CHAPTER 4

The Art of Writing a Business Plan

In preparing for battle I have always found that plans are useless, hut planning is indispensable.

—Dwight D. Eisenhower

GIST

According to Celtic myths, there were once magical vessels that "satisfied the tastes and needs of all who ate and drank from them."* These myths led to the legend of the Holy Grail. The modern-day equivalent of the Holy Grail is the business plan.

It, too, is supposed to satisfy everyone (investors, directors, founders, and managers) and induce magical effects on those who partake of it—specifically, the irresistible urge to write a check or approve a go-ahead action.

Also, like the Holy Grail, the business plan remains largely unattainable and mythological. Most experts wouldn't agree, but a business plan is of limited usefulness for a startup because entrepreneurs base so much of their plans on assumptions, "visions," and unknowns.

""Found at http://www.bl.uk/whatson/exhibitions/gfail.html.

An entrepreneurial endeavor within an existing company will also find that a business plan is of limited use. For external and internal startups, the MAT (Milestones, Assumptions, and Tasks) that we discussed in Chapter 1 is the most useful guide for the day-to-day operation of an organization.

However, many investors, recruits, potential board members, and internal decision makers do expect a business plan and won't proceed without one. Plus, writing a business plan does have the benefit of forcing a team to work together to formalize intentions. So write a plan, and write it well, but don't convince yourself that it's the Holy Grail. Organizations are successful because of good implementation, not good business plans.

WRITE FOR THE RIGHT REASON

Ironically, for most entrepreneurs the business plan itself (that is, the document) is one of the least important factors in raising money.

- If an investor is leaning toward a positive decision, then the business plan only reinforces this inkling. It probably wasn't responsible for the positive position itself.
- If the investor is leaning toward a negative decision, then it's unlikely that the plan will change his mind. In this case, the investor probably won't even read the entire plan.

Unfortunately, naive entrepreneurs believe that a business plan alone can produce an awestruck reaction, followed by one follow-up question: "Can you send me wiring instructions for the money?"

Dream on. The right and realistic reasons to write a business plan are

- In the later, due-diligence stage of courting an investor, the investor will ask for one. It's part of the game—a business plan has to be "in the file."
- Writing a plan forces the founding team to work together. With any luck, this will help generate a strong, cohesive team. You might even figure out whom you *don't* want to work with.

- Writing a plan makes the team consider issues that it had overlooked or glossed over in its euphoria—for example, developing a customer service policy.

- Finally, the writing of a plan uncovers holes in the founding team. If you look around the room and realize that no one can implement key elements of the plan, you know that someone is missing.

All the late-night, back-o'-the-envelope, romantic intentions to change the world become tangible and debatable once they're put on paper. Thus, the document itself is not nearly as important as the process that leads to the document. Even if you aren't trying to raise money, you should write one anyway.

PITCH, THEN PLAN

Many entrepreneurs try to perfect their business plan and then pull PowerPoint slides out of it. They view the business plan as the be-all and end-all, and the pitch as a subset of this magnificent document.

This is backward thinking. A good business plan is a detailed version of a pitch—as opposed to a pitch being a distilled version of a business plan. If you get the pitch right, you'll get the plan right. The converse is not true. Here's the proper process:

- Throw together a pitch that contains the ten slides we discussed in the previous chapter.
- Try it out on some mentors, colleagues, relatives, angels, and investors. Do this about ten times.
- Get the team in a room and discuss what you've learned.
- Fix the pitch.
- Start writing the plan.

Here's why this is the right methodology to writing a plan:

- Your pitch is more important than your business plan, as it will determine whether you're rejected or generate further interest. Few sophisticated investors will read a business plan as the first step.
- A pitch is easier to fix than a business plan because it contains less text.
- You won't get feedback on your business plan. Frankly, it may not even be read. You will, however, get immediate reactions to your pitch.
- You may get lucky and raise money without ever having to write a business plan. (But I would still write one for the value of the process.)

FOCUS ON THE EXECUTIVE SUMMARY

As a refresher, these are the ten slides that are necessary in a good pitch for investors:

1. Title slide
2. Problem
3. Solution
4. Business model
5. Underlying magic
6. Marketing and sales
7. Competition
8. Management team
9. Financial projections and key metrics
10. Current status, accomplishments to date, timeline, and use of funds

These ten items provide the framework for your business plan as well. An executive summary takes the place of the title slide and is the most important part of the plan. A good executive summary is a concise and clear description of the problem you solve, how you solve it, your business model, and the underlying magic of your product or service. It should be approximately four paragraphs in length.

It is the most important part of your business plan because it will determine whether people read the rest of the document. If all goes well, they'll ask you to come in for a meeting. However, if the executive summary fails to spark interest, then the game is lost before it even begins, and the rest of the business plan won't matter because no one will ever get to it.

Thus, of the effort you put into writing a business plan, 80 percent should go into the executive summary. These are the most important paragraphs of your organization's existence.

EXERCISE

Print your current business plan. Throw away page 3 and beyond. Would the first two pages make you want to read the whole document?

KEEP IT CLEAN

In addition to writing a great executive summary, you can increase the effectiveness of your entire business plan by keeping it short, simple, and effective:

- **DO NOT EXGEED TWENTY PAGES IN LENGTH.** You're probably thinking that this principle is only relevant to other people's plans, and that your own curve-jumping, revolutionary organization is the exception to the rule. You're wrong. The shorter the plan, the more likely it is to be read.
- **SELECT ONE PERSON TO WRITE THE BUSINESS PLAN.** While the plan should reflect the wisdom of the team, it should be articulated by a single voice. It should not read like a patchwork of cutting and pasting.
- **BIND THE PLAN WITH A STAPLE.** Leather-bound, gold-leaf, embossed tomes make you stand out—but as a clueless bozo. Investors will probably ask for a Word document or PDF electronically transmitted copy anyway.
- **SIMPLIFY YOUR FINANCIAL PROJECTIONS TO TWO PAGES.** Investors don't care—and you have no way of knowing—how much you'll spend for pencils in the eleventh month of the fourth year. The most important projection is your cash flow statement for the first five years. (See the next section for more information about financial projections.)
- INCLUDE THE KEY METRICS, SUCH AS THE NUMBER OF CUSTOMERS, LOCATIONS, AND RESELLERS. Often these metrics provide a better understanding of an organization's plans than financial projections. For example, you may project that you'll sell to 250 of the *Fortune* 500 companies in the first year.
- INCLUDE THE ASSUMPTIONS THAT DRIVE YOUR FINANCIAL PROJECTIONS. Everyone knows that you picked a revenue number that you think makes your business look interesting but not hallucinatory. The assumptions behind your forecast are much more informative and important than the forecast itself.

PROVIDE THE RIGHT NUMBERS

Investors don't spread business plans across the table and pick the ones to fund based solely on financial projections. Most business plans submitted to venture capitalists are more similar than they are different. Specifically, they all project fourth- or fifth-year sales of $25 million to $50 million. Anyone who can boot Excel can achieve these theoretical results.

However, financial projections, which investors require, are a significant part of a business plan. Generally, they want five years of projections to help them understand the scale of your business, determine how much capital you'll require, and consider the assumptions inherent in your business model. Here is how four leading venture capitalists describe what they look for in financial projections.

HEIDI ROIZEN (MOBIUS VENTURE CAPITAL): "I like to see detailed monthly numbers for the whole use of the round of capital in question, then quarterly for the year after that, then annual through profitability, which I realize are fantasy but I want to understand the assumptions the entrepreneur is using to get to total market, total share they will get, and what it will cost to get there."

MIKE MORITZ (SEQUOIA CAPITAL): "No projections ever come true, so entrepreneurs should forget about trying to assemble a compendious set of financials. An early-stage venture capital investor really just wants to gauge how much money is going to be required until the company can support itself from its own cash flow. We always focus on the first eighteen months to two years on the assumption that if we can weather this period we will be in far better shape to deal with what comes after. We like a few well-thought-out projections (by quarter for the first two years and annually for years 3, 4, and 5) that present a profit-and-loss statement, a balance sheet, and cash flow projections."

GARY SHAFFER (MORGENTHALER VENTURES): "Five years is typical, despite the typical lack of credibility of the further-out years. A shorter time frame, like three years, may be fine for raw startups. As a rule of thumb, investors are typically looking for a forecast that goes out to whatever year is necessary for the company to get to 'significant' revenues. And if that's more than five years, that might be appropriate. That helps bracket how much cash will be required to finance the company to profitability, which is something investors always want to have a rough idea about."

STEVE JURVETSON (DRAPER, FISHER, JURVETSON): "Every business plan has financial projections that start low and shoot up to absurdly high profit forecasts for the third year. We typically discount these projections, but the forecast is useful to show optimism and growth potential. What's more important than the projection, however, are the assumptions used to reach the conclusions: the business model, the market size, the pricing, channels and resulting gross margins, and the capital intensity needed to fund growth. Ultimately, we want to fund entrepreneurs who want to change the world, and to initiate those discussions, a half-page of five-year financial projections coupled with a thoughtful discussion of the key drivers should suffice."

WRITE DELIBERATE, ACT EMERGENT

In *The Innovator's Solution* coauthors Clayton Christensen and Michael E. Raynor explain the difference between a "deliberate strategy-making process" and an "emergent strategy-making process." The

former is "conscious and analytical," featuring rigorous use of historical data, technology road maps, and competitive analysis. It is useful for mature companies with operating histories.*

By contrast, an emergent strategy-making process is influenced by the day-to-day realities experienced by middle managers and workers on the front line. It is ad hoc and can react quickly to problems and opportunities. This is the right process to use in situations where the future is murky, and it's therefore difficult to develop suitable strategies. + It is appropriate for startups, and for startups within mature companies.

Here's the dirty little secret of business plans for startups: You should write them in the "deliberate" style, but you should be thinking and acting in the "emergent" style. Investors want deliberate plans because they want to invest in companies that supposedly know what they are doing. Most of them will not find "we'll react fast" to be a palatable strategy.

You and I both know that you don't know when your product or service will ship, who will buy it, how much they will pay, and if they'll ever reorder it, but you can't state this in a business plan. So write as if you know exactly what the future holds, but react opportunistically when you encounter reality.

Rest assured that many successful organizations have changed their business models along the way. This means you have to conserve your capital so you have money to make it through the changes (hence Chapter 5 on bootstrapping later in this book), and you have to be willing to alter your plans.

The worst thing to do is to write a deliberate plan and then stick to it simply because it is "the plan." If you're successful, no one will care if you didn't follow the plan. And shame on you if you fail but you did.

*Clayton Christensen and Michael E. Raynor, *The Innovator's Solution* (Boston: Harvard Business School Press, 2003), 214.
†Ibid., 215

FAQ

Q. Won't my business plan look pretty much like everyone else's?

A. This depends on what you mean by "look like everyone else's." In one sense, it *should* look like other plans. That is, it should contain the essential topics mentioned earlier in this chapter. Furthermore, it should not have an unusual layout, design, or binding—much less your color picture on the cover. Arial font for headings and Palatino font for text are just fine.

Q. OK, then how do I make my plan stand out?

A. There are four ways to make your plan stand out. First, have a credible referral source bring it to the attention of the reader. Second, provide a list of customers the reader can call to discuss how much they need your product or service—or, even better, how much they are *already* using your product or service. Third, ensure that the plan is infused with real-world knowledge about and experience with the market. Fourth, include diagrams and graphics to explain complex points.

Q. Is it better to write the plan myself or use a consultant? How about a consultant just for the financial model?

A. You, or your team and you, should write the entire plan, including building the financial model. As I mentioned above, the most important outcome of the business plan process is getting the founding team, no pun intended, on the same page. If you abdicate any part of the process, you're making a big mistake. After you write the plan, you can use a consultant to review what you've done.

Q. How often should I review the business plan?

A. The usefulness of a business plan rapidly declines after the first six months or so. Initially, a business plan gets the team on the same page, helps get new employees up to speed, and raises money.

However, from the second year on, you won't be writing emergent plans. At that point, your business plan will be deliberate: focusing on budgeting and forecasting with quick summarizations of goals (what) and strategies (how).

RECOMMENDED READING

Christensen, Clayton, and Micriael E. Raynor. *The Innovator's Solution: Creating and Sustaining Successful Growth.* Boston: Harvard Business School Press, 2003

Nesheim, John. *High Tech Startup: The Complete Handbook for Creating Successful New High-Tech Companies.* New York: Free Press, 2000.

Trout, Jack. *The Power of Simplicity: A Management Guide to Cutting Through the Nonsense and Doing Things Right.* New York: McGraw-Hill, 1999.

Activation

CHAPTER 5

The Art of Bootstrapping

It's all right to aim high if you have plenty of ammunition.
—Hawley R. Everhart

GIST

Bill Reichert, a managing director of Garage, likes to tell entrepreneurs that the odds of raising venture capital are equal to the odds of getting struck by lightning while standing on the bottom of a swimming pool on a sunny day. He's exaggerating. The odds aren't that good.

Most entrepreneurs have to dig, scratch, and claw out a business while living on soy sauce and rice. This chapter explains how to survive the critical, capital-deprived early days of any startup's existence by picking the right business model, making cash king, immediately getting to market, and taking the "red pill."

Incidentally, some people think that a bootstrappable business must by its very nature be a trivial one—that is, if you keep capital requirements low and can't raise wheelbarrows full of venture capital, you've limited yourself to something small. They are wrong. Companies such as Hewlett-Packard, Dell, Microsoft, Apple, and eBay all started with a bootstrap model.

If you plan carefully, bootstrapping will only be a stage in your business's development. It doesn't have to be your permanent lifestyle—because after a while, soy sauce and rice do get boring. But for the time being, think big and start small.

MANAGE FOR CASH FLOW, NOT PROFITABILITY

*In the early days of*The New Yorker, *the offices were so small and sparsely furnished that Dorothy Parker preferred to spend her days at a nearby coffee shop. One day, the editor found her sitting there.*

"Why aren't you upstairs, working?" demanded Harold Ross.

"Someone was using the pencil," Mrs. Parker explained. *

Entrepreneurs can bootstrap almost any business—especially if they have no choice in the matter. I may never be invited to speak at a business school again for saying so, but a bootstrappable business model means managing for cash flow, not "paper" profits, growth, market share, or branding.

A bootstrappable business model has many of the following characteristics:

- low up-front capital requirements
- short (under a month) sales cycles
- short (under a month) payment terms
- recurring revenue
- word-of-mouth advertising

On the revenue side, managing for cash flow means passing up sales that are profitable but take a long time to collect. On the expense side, it means stretching out payments for everything you buy.

On paper, your organization will appear to be less profitable—primarily because of the foregone sales. However, paper profits are a secondary consideration for a bootstrapper.

*Peter Hay, *The Book of Business Anecdotes* (New York: Wings Books, 1988), 149.

These requirements point to products, services, and target markets with the following characteristics:

- People already know, or it becomes immediately obvious, that they need your product or service. You don't have to educate your potential customers about their pain.
- Your product or service is "auto-persuasive." * That is, once people recognize their pain and how you solve it, they can persuade themselves to take the next step and buy what you're offering.
- 8 A megatrend tsunami of a market is breaking down barriers for you. The Internet was an example of this. (Realize, however, that every wave eventually runs out of energy, so you must have a "real business" by the time that happens.)
- You can piggyback on a product or service that already has a large installed base. You reduce risk by betting on another product or service that is already successful.

Managing for cash flow, not profitability, isn't a long-term practice, but until you are sitting on a pile of cash, it's the way to go for a bootstrapper.

BUILD A BOTTOM-UP FORECAST

No bootstrapper in his right mind would do a top-down forecast by calculating how much of a market one needs to be successful. This is the kind of model that typically starts with a large number and works down to extrapolate projected sales from that figure. For example, let's say you're starting a company to sell Internet access in China. Here's a typical top-down model:

- There are 1.3 billion people.
- 1 percent want Internet access.
- We'll get 10 percent of that potential audience.

"Michael Schrage, "Letting Buyers Sell Themselves," *Technology Review* (October 2003): 17.

- Each account will yield $240 per year.
- 1.3 billion people X 1% addressable market X 10% success rate x $240/customer = $312 million. And—added bonus!—look at how conservative these percentages are!

If you pick a big enough market, it's easy to fool yourself into thinking success won't be hard to achieve. One percent, for example, always seems like a small, easily attained market share.

Bootstrappers don't build top-down models. For them, top down = belly up! Instead, they build bottom-up models, starting with real-world variables such as

- Each salesperson can make ten phone sales calls a day that get through to a prospect.
- There are 240 working days per year.
- Five percent of the sales calls will convert within six months.
- Each successful sale will bring in $240 worth of business.
- We can bring on board five salespeople.
- Ten calls/day X 240 days/year x 5% success rate x $240/sale X 5 salespeople = $144,000 in sales in the first year.

You can argue as much as you like about the precise number of calls per day, success rate, average sale, etc.; the point here is that a bottom-up model yields a much more realistic forecast than even the most pessimistic market share estimates of a consultant's forecast about the total size of a market.

The magnitude of your bottom-up forecast will establish the degree of bootstrapping you'll have to do. The only information that will point out the need for bootstrapping more accurately is looking at your bank account balance.

SHIP, THEN TEST

If you're starting a biotech or medical device company, ignore this section. All others, read on. One of the hallmarks of bootstrapping is to get your product or service immediately to market. Think this way:

Ship, fix, ship, fix, ship, fix, ship . . . instead of fix, fix, fix, ship. Admittedly, there are pros and cons to this philosophy.

PROS

- immediate cash flow
- real-world feedback

CONS

- tarnished image if there are quality problems

Because a tarnished image is potentially a big negative, there's always a god-awful tension involved in deciding between shipping and perfecting. Here are some questions to consider as you make this decision:

- Does our product or service, at this stage of development, leapfrog the competition?
- Can we ship it into a geographic area or market segment that is small and isolated, so that potential damage is limited?
- Is there a tolerant and understanding customer or group of customers who are willing to be guinea pigs?
- Does our product or service largely fulfill our vision for making meaning?
- Does it largely fill the needs of our customers?
- Can the current state of our product or service endanger or do harm to the customer?
- Have we already done so much "in vitro" testing that we need to know what the real world thinks?

EXERCISE

I True or false? The first Macintosh (1984) did not have software, hard disks, slots, color, and Ethernet.

You can spend hours discussing these questions with your team. It won't be easy to reach a conclusion, and there is no "right" or "wrong" answer. Another way you can approach this dilemma is to ask yourself, *Would I let my mother or father use the product or service in its current state?* If the answer is yes, ship it.

Another question you could pose is this: *Are we running out of money?* Nothing can focus an organization like the prospect of death.

FORGET THE "PROVEN" TEAM

Experience is the name everyone gives to their mistakes.

—Oscar Wilde

If you're bootstrapping your organization, forget about recruiting the well-known industry veterans and building a dream team. Focus, instead, on affordability—that is, inexperienced young people with bushels of raw talent and energy.

This will initially reduce the prospects of raising venture capital, but standing on the bottom of a swimming pool isn't that enjoyable anyway. Besides, the following table shows how easy it is to build a case for unproven people.

	PROVEN PEOPLE	UNPROVEN PEOPLE
Salary	High, but you don't always get what you paid for	Low, and you almost always get at least what you paid for
Perks	Secretaries, nice hotels, first-class travel, limos, and top-of-the-line equipment	Self-service, motels, coach class, car pools, and equipment bought at auctions
Energy Level	Still high, ideally	Controllable, ideally
Knowledge	Don't admit what they don't know, but you assume they know everything	Don't know what they don't know, so they're willing to try anything

Of these factors, the last one is the most important: Ignorance is not only bliss, it's empowering. Back in the eighties (when I was young), I didn't know how hard it would be to evangelize a new operating system, so when Apple offered me a job, I jumped at it—it was like being paid to go to Disneyland. Post-Macintosh, I know how hard it is, and I would never try to do it again. Had I not been empowered by ignorance of the "impossibility" of my task, I would never have attempted it.

EXERCISE

Go on the Internet and investigate the backgrounds of the following entrepreneurs:

Bill Gates
Steve Jobs
Michael Dell
Pierre Omidyar
Jerry Yang
David Filo
Larry Page
Sergei Brin
Oprah Winfrey
Anita Roddick

You will see that "on paper," none of them had the "right" background to create a multibillion-dollar company.

START AS A SERVICE BUSINESS

One of the advantages of a service business is that cash starts flowing immediately. The classic example of this form of bootstrapping is a software company. The fairy tale goes like this:

- Some programmers get together to provide services to a niche market. They operate as consultants—getting down and dirty with the client. Billing is on an hourly basis and payable within thirty days.
- In the course of providing this service, they develop a software tool for the client. As they add clients, they continue to enhance the tool. Soon, they realize that there are many customers who can use this tool.

- They use the consulting fees from clients to fund further development of the tool. At this point, the consulting practice has grown and provides a steady base of profits.
- They complete development of the tool and try to sell it independent of consulting services. Sales take off. The company stops doing consulting because "there's no leverage in consulting."
- The company goes public, or Microsoft acquires it. The founders buy Porsches, Audis, or Mercedes and live happily ever after.

Another way, slightly grimmer, that companies adopt the service model goes like this:

- A couple of guys have an idea for a software company. They are going to put Oracle, Microsoft, or Symantec out of business.
- They start creating the product. Maybe they raise venture capital. Maybe they raise angel capital. Maybe they just starve.
- For the first time in the history of mankind, development takes longer than the entrepreneurs expected. Also, customers aren't willing to buy the product from two guys in a garage. The company is running out of money.
- To get some cash flowing, the guys decide that they should do some consulting. They take their partially finished product and pound the pavement looking for any business they can find. They rationalize this decision as a positive step because it helps them develop a product that customers truly need.
- Lo and behold, customers really do need their product. The developers complete it and start selling it. Sales take off, and they stop doing consulting because "there's no leverage in consulting."
- The company goes public, or Microsoft acquires it. The founders buy Porsches, Audis, or Mercedes and live happily ever after.

Whether the path your company takes is the fairy tale or the grim fairy tale doesn't really matter, if you pull it off. The message is that starting (or being driven to) a service model is a viable bootstrapping technique.

If you do take this path, however, understand that starting as a service business is a good initial path but isn't always the right long-term strategy. Getting customers to pay for your research and development should be only a temporary strategy for a product-based company.

In the long run, a service business is fundamentally different from a product business. The former is all about slave labor and billable hours or projects. The latter is all about research and development, shipping, and spreading costs over thousands of boxes going out the door.

FOCUS ON FUNCTION, NOT FORM

When spending money, always focus on the function you need, not the form it takes. For example, proper accounting does not mean retaining a big-name firm (form) and then assuming the job will get done (function). What's important is the function, not the form (see the following table).

Service providers are a big part of startup costs, so here are tips on making the right choice when assessing them:

- Select a firm that specializes in the type of work that you require. For example, to review venture capital finance work, you should not hire Uncle Joe the divorce lawyer because he's cheaper, or a Wall Street law firm simply because it has a big name.
- Understand that at times the right decision will be to pay more. Investors, for example, may feel more comfortable dealing with companies that use the "usual" lawyers and accountants who do your type of work.
- Check the references of the individuals who are handling your business—and not just "the firm's." The most powerful reference these providers can have is happy entrepreneurs.
- Negotiate everything. Circa 2004, *everything* is negotiable: rates, payment schedules, and monthly fees. Even in good times, don't be

	FORM	FUNCTION
Legal	Offices around the world for a *Fortune* 500 clientele and box seats at sporting events.	Understanding your legal liabilities, protecting your assets, and facilitating deals.
Accounting	Big-Six status with former clients in jail and walnut walls in conference rooms.	Controlling costs and ensuring fiscally sound operation.
PR	Good-looking account reps who majored in Asian art history and who tell you that you're a great speaker are at the $100,000 press event they planned.	Creating and proselytizing effective positioning and establishing close contacts with the press.
Advertising	A wall full of awards for television commercials and print ads with employees who do nothing but buy media.	Understanding and reaching your customer and getting current customers to attract future customers.
Headhunting	Established reputation for placing the CEOs of publicly traded companies that own private jets.	Hiring great employees who will trade options for salary.

afraid to negotiate—it's part of the game. Many firms, for example, will delay billing until you're funded if you have the chutzpah to ask.

- If you can't stand the person you'll be working with, switch people or switch firms. Life is short, so work with vendors you like.

This logic of focusing on function, not form, applies to almost every element of a startup organization. One of the symbols of the dotcom craze, for example, was the Herman Miller Aeron chair. This was a $700 piece of office equipment that was the de rigueur indicator of cool during the period. It was a terrific chair, but I don't know if it was $700 terrific. The function of a chair, after all, is to support one's butt.

'k EXERCISE

j Go to eBay and search for used Aeron chairs. The more you find, the more it means that entrepreneurs focused on form, not function.

PICK YOUR BATTLES

Whisper the word *commodity* to most entrepreneurs, and you'll send shivers up their spines. The term has come to mean the process by which a product that was once unique and proprietary and that commanded high margins has become commonplace, standardized, and cheap.

However, bootstrapping startups love it when products become commodities, because their cost of goods sold decreases. For example, Neoteris, the Sunnyvale, California, provider of networking security devices, sells its product for $10,000. The cost of parts is only $2,000.*

If Neoteris were to design and manufacture the parts for its product, the cost and risks would be much greater. By buying off-the-shelf parts from larger businesses, the company is tapping into the resources of industry giants such as Intel.

Bootstrappers pick their battles. The battle for Neoteris, and where it makes its money, is in writing software—not designing and manufacturing chips or hard disks. Don't try to make money doing the things anyone can do. Make money from your magic:

- What is the crucial "magic" that we're creating?
- Are customers buying from us because of the "parts" in our product or service—or because of how we integrate them to create a solution?
- How can we tap into the efforts of other organizations to get to market better, faster, and cheaper?
- How many processes can we do well? Are there other organizations that can do them better for us?

GO DIRECT

Many startup organizations try to implement a multiple-tiered distribution system. That is, the company sells to a reseller, who then sells

*Om Malik, "The Rise of the Instant Company," *Business 2.0* (December 2003): 99.

to the final user of the product or service. The thinking here is that an established reseller/consultant/distributor brings the benefits of a sales force, brand awareness, and preexisting customer relationships.

That's the theory, anyway. It usually breaks down because most resellers want to fill demand, not create it. They're not interested in helping you establish a market—they simply want to tap into a proven one. Marxist (Groucho) as this may seem, you wouldn't want any reseller that would have you.

There are three additional issues to be weighed when considering a multiple-tiered distribution system. First, it isolates you from your customer. With a new product or service, you need to hear what's wrong and what's right as soon as possible and as unfiltered as possible. Second, because there's much less profit margin, you need to generate a large volume of sales, and it's usually difficult to achieve large volume as a startup. Finally, it takes a long time to both set up a distribution system and get your product through the system into the hands of customers.

For all these reasons, sell directly to customers. Once you've debugged your product or service and established sales, use resellers to accelerate, expand, or supplement your efforts. But do not think that resellers can establish your product or service for you or provide the quality feedback you'd get from selling to customers on your own.

POSITION AGAINST THE LEADER

Seth Godin, the author of *The Bootstrapper's Bible,* makes a strong case for positioning against the market leader or against accepted ways of doing things as a valuable bootstrapping technique. Rather than trying to establish your product or service from the ground up, you utilize the existing brand awareness of the competition.

Consider these examples of how you can do it:

- Lexus: "As good as a Mercedes or BMW, but 30 percent cheaper"
- Southwest Airlines: "As cheap as driving"
- 7UP: "The Uncola"
- Avis: "We try harder" (than Hertz)

Positioning against the leaders or standard ways of doing business can save lots of marketing, PR, promotion, and advertising dollars, so pick the "gold standard" in your industry and isolate an important point of differentiation in your own product, such as

- cost
- ease of use
- convenience
- industrial design
- reliability
- speed/performance
- range of selection
- customer service
- geographic location

By spending millions of dollars and years of effort to establish its brand, your competition has done you a terrific favor—all you have to do is positioned against it. There is a catch, though, because successful positioning against a leader requires three conditions:

- The leader is, and remains, worth positioning against. Imagine, for example, if you had positioned your company against Enron when Enron was the darling of Wall Street.
- The leader doesn't get its act together and erode your advantage—for example, if you position your computet as faster than IBM's and then IBM quickly responds with an announcement of a radically faster model.
- Your product or service surpasses the competition's in truthful, perceptible, and meaningful ways. If not, no one will care about your hype. Worse, you'll lose your credibility, and credibility is hard to regain.

Still, for the near term, this can be a useful technique to enable you to explain what you do on a low budget.

TAKE THE "RED PILL"

This is your last chance. After this, there is no turning back. You take the blue pill—the story ends, you wake up in your bed and believe whatever you want to believe. You take the red pill—you stay in Wonderland and I show you how deep the rabbit hole goes.

—*The Matrix,* 1999

In *The Matrix* Neo chooses the red pill, which brings him face to face with the harsh realities of the world. If he had taken the blue pill, he could have lived in the comfortable fantasy of the Matrix.

The leaders of new organizations face the same choice: reality or fantasy. The choice is as simple as Neo's. If you want to be a successful bootstrapper, you have to take the red pill and determine how deep the rabbit hole called your organization goes. If you are serious about staying in touch with reality, these are the ten most important questions you can ask:

1. When is your product or service going to be ready for market?
2. What are your true, fully loaded costs of operations?
3. When will you run out of money?
4. How much of your sales pipeline is going to convert?
5. How much of your account receivables is collectible?
6. What can your competition's product or service do that yours can't?
7. Who are your nonperforming employees?
8. Are you doing all you can to maximize shareholder value?
9. What is your organization doing to change the world and make meaning?
10. How good are you as the leader of the organization?

GET A MORPHEUS

Every drug, even truth, needs a delivery system. In *The Matrix,* it was Morpheus, the character played by Laurence Fishburne. Who is Morpheus in your organization?

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If you don't have one, you need to get one. Typically, your Morpheus is a chief financial officer, chief operations officer, controller, or accountant.

- The adult doesn't need to be a grump, but simply someone knowledgeable about the real-world operation of an organization. The person's role isn't "naysayer" but "realist."
- As such, this person is the yin to the CEO's yang. The CEO decides "what," while this person decides "how" and "why not." Their relationship is not an opposition but a counterbalance.
- Morpheus should have at least ten years of operating experience. A background primarily as a consultant, auditor, banker, journalist, or analyst is a bad idea because it's easy to "advise" but hard "to do." The single best question to determine if a person's background is adequate is "Have you ever fired or laid off someone?" If the answer is no, keep looking.

In actuality, your Morpheus may not wind up being a single person. During different phases and for different tasks, the Morpheus role may shift around, with

- a research-and-design Morpheus to tell you that what you're creating is flawed
- an operations Morpheus to tell you that your systems can't handle the business
- a finance Morpheus to tell you that you're spending too much (or too little) money
- an ethics Morpheus to tell you that you're inculcating the wrong values

Each organization has a need for a different kind of Morpheus, but all organizations need at least one of them to deliver the red pill, when necessary.

UNDERSTAFF AND OUTSOURCE

There's an age-old question that all CEOs face: Which is worse—to leave money on the table because you can't handle all the business, or to lay people off because you overestimated revenues? The thought of leaving money on the table makes my ears ring, but laying off people is worse.

At its peak, the headcount of Garage was fifty-two people. After a series of layoffs, I reduced the head count to under ten people. Sure, almost everyone at the time thought that the technology market was going "to infinity and beyond" (as Buzz Lightyear would say), so we weren't alone in ramping up the staff.

I made a mistake, though; CEOs are paid to do the right thing, not the same thing as everyone else. Overstaffing causes a wicked web of problems. Dealing with it is not simply a matter of lowering head count, as you'll have to face the issues of

- excess space locked in a long-term lease
- excess furniture and computers
- trauma in the organization as people are let go
- trauma in the lives of the people who are let go
- trying to hire different kinds of people (for your new reality) in the midst of letting others go
- going through gyrations to convince the world that you're not imploding

There's a short-term solution to understafnng, and that's to outsource as many functions as you can. Don't outsource strategic functions such as research and development,* marketing, and sales. But there's

Tve heard the arguments about why companies should do their software programming in Russia and India. Maybe this is a good strategy when the programming is just spitting out lines of code, but when you're working on version 1.0 of a product, I disagree. Programming at this stage of a company is more art than contract labor. Leonardo da Vinci surely would not have outsourced the table in *The Last Supper* and focused on the humans—although having read *The Da Vinci Code,* I'm not sure what to believe about him anymore.

little reason to calculate payroll internally when organizations such as PayChex* and ADP can handle this for you.

Do as I say, not as I did. If you want to bootstrap your organization, then intentionally understaff. You may leave some sales on the table, and you may not achieve escape velocity as fast as you'd like. But it sure beats laying people off or running out of money.

BUILD A BOARD

Many entrepreneurs believe that a board of directors is appropriate only for organizations that have raised boatloads of money and are fairly far along. According to this theory, until then, these organizations should make do with no board or with a board of only the internal team members.

This reasoning is wrong on several counts. First, good guidance is always valuable. The need for it is not dependent on the stage of the organization or the amount of capital it has raised.

Second, money, or the amount of capital you've raised, is not the only factor that can attract high-quality board members. Other factors include the innovativeness of your product or service, the meaning you're going to make, and your personality.

Building a board of high-quality directors—just as assembling a great team—without funding is solid testimony to your product or service and your evangelism skills. Plus, a great board will help you get money as much as money will help you get a great board.

SWEAT THE BIG STUFF

Bootstrapping goes awry when entrepreneurs focus on saving pennies to the detriment of the Big Picture. The reason for starting an organization is not to build desks out of sawhorses and doors—nor is it to

"Plus, the Buffalo Sabres need all the help they can get.

QC:

make Herman Miller a bigger company. Here is a list of the usual big stuff and small stuff entrepreneurs must manage.

SMALL STUFF

- office space
- furniture
- computers
- office equipment
- office supplies
- business cards and letterhead

BIG STUFF

- developing your product or service
- selling your product or service
- collecting the money for your product or service

Whenever you can do so reasonably, do the small stuff cheap and don't waste money on the accoutrements. Rick Sklarin, a former Accenture consultant, puts it this way: "Make one trip to Costco and be done with it." Do sweat the big stuff, however—but there isn't that much big stuff.

EXERCISE

The next time there's something that you "can't live without," wait for a week and then see if you're still alive.

EXECUTE

A friend at Stanford University, ex-Sun Microsystems, George Grigoryev, pointed out to me that the real enemy of bootstrapping isn't spending—it's failing to execute. If bootstrapping is all it took to succeed, every organization in the world would be using sawhorses and wooden doors for desks. Just because you're cheap doesn't mean

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you're effective. For this reason, here are the recommendations that George and I came up with about the art of executing.

- **SET AND COMMUNICATE GOALS.** The simple act of setting goals and communicating them increases the likelihood that your organization will achieve them. It gets everyone on the same page and provides a day-to-day guide for what employees need to do. This applies to every task: finalizing specifications, building a prototype, signing up early customers, shipping, collecting, recruiting, finishing marketing materials . . . the list is endless.
- **MEASURE PROGRESS.** Goals only work if you measure progress. As the old saying goes, "What gets measured gets done." This also means you'd better pick the right goals, or the wrong things will get done. In a startup, you should measure and report results every thirty days. As your organization gets older and more deliberate, you can shift to a quarterly schedule.
- **ESTABLISH A SINGLE POINT OF ACCOUNTABILITY.** If it takes more than ten seconds to figure out who is responsible for achieving a goal, something is wrong. Good people accept accountability. Great people ask for it. For the good of your entire organization, establish it. A person who knows he is being measured and held accountable is highly motivated to succeed.
- **REWARD THE ACHIEVERS.** The people you reward in a startup are the ones who deliver. You can use options, money, public praise, days off, or free lunches—it doesn't matter. What does matter is that you recognize achievers—and only achievers, not the people who are along for the ride.
- **FOLLOW THROUGH UNTIL AN ISSUE IS DONE OR IRRELEVANT.** We all like to work on the newest, hottest stuff. It's human nature. Who wouldn't rather be involved with the next breakthrough product rather than fixing the current one? Don't stop when something simply gets boring. Fixing bugs may be boring to you, but it's not to the customer who recently bought your product.

- **HEED MORPHEUS.** Realism is the ally of execution, so pay attention to what your Morpheus says. Everyone in a given company is in denial about something. Some denial is good for an entrepreneur—for example, denying that the "experts" are right when they say you can't succeed. The critical issue is whether the denial is ultimately going to hurt the organization. Insist on realism, and your organization will bootstrap better.

- **ESTABLISH A CULTURE OF EXECUTION.** Execution is not a one-time event. Nor is it a process where you check off goals as if your sixth-grade teacher were looking over your shoulder. Rather, execution is a culture that produces a set of organizationwide habits. The only way to establish this culture is for the CEO to set the right example: answering inquiries, solving problems, and promoting people who deliver results. This sends an unmistakable message: Execution counts in this organization.

FAQ

Q. How do I know when bootstrapping has taken us as far as we can go?

A. This is a seemingly logical question, but it will seldom come up in a real-world situation. If you're bootstrapping merrily along, you'll eventually be able to fund new efforts. More likely, the question you'll face will be, "What would I do if I had more capital?"

Q. Will I forsake growth—and maybe even success—if I bootstrap too much?

A. I can't come up with a single example of an organization that bootstrapped too much. There's greater danger of blowing an opportunity because of too much money than because of too little. Negatively stated, think of venture capital as steroids: It might give you an immediate advantage, but it could kill you.

0. If I can successfully bootstrap an organization, do I even have to look for outside capital? What's wrong with doing it the old-fashioned way?

A. Respectively, no and nothing. Outside capital isn't the only way—it's simply one way. The goal is to build something great, no matter how you raise capital.

Q. If we don't have several million dollars in venture capital funding, will we not be taken seriously?

A. Only by people who don't matter. If you do raise this kind of money, use it to add to your credibility, but don't believe that it will guarantee your success. If you don't raise this kind of money, don't sweat it. Just build a great business and don't look back.

Q. With your emphasis on execution, what do I do if someone doesn't execute? Should I simply fire the person?

A. It's not that simple. Find the real reason that a person failed to execute. There may be problems that were out of his control. Isolate those problems and fix what you can. A good rule of thumb is to give the person the same "due process" that you'd like your board of directors to give you. When due process is exhausted, make the cut, and make it quickly and decisively.

RECOMMENDED READING

Godin, Seth. *The Bootstrapper's Bible: How to Start and Build a Business with a Great Idea and (Almost) No Money.* Chicago: Upstart Publishing, 1998.

Hess, Kenneth L. *Bootstrapping: Lessons Learned Building a Successful Company from Scratch.* Carmel, CA: S-Curve Press, 2001.

CHAPTER 6

The Art of Recruiting

It is essential to employ, trust, and reward those whose perspective, ability, and judgment are radically different from yours. It is also rare, for it requires uncommon humility, tolerance, and wisdom.

—Dee W. Hock

GIST

There are few tasks that face an entrepreneur that are more enjoyable than recruiting employees to a hot startup. What could be better than finding people to help change the world? And there are few factors that are more critical to the success of a startup than good people.

Good recruiting starts at the top: CEOs must recruit the best people they can find. Next, good recruiting requires looking beyond superficialities such as race, creed, color, education, and work experience. Instead, you should focus on three factors:

1. Can the candidate do what you need?
2. Does the candidate believe in the meaning you're going to make?
3. Does the candidate have the strengths you need (as opposed to lacking the weaknesses you're trying to avoid)?

If candidates pass these tests, then go get them, but in a smart way—by using all your weapons, negotiating at the right moment, and double-checking your intuitions.

After they're on board, you should define a honeymoon period during which both parties can analyze whether things are working out. Finally, as a philosophical framework, make the effort to "recruit" your employees every day—to make sure they want to come back the next day.

HIRE "A" PLAYERS

I start with the premise that the function of leadership is to produce more leaders, not more followers.

—Ralph Nader

Steve Jobs has a saying that A players hire A players; B players hire C players; and C players hire D players. It doesn't take long to get to Z players. This trickle-down effect causes bozo explosions in companies.

If there is one thing a CEO must do, it's hire a management team that is better than he is. If there is one thing a management team must do, it's hire employees who are better than it is. For this to happen, the CEO (and management team) must possess two qualities. The first is the humility to admit that some people can perform a function better than they can. Second, after making this admission, they need the self-confidence to recruit these people.

Admittedly, urging managers to hire A players is hardly a revelation, and yet many organizations are filled with bozos. This happens because most people don't heed this principle and because it is so difficult to filter out bozos. I can't force you to take this advice, but I can provide five ways to avoid hiring the wrong people:

- **DON'T CONFUSE CORRELATION AND CAUSATION.** A candidate may have worked at an organization when it achieved success; this doesn't necessarily mean he contributed to the success. He could have just been along for the ride. The rising tide floats all boats.

To separate the eagles from the dodos, find out what specific projects the candidate managed and analyze his results. Also, try to find someone inside the company who worked with the person to see if the candidate caused or correlated.

DON'T CONFUSE BIG-ORGANIZATION SKILLS WITH NEW-ORGANIZATION SKILLS. Success in a big organization doesn't guarantee success in a startup. The skills needed in each context are different. A vice president of Microsoft (with its established brand, infinite resources, and 100 percent market share) may not be the right person for a "two guys in a garage" operation.

BIG ORGANIZATION SKILLS	STARTUP SKILLS
Sucking up to the boss	Being the boss
Generating paper profits	Generating cash flow
Beating charges of monopoly	Establishing a beachhead
Evolving products and services	Creating products and services
Market research	Shipping
Squeezing the distribution channel	Establishing a distribution channel

- **DRAMATIZE YOUR EXPECTATIONS.** Make it crystal clear that working in a startup is different from what they might be used to in their previous organization: "Can you function without a secretary, fly coach, and stay in cheap motels?" You might scare off a few desirable candidates this way, but it's worth risking this to aVoid ending up with people who cannot function in a startup atmosphere.

READ THE TEA LEAVES WHEN CHECKING REFERENCES. Because the laws in the United States prevent providing job references that may damage a candidate's ability to get a job, whenever you don't get a reference that's superlative, you are in effect getting a negative one. If the reference sends you to the human resources de-

partment, then you know the candidate had problems. (See the end of this chapter for more on reference checking.)

- **TRUST THE RICHEST VEIN.** Your current employees are the richest resource for finding great people and for preventing a bozo explosion at your organization. If your employees aren't motivated to bring in good staff, who is? If there's a close call between two candidates, and one is known by an employee, you should usually take that one.

Many entrepreneurs don't realize this, but startups need three kinds of A players: first, *kamikazes* who are willing to work eighty hours a week to achieve success; second, implementers who come in behind the first group and turn its work into infrastructure; third, operators who are perfectly happy running the infrastructure.

Thus, good hires should not only be better than the CEO and management team, they should also be different from them. Startups need people with diverse skills that complement, not overlap, each other. For example, a geek CEO should hire someone who has sales skills—not another engineer to handle sales.

HIRE "INFECTED" PEOPLE

It's not enough that candidates are good and different; they must also believe that your organization can change the world. They must be infected with enthusiasm for what you do. Working in a startup isn't easy: Salaries aren't as high as elsewhere, benefits aren't as generous, and there's always the risk of running out of money. Therefore, belief in what you're doing is as important as competence and experience. It's often easier to teach an infected candidate how to do a job than to teach an agnostic (or atheist) how to believe.

I recommend taking a chance with any reasonably qualified candidate who already believes in your meaning. This means that the person is a user of your product or service. For that reason your customer base is the most fertile ground for recruiting. For example, someone who loved using a Macintosh made a good candidate for Apple.

If the candidate isn't coming to you as a proven believer, then use these techniques to determine if he "gets it."

- Ask the candidate to demonstrate your product or service. (Companies with crappy products, though, run the risk of losing candidates this way.) Someone who truly loves a product or service will be able to present it to its advantage.
- Measure the amount of time the candidate talks about compensation, benefits, and perks versus your product or service. This provides a good approximation of whether the candidate views the position as a way to make money or to make meaning.
- Analyze the candidate's questions: Are they built on a strong foundation of knowledge about your organization? Or, is the candidate trying to figure out the basics—what you do, who your customer is, and who your competition is?

IGNORE THE IRRELEVANT

There is a shortage of A players in this world. Therefore, it's stupid (not to mention illegal) to make recruiting decisions based on gender, race, religion, sexual orientation, or age. Why reduce the gene pool by taking a limited view?

Your goal, remember, is to make meaning and change the world. Many people put too much emphasis on the experience and backgrounds of candidates. To misquote George Orwell, ignoring is bliss.

It sometimes pays to ignore the lack of the perfect and relevant background, while at other times it pays to ignore the presence of the perfect and relevant background. Both can ultimately be irrelevant.

- **EXPERIENCE IN A BIG, SUCCESSFUL ORGANIZATION.** As we discussed earlier, a big-organization pedigree is not necessarily a reliable predictor of success in a startup environment. These pedigrees might be good for fundraising, but there's scant room for window dressing in a startup. The relevant question, again, is, "Did the candidate help create the success, or was he along for the ride?"
- **EXPERIENCE IN A FAILED ORGANIZATION.** This is the flip side of experience in a big, successful organization. Many factors could have caused the failure of an organization—perhaps the candidate was one[1] of them. Or perhaps not. Failure, however, is usually a better teacher than success. The candidate to avoid, though, is one who has a consistent history of working for failures.
- **EDUCATIONAL BACKGROUND.** You want smart people, not necessarily "degreed" people. The two are not the same. Steve Jobs never finished Reed College. Steve Case, the founder of AOL, went to Punahou.* Half the engineers of the Macintosh Division of Apple didn't complete college. I dropped out of law school, and Stanford Business School rejected me.
- **EXPERIENCE IN THE SAME INDUSTRY.** Industry experience is a double-edged sword. On the one hand, understanding the industry lingo and possessing preexisting relationships are helpful. On the other hand, a candidate who is stuck in his way of thinking about an industry ("this is what computer interfaces have always looked like") can be a problem.
- **EXPERIENCE IN THE SAME FUNCTION.** Functional experience is also a double-edged sword. Apple once hired an executive from the tampon business because we thought we needed consumer marketing expertise to sell Macintoshes as a consumer good. However, his experience did not effectively transfer to the computer business. On the other hand, Ford Motor Company built the first assembly line for cars using the expertise of people from meatpacking houses, granaries, and breweries.[1]"

There is one final characteristic that should often be ignored: functional weaknesses. You wouldn't say that one of Steve Jobs's strengths is compassion. Nor is Bill Gates's strength aesthetic design. Should you therefore not hire the next Steve Jobs or Bill Gates because of such weaknesses? There are two theories in hiring people:

§"This is an inside joke for people from Hawaii. Suffice it to say that I went to Iolani.
fAndrew Hargadon, *How Breakthroughs Happen: The Surprising Truth About How Companies Innovate* (Boston: Harvard Business School Press, 2003), 42-43.

- Find the candidate who lacks major weaknesses (but doesn't have major strengths).
- Find the candidate who has major strengths (even though he has major weaknesses).

The first line of reasoning is flawed because everyone has major weaknesses—it's just a matter of finding out precisely what they are over time. Performing well in one area is tough enough; trying to find people who can do everything is Mission: Impossible.

The second line of reasoning is the way to go. A team of people with major and diverse strengths is what your organization needs in the early days when headcount is low, and there's no room for redundancy. High achievers tend to have major weaknesses. People without major weaknesses tend to be mediocre.

j EXERCISE

J Think back about your first few jobs. True or false? f

s_____I was perfectly qualified. f

j_____I am holding candidates up to standards higher than the person who
l hired me used.

USE ALL YOUR TOOLS

As I write this in 2004, it seems silly to worry about recruiting, since people are desperate to get jobs. However, in good times or bad, it is hard to hire the best people, so when you are pursuing them, you have to use all your tools.

Most people think their recruiting tools are limited to salary and equity plus fringe benefits such as insurance and medical care. But there are more incentives at your disposal:

- **YOUR VISION.** For many people, money isn't the most important reward of a job. They will work for less to do more by making meaning and changing the world.
- **YOUR TEAM.** Don't limit the candidate's interviews to his immediate supervisor and co-workers. If you've got a few superstars in other departments, add them to the seduction process.
- YOUR BOARD OF DIRECTORS, ADVISORS, AND INVESTORS. There's likewise something powerful about meeting with these folks. They are usually well known, highly respected, and rich. They can influence candidates to accept your position, so ask them to spend some time with your top candidates.
- **RESUME-BUILDING POTENTIAL.** Let's face it: Few people work for one organization for their entire career. If you can get a few good years out of great people and help them build their resumes, do it. Plus, you never know, they may stick around longer than you anticipated.

Once you decide on a person, don't hold anything back and use all your tools to hire him.

SELL ALL THE DECISION MAKERS

Most people assume that the sole decision maker in a job search is the candidate. Slightly more enlightened people consider the spouse of the candidate, too. However, accepting a position, particularly in a startup organization, is usually even more complex than this.

The decision makers can also include such relations as the children, parents, and friends of the candidate. It's easy to imagine someone asking a parent if he should go to work for a startup and being told, "Don't. It's too risky. Get a job in a nice, safe company that will be around a long time—like Arthur Andersen or Enron."

Therefore, be sure to ask the candidate who all his important decision makers are, and then work with the candidate to answer their concerns, too. However, be aware that some candidates may fear this is a trick question—*If I admit that my parents are part of the process, they'll think I'm a wimp and won't hire me*—so do your best to assure them that the question is a serious one.

You're going to have to do your best to find out who all the decision makers are in order to ensure the best fit for both your organization and the candidate. After you learn who all the decision makers are, sell them, too.

WAIT TO COMPENSATE

Many companies make the mistake of preparing an offer letter too early in the hiring process. They use it as a "strawman"* to get compensation details on paper in order to show how interested they are and to reach closure quickly. This is a big mistake.

An offer letter should come at the end of the recruiting process. It is not a negotiating tool to get the candidate to say yes, but simply a way to confirm a verbal agreement. It's like a marriage proposal: Make it when you know the answer will be yes.

INTERPRET THE LIES

Amy Vernetti, a headhunter at Kindred Partners, came up with this list of the top ten lies of job candidates while she worked at Garage. Study them. They will help you avoid making hiring mistakes.

LIE	TRUTH
"I've got three other offers, so you'd better move quickly."	I've had three other interviews, and no one has flat-out rejected me yet,
"1 was responsible for my company's strategic alliance with Microsoft,"	1 picked up the fax after Bill Gates signed the document.
"I'm leaving my current organization after only a few months because the organization isn't what the CEO told me it was."	1 don't know how to do due diligence on an opportunity.

(continued)

*"A StrawMan has two features: it is easy to knock down, and it is a poor substitute for a real man" (http://c2.com/cgi/wikiPStrawMan).

LIE	TRUTH
"I've never been with a company for more than a year because 1 get bored easily."	It takes people about a year to figure out that I'm a bozo.
"1 didn't really report to anyone at my old company."	No one wanted me in his department.
"Most of my references are personal friends because they know me best."	No one 1 worked for is willing to give me a reference.
"You've never heard of my last three employers because they were in stealth mode."	All the companies 1 worked for imploded.
"I'm no longer with the organization, but i maintain an excellent relationship with people there."	1 was forced to sign a nondisparagement agreement to get my severence package.
"1 am a vice president, but no one reports to me."	Any bozo can become a vice president at my company.
"I'm expecting to at least double my prior compensation package."	1 was overpaid and understand that that 1 may have to take a cash hit for a good opportunity.

DOUBLE-CHECK YOUR INTUITION

According to common wisdom, to make great hires you must learn to trust your intuition about people. You'll frequently encounter two circumstances in recruiting:

- The candidate's education and background aren't quite right. For these reasons, others don't think you should hire him. Your rational side says, *Don't hire him. He doesn't have the right experience,* but your intuition says, *Grab him.*
- The candidate is perfect on paper (education, work experience, etc.), and the rest of your team thinks that you should grab him. Your intuition, however, tells you to pass.

These are both situations when you want to trust what your intuition is telling you. Unfortunately, your intuition is often wrong. Perhaps you liked a candidate, so you softened up on the interview questions and reference checking. Also, you may remember when your intuition proved right and conveniently have forgotten all the times it was wrong. Follow this procedure"' to balance any undue influence from your intuition:

- PREPARE A STRUCTURE FOR THE INTERVIEW BEFOREHAND. You and your team should decide on exactly the attitude, knowledge, personality, and experience that are necessary for the position before you conduct interviews.

- **ASK QUESTIONS ABOUT SPECIFIC JOB SITUATIONS.** For example, ask the following kinds of questions for a vice president of marketing position:

    How did you manage a product introduction?

    How did you determine the feature set of a new product?

    How did you convince engineering to implement these features?

    How did you select your PR firm?

    How did you select your advertising firm?

    How did you handle a crisis such as a faulty product?

- **STICK TO THE SCRIPT.** Minimize spontaneous follow-up questions and making up new questions in real time. If you're afraid that you, and therefore your organization, will appear rigid and standoffish to the candidate, explain that you're using a technique from "this book about startups" that you read and that you're normally not like this.

- DON'T OVERDO OPEN-ENDED, TOUCHY-FEELY QUESTIONS. For example, any half-decent candidate can bluff through questions such as "Why do you want to work for this organization?" More pointed questions are better: "What are the accomplishments you're most proud of?" "What were your biggest failures?" "What was your most gratifying learning experience?"

"Inspired by David G. Meyers, *Intuition: Its Powers and Perils* (New Haven, CT: Yale University Press, 2002), 196.

- **TAKE COPIOUS NOTES.** You'll need these notes to accurately remember what each candidate said. Don't depend on your memory because it will be warped by the passing of time and your subjective reactions to candidates.

- **CHECK REFERENCES EARLY.** Many organizations check references for a candidate to whom they've already decided to make an offer. This is a setup for a self-fulfilling prophecy because you're going to hear, and want to hear, comments that affirm your decision.

    Big mistake. You should use reference-checking as a means to decide whether the candidate is even acceptable, and not as a confirmation of a choice that you've already made. (More on reference checking appears at the end of this chapter.)

After this process, if your intuition is telling you one thing and "the facts" are telling you another, answer these questions:

- Should you like the candidate (because he is well qualified), but you don't?
- Should you not like the candidate (because he is not well qualified), but you do?
- Is there a factual and objective basis for your intuition?
- Would the interview have gone differently if you had conducted it over the phone? Let's not deny that the physical appearance of a person can influence your decision.

After taking all these precautions, follow your intuition. Going with my intuition has served me well in the past (granted, my memory is selective). And I would be a hypocrite to tell you to rely on "just the facts" because Apple hired me—an ex-jewelry-schlepper with a psychology degree—to evangelize the most important product in the company's history.

On paper, I was not even close to being the right person for evangelizing Macintosh to software developers. Somebody's gut reacted positively—or at least not too negatively—to me. Either that or Steve Jobs was out of the office that day.

APPLY THE STANFORD SHOPPING CENTER TEST

There's one more test to apply to a candidate once you're past double-checking your intuition. It's called the Stanford Shopping Center Test, This mall is located in Palo Alto and is close to Menlo Park, Portola Valley, and Woodside—communities populated by entrepreneurs, venture capitalists, and investment bankers. Whenever you shop there, you're bound to see someone from the high-tech business.

A few years ago, I was at the mall when I caught sight of a Macintosh software developer, but he had not yet seen me. I instantly made an abrupt turn in order to avoid having to talk to him because he was a pain in the ass. This experience led me to conceive the Stanford Shopping Center Test.

This is how it works. Suppose you are at a shopping center. You see a candidate (or employee or partner or service provider) before he notices you. At that point, you can do one of three things:

1. Scoot over and say hello.
2. Figure that if you bump into him, fine. If not, that's OK, too.
3. *Get* in your car and go to another shopping center.

No matter what your intuition and a double-check of your intuition tell you, you should only hire and keep people that you'd hustle over to and engage in a conversation. If you find yourself picking option 2 or 3, don't make the hire. Life is too short to work with people you don't naturally like—especially in a young, small organization.

(By the way, if you pick option 2 or 3 for someone currently employed at your organization, either fix the situation or get rid of the person.)

DEFINE AN INITIAL REVIEW PERIOD

Despite your best efforts, your recruiting process (or your intuition) is sometimes wrong, and the new hire does not perform to your expectations. For me, one of the hardest tasks is to admit this mistake and correct it.

However, if there's one thing that's harder than firing someone you don't want around, it's laying off people you want to keep. Rest assured, if you don't make a course correction or terminate people who aren't working out, you increase the probability of having to lay off people who are.

To make this easier on both the organization and the employee (because it's also the right thing for the employee to stop working for the wrong organization), establish an initial review period with incremental milestones. The more concrete the performance objectives, the better. For example, objectives for a salesperson might include

- completion of product training
- completion of sales training
- participation in five sales calls

This period needs to be longer than the hiring afterglow, but shorter than the time it takes for the predominant feeling to become *Why did we hire this person?*

In short, ninety days.

Establish an understanding that after ninety days, there will be a joint review in which both sides discuss what's going right, what's going wrong, and how to improve performance. Some issues will be your fault!

DON'T ASSUME YOU'RE DONE

In 2000 Garage recruited a well-known investment banker from a big-name company. It took weeks of wooing and two rounds of offers and counteroffers as his current employer sweetened his current compensation.

Finally, we landed him. Everything was set to go. He and his family even came to our company BBQ. A few weeks later he started at our firm. He showed up for work for a few days. Then he called in sick for a couple of days. Late one night, I got an e-mail from him saying that he was resigning.

He left Garage to work for a former client of the investment bank. A few months after that, he returned to his original employer. I learned three lessons from this experience:

- We should have checked him out better; perhaps we would have learned that he wasn't suited to a startup.
- Beware of "big-company disease." That is, once someone works for the top-of-the-line, most lucrative, most prestigious firm, it's extremely unlikely that the person is right for a bootstrapping startup.
- Never assume you're done. Recruiting doesn't stop when a candidate accepts your offer, nor when he resigns from his current employer, nor on his last day at his current employer—not even after he starts at your organization.

In actuality, recruiting never stops. Every day is a new contract between a startup and an employee.

MINICHAPTER: THE ART OF REFERENCE CHECKING

You can't build a reputation on what you're going to do.

—Henry Ford

Reference checking is a crucial part of recruiting a great team. However, startups usually do it in a cursory and casual way—usually *after* the company has made a hiring decision. Courtesy of Amy Vernetti, the headhunter for Kindred Partners, here's a short course on reference checking to improve your results.

The goal of referencing is not to disqualify a candidate, but to look for consistency in how the candidate represented himself. You are also looking for clues about whether the candidate can be effective at your organization.

In order to paint a complete picture of a candidate, you should speak with at least two subordinates, two peers, two superiors, and two customers. Investors or board members are also interesting references. ^

These are suggested questions:

- How do you know this person? How long have you known him?
- What are your general impressions of him?
- How would you rank him against others in similar positions?
- What contributions has he made to the organization?
- How do others in the organization view him?
- What are his specific skills? What is he best/worst at?
- What are his communication and management styles?
- In what areas does he need improvement?
- Is he capable of functioning effectively in a small organization?
- How would you comment on his work ethic?
- Would you hire/work for/work with him again?
- Should I speak with anyone else about him?

In addition to following Amy's suggestions about reference checking, you should get unsolicited references from people the candidate did not provide, too. Find someone who knows someone at the company and check out the candidate. You can also cold call into the company and simply ask the operator to connect you to someone who worked with the candidate.

FAQ

Q. When interviewing candidates, should I be honest about our organization's weaknesses as well as our strengths?

A. Let me get this straight: You're wondering if you should lie to candidates knowing that if they take the job, they'll eventually discover that your organization sucks?

Always tell it like it is. Lower their expectations. You'll encounter three types of responses to your candor. Some candidates simply need an explanation of the problems. Go down the list of problems and explain them. Chances are, they just want to know what they're getting into, and you won't scare them off.

Other candidates want the challenge. For them, problems are opportunities. You should consider telling this type, "You're the guy we need to save us. Can you step up and be a hero?"

You will scare off the third kind of candidate. This person probably wasn't well suited to a startup anyway. You've done yourself a favor.

Q. Does it look bad to the outside world if we only have a few employees? Is it better to have six part-time employees rather than three full-time employees, for the sake of numbers?

A. Having six part-time employees for the sake of looking bigger is insane. If you're doing this for other reasons—offering flexible hours to get better people, for example—it's OK. But not for a silly reason like this.

Q. When is the right time to recruit CXO-level people: before or after funding the organization?

A. Many people think that the process of starting an organization is serial: A followed by B, followed by C, etc. It's not that simple. Starting an organization is a parallel process: You do A, B, and C at the same time. The answer to your question is that you're recruiting before, during, and after the funding process.

I caution you, however, against falling into this trap: An investor tells you that he would invest if you had a "world-class" CXO. You take this as a yes, recruit the person, and go back to the investor. Then the investor comes up with a different reason: "Good job. Now show us some customers actually paying for your product." The lesson is this: Don't recruit to make an investor happy. Recruit to build a great organization.

Q. Should I spend money on retainer-based searches or rely on my own capability to attract the best talent?

A. Prior to funding, your job is to use your passion to tap your network to find the right person without paying fees. After funding, use whatever you have to—including retainer-based searches.

a. If asked, should I provide a salary range?

A. No. If you're asked directly, respond by saying something such as, "We will pay what it takes to get a great candidate." Then ask, "What is your current salary level?" This will teach them to ask tough questions.

The beginning of the interview process is too early to start mentioning numbers. Candidates will remember what you said—especially the top end of the range. And whatever number you throw out could affect the candidates' answers in the interviews.

Q. If my goal is to recruit "people more talented than myself," how do I retain control of the venture and avoid getting ousted from my own business?

A. This question says more about you than you probably intended. Your goal shouldn't be to "retain control" and "avoid getting ousted." Your goal should be to build a great organization. There may come a time when you should be ousted. Deal with it. Would you rather have an inferior organization that failed, but that you were in control of until the bitter end?

Q. I'm working with my best friend. Do I really need a legal agreement?

A. Yes, absolutely. Times change, people change, and organizations change. Difficult and inappropriate as it may seem, you must do this. Such a legal agreement may turn out to be the best thing for your friendship and your organization.

Q. What is a reasonable enticement and compensation for a member of my board of directors?

A. The range is usually .25 to .5 percent, but for an absolute superstar, I'd go as high as 1 to 2 percent of the company. If it takes more than this to get the candidate, move on. The person is more interested in making money than in making meaning.

Q. What do you do when you have to fire the partner who conceived the business, brought you in to help run it, trusts you, and is now clearly in over his head?

A. You take him aside and have a private conversation explaining the situation. You offer the person some choices about how to take a smaller role, but you are clear that such a move is necessary. A smaller role can mean taking a different position or serving only on the board of directors or board of advisors. Try to preserve the person's dignity. In most cases, there will be a blowup. Expect that. It might take years to heal your relationship, but that's how it goes.

RECOMMENDED READING

Lewis, Michael. *Moneyball: The Art of Winning an Unfair Game*. Waterville ME: Thorndike Press, 2003.

Meyers, David G. *Intuition: Its Powers and Perils*. New Haven, CT: Yale University Press, 2002.

CHAPTER 7

The Art of Raising Capital

At a presentation I gave recently, the audience's questions were all along the same lines: "How do I get in touch with venture capitalists?" "What percentage of the equity do I have to give them?" No one asked me how to build a business!

—Arthur Rock

GIST

This chapter explains the process of raising capital from outside investors. These investors may be venture capitalists, management, foundations, government entities, or any of the three Fs: friends, fools, and family.

My experience is with the Silicon Valley venture capital industry, a group from which you may never try to get an investment. However, if you can raise capital from a Silicon Valley venture capitalist, you can raise capital from anyone. As the Frank Sinatra song goes, "If I can make it there, I'll make it anywhere."

Skillful pitching, which we covered earlier, is a necessary, but not sufficient, part of raising capital. More important are the realities of your organization: Are you building something meaningful, long-lasting, and valuable to society?