitchell: How Silicon Valley Won in Washington," *Wall Street Journal*, 6 April 2012, http://www.wsj.com/articles/SB10001424052702303299604577326270090887812.

Table of Contents for *Kauffman Fellows Report* Volume 6

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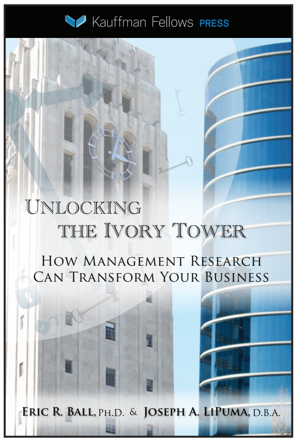

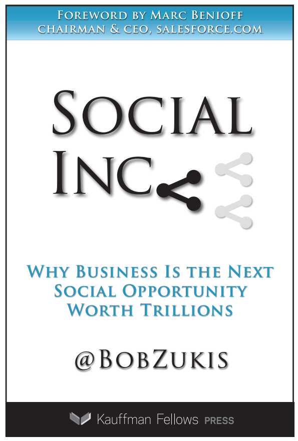

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Inspired by Ewing Marion Kauffman and his legacy of shared ownership, accountability, and experimentation, we measure success in enduring new businesses that generate long-term returns for principals, investors, and society as a whole.

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