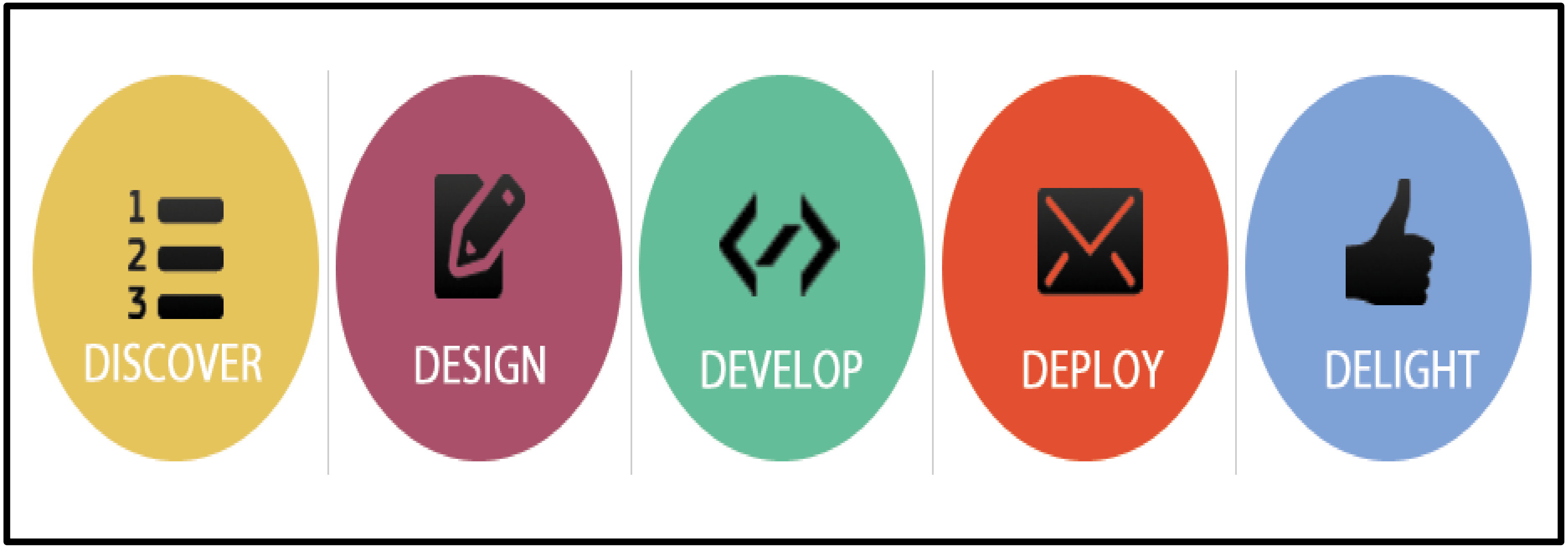
Entrepreneurship
To
Digital Entrepreneurship

Dr. S. K. Majumdar

- **Entrepreneurship has been described as the "capacity and willingness to develop, organize and manage a business venture along with any of its risks in order to make a profit".**

- Business Dictionary

5 Ds of Entrepreneurship



- **An Entrepreneur has to have the ability to Find and Act Upon opportunities (Pain-Points) and Transform the Opportunity into Commercially viable New Products/ Services.**
    - **Entrepreneurs are Solution Providers.**

Adapted from: Audretsch; et al. (2002). "The Economics of Science and Technology". *The Journal of Technology Transfer*. **27** (2): 157. doi:10.1023/A:1014382532639

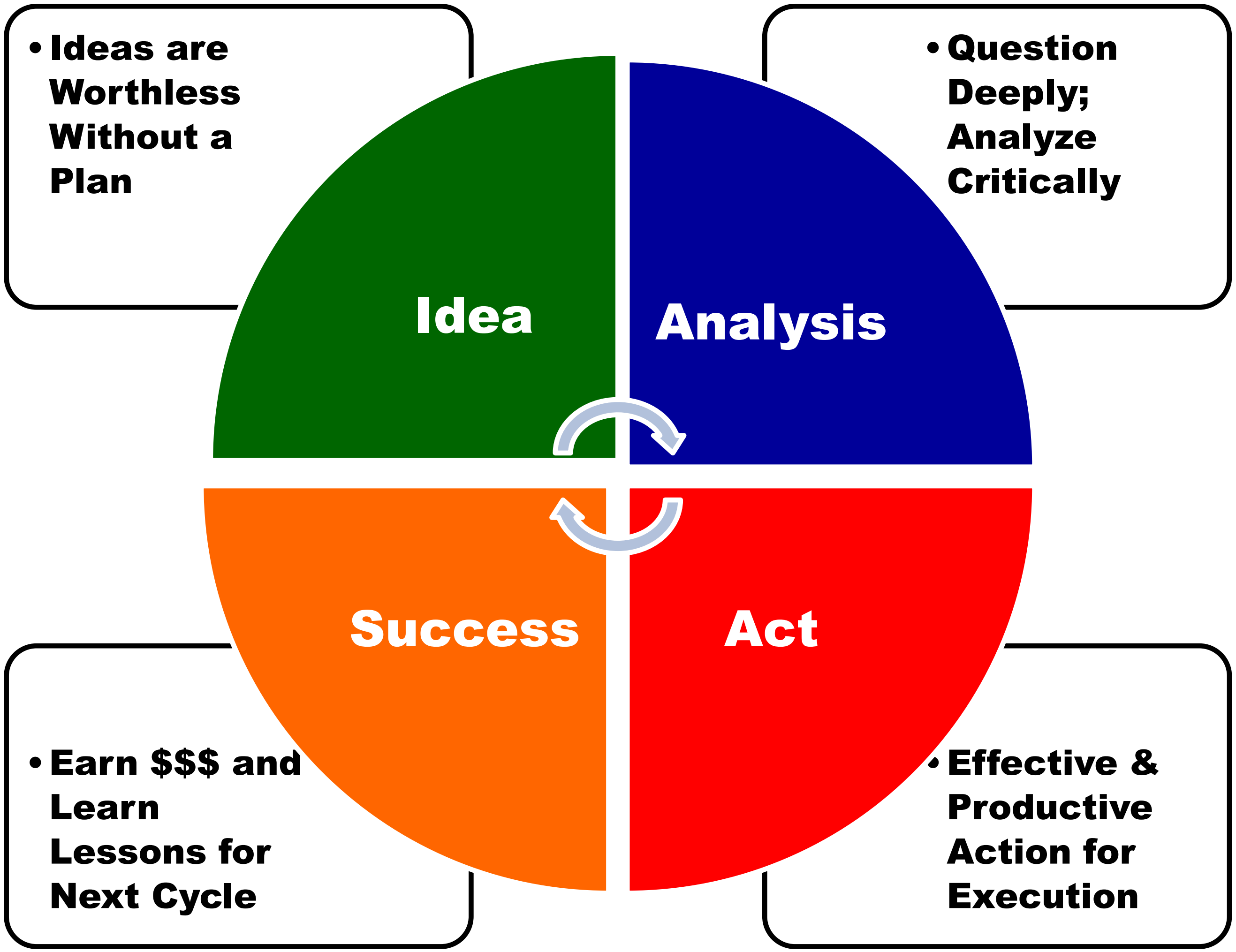
Why Entrepreneurship?

1. **Entrepreneurship can improve standards of living and create wealth, not only for the entrepreneurs but also for related businesses.**
2. **Entrepreneurship spurs innovation - new innovations, particularly radical innovations that spawn entirely new markets make radical changes and create wealth.**
3. **Entrepreneurship creates jobs – new and young businesses, are the engine of net job creation.**
4. **USP of the start-up world is its disruption and diversification capability.**

7 Key Questions of DE:

1. What is the Disruptive Idea?
2. What would be the Mission of the Venture?
3. How to Transform the Idea into Viable Products and Services?
4. How to Fund the Venture?
5. How to Assess the Risks-Return Profile of the Venture?
6. How to Cross the Death Valley?
7. How to Scaleup and Sustain?

Zest 2 Zoom



Source: Dr. S. K. Majumdar

No Set Formula, Except the "Blue Seed"

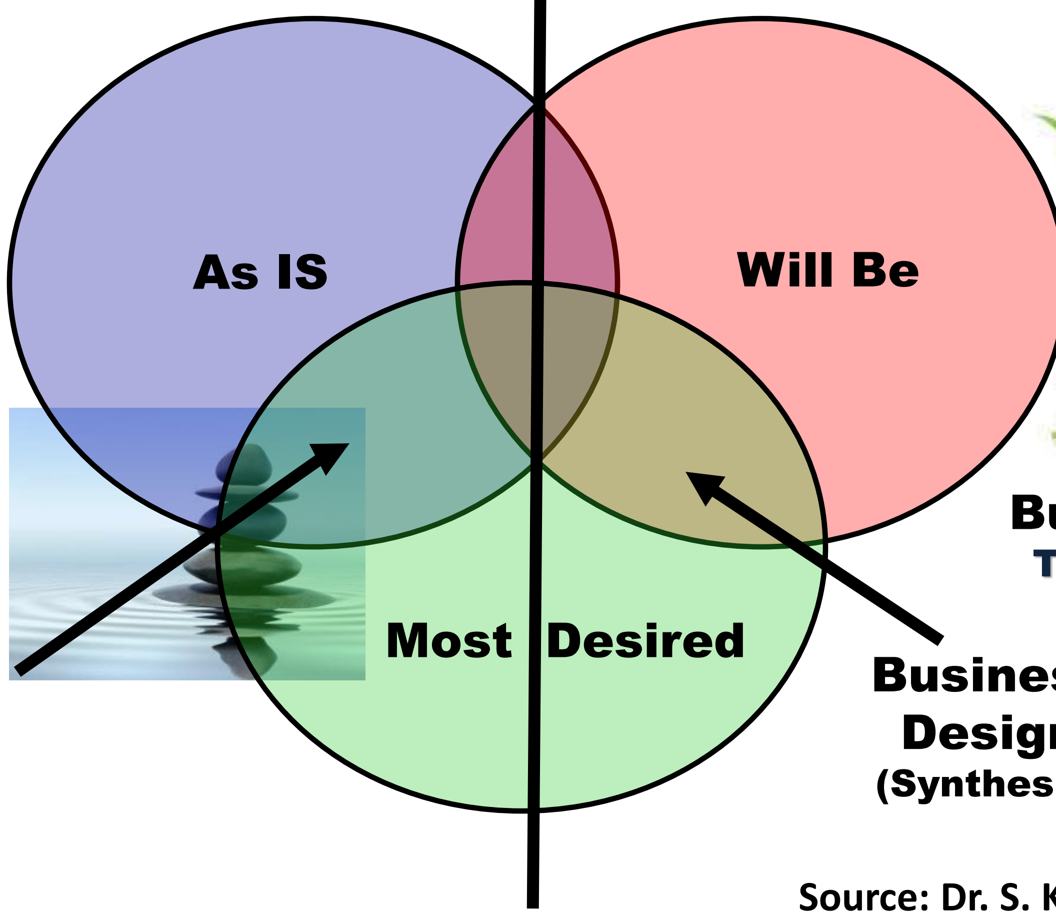
- Passion
- Perseverance
- Patience
- Zen Thinking

Source: Dr. S. K. Majumdar

Zen Thinking

Critical & Creative Thinking | **Constructive & Design Thinking**

Why ?
How?
What?
What For?
When?
For Whom?
Where?
How Much?



Business Plan
The Blue Print of the Business

Business Design
(Synthesis)

What?
How?
Why?

Source: Dr. S. K. Majumdar

What is Zen?

- **Zen is Understanding Yourself**
  - **Finding the “Seeds of Success” and the “Roots of Failures”.**
- **Zen Removes FUD**
  - **Illuminates the Hidden and Suppressed Power of the Soul**
  - **Enhances Ability to Focus, Listen and Pay Attention.**

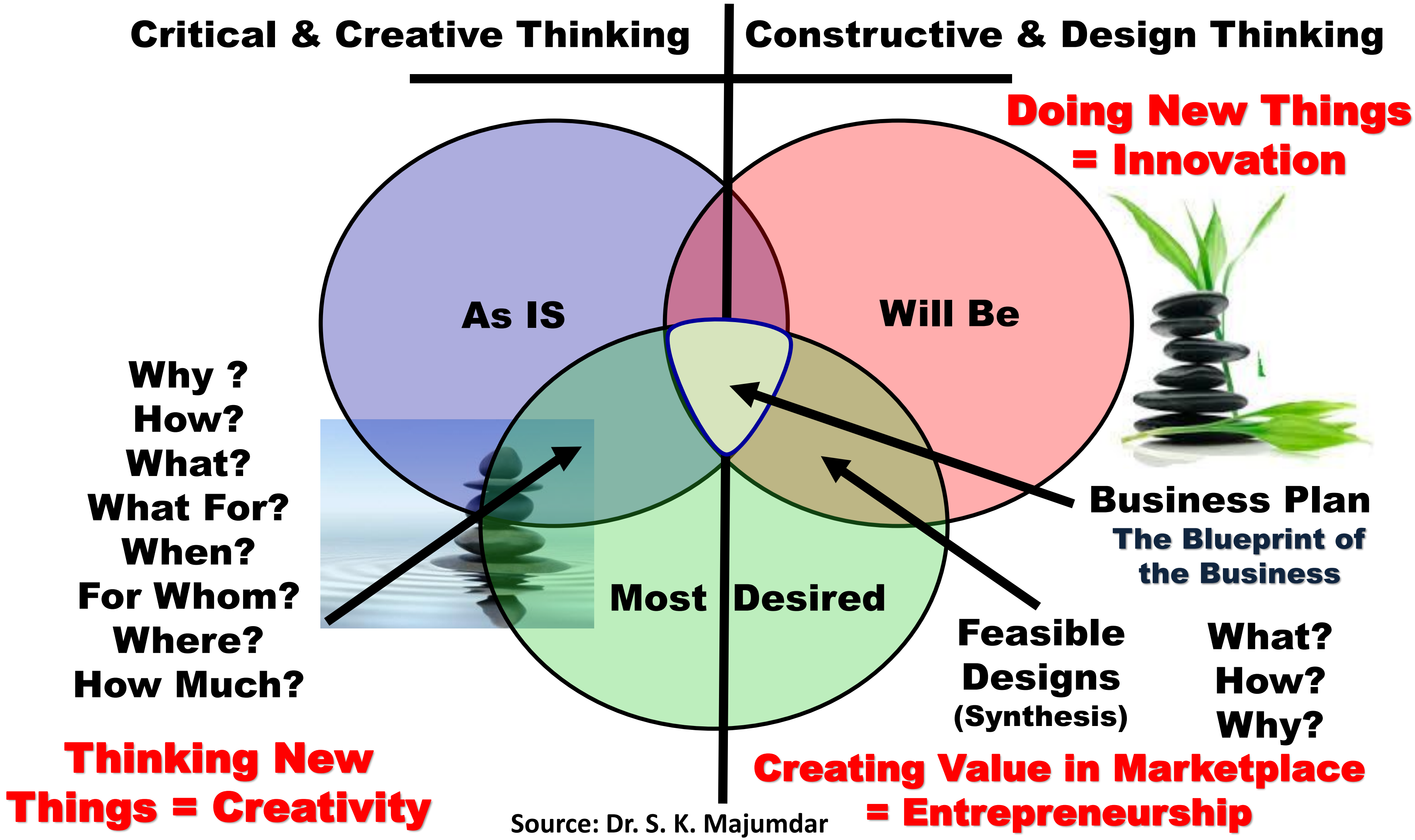
FUD = Fear,, Uncertainties and Doubts

Unless You Understand Your Power, You are as Good as a Blind Person.

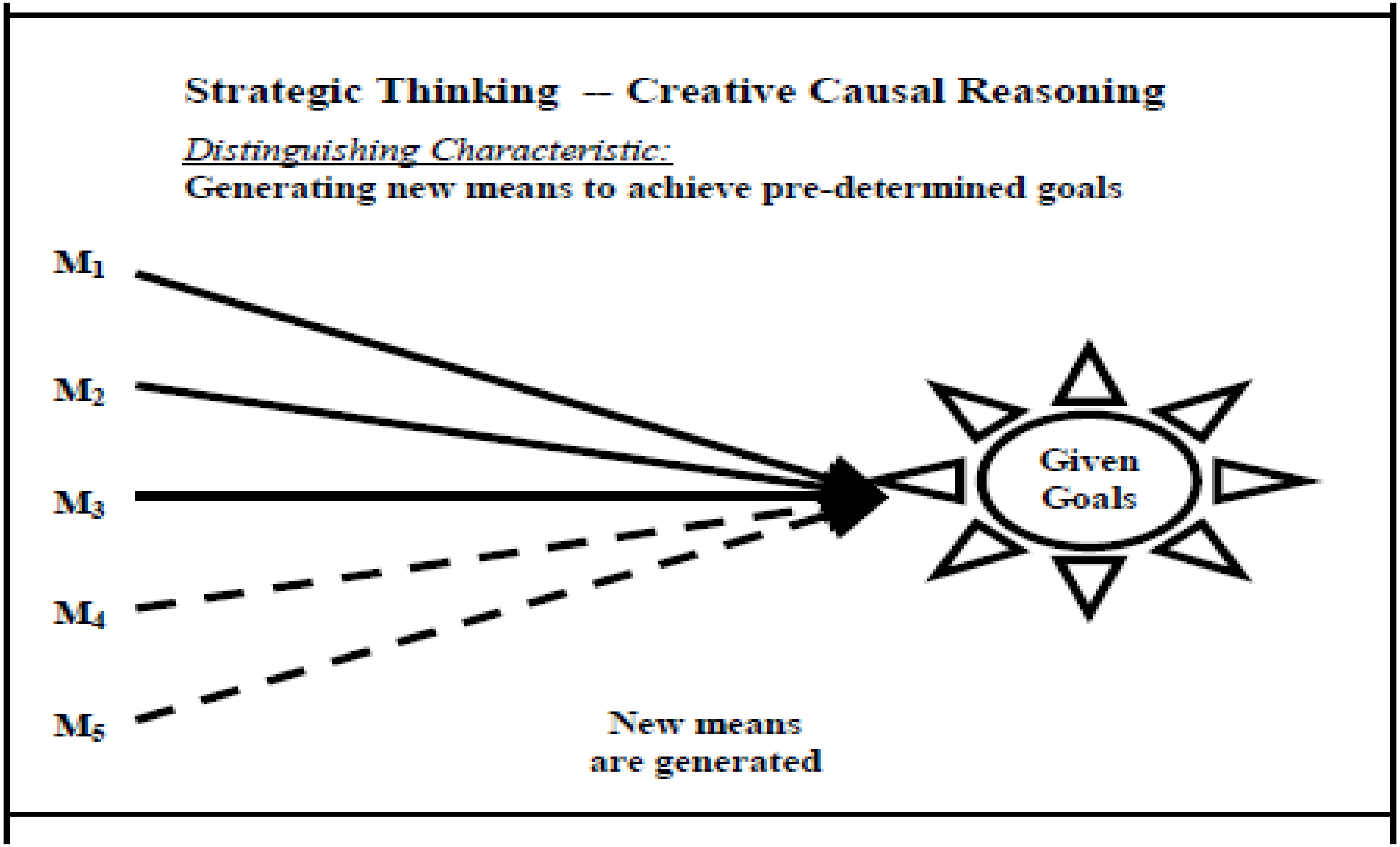
How Can a Blind, Lead Others Who are Equally Blind?

Zen Gives Power to Remain Calm & Focused in Action

Creativity to Entrepreneurship

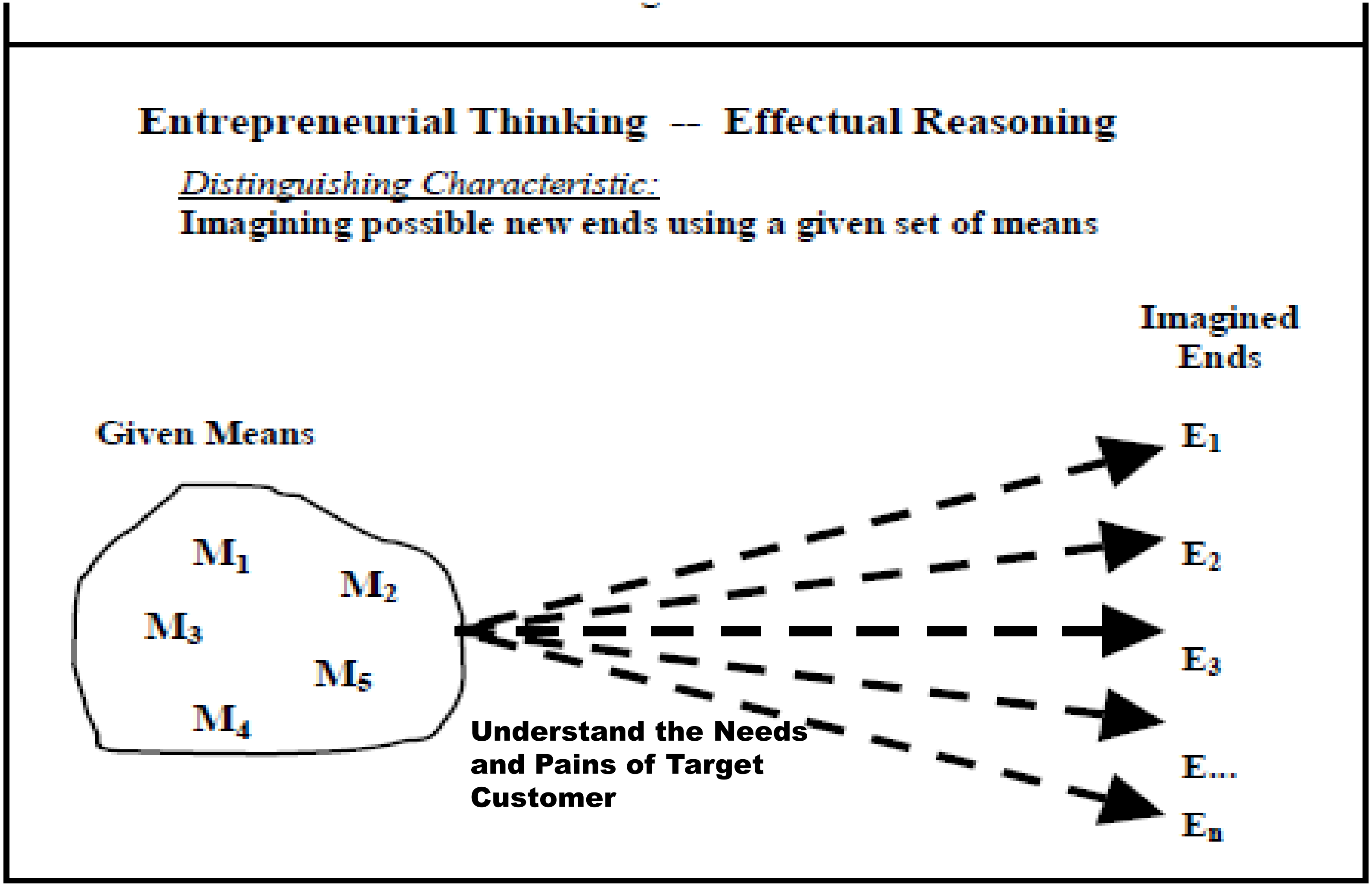


Creative Causal Reasoning



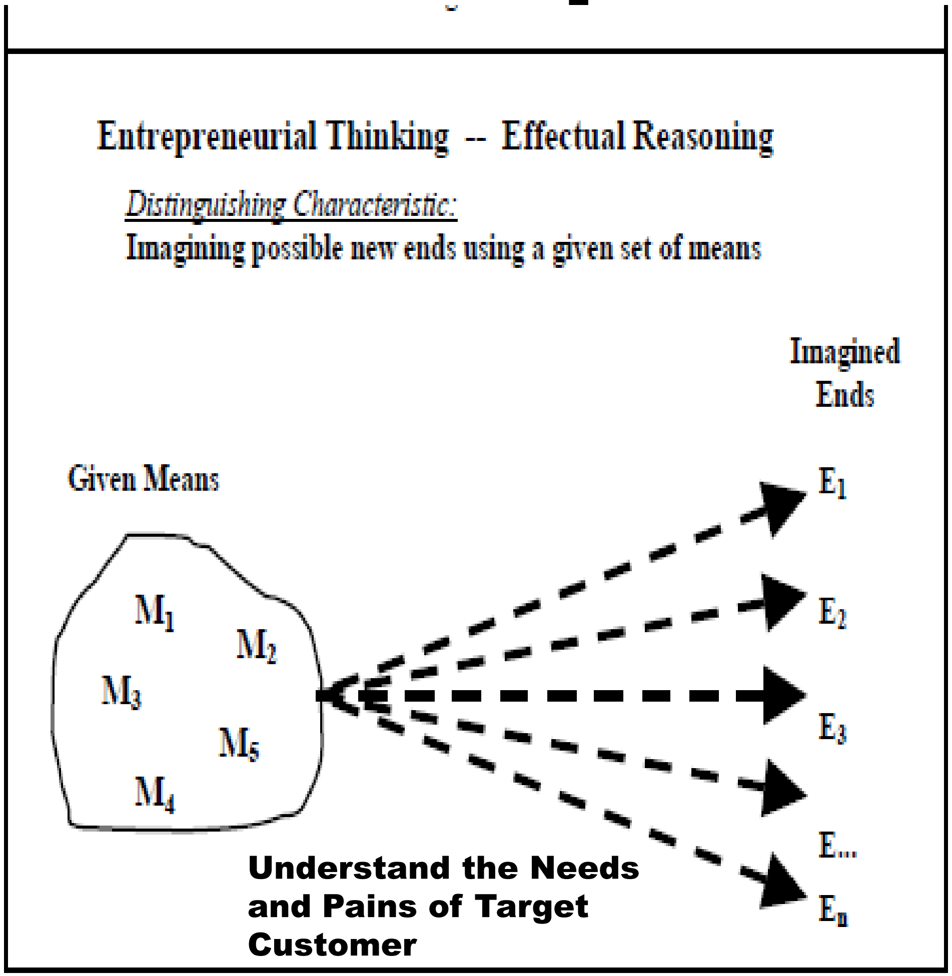
Many to 1

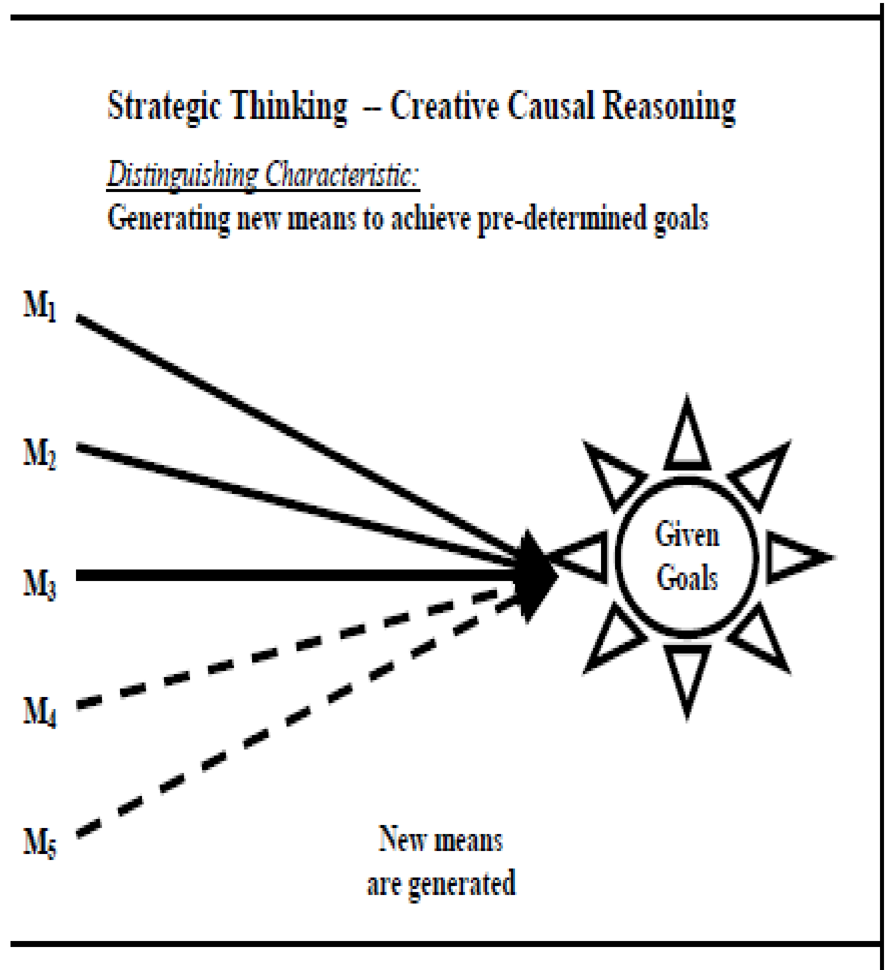
Entrepreneurial Thinking



Many to Many

Entrepreneurial Journey



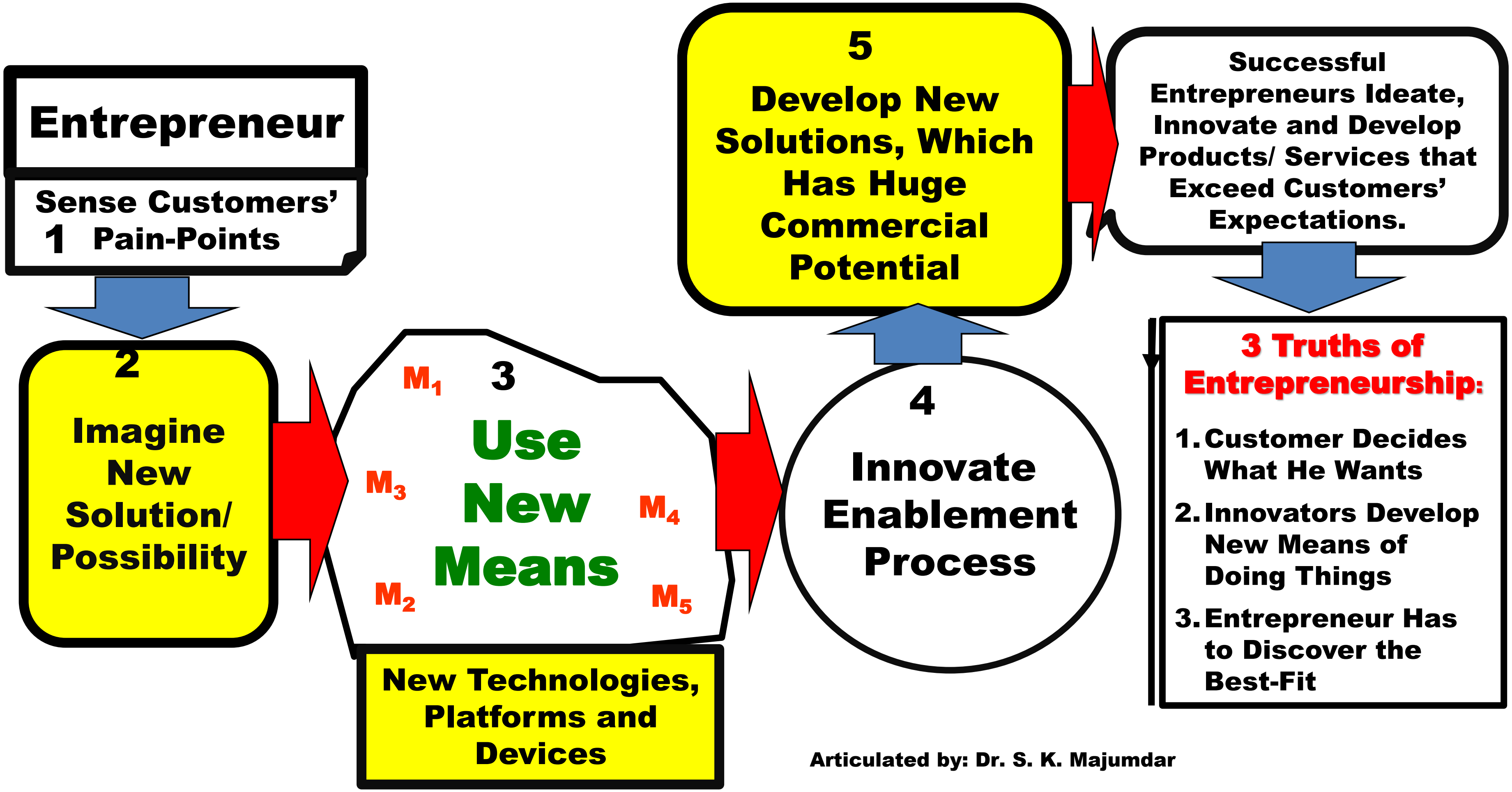


Many to Many

Many to 1

5 Steps of Entrepreneurial Innovation Process

Imagine Possible New Ends by Using New Means



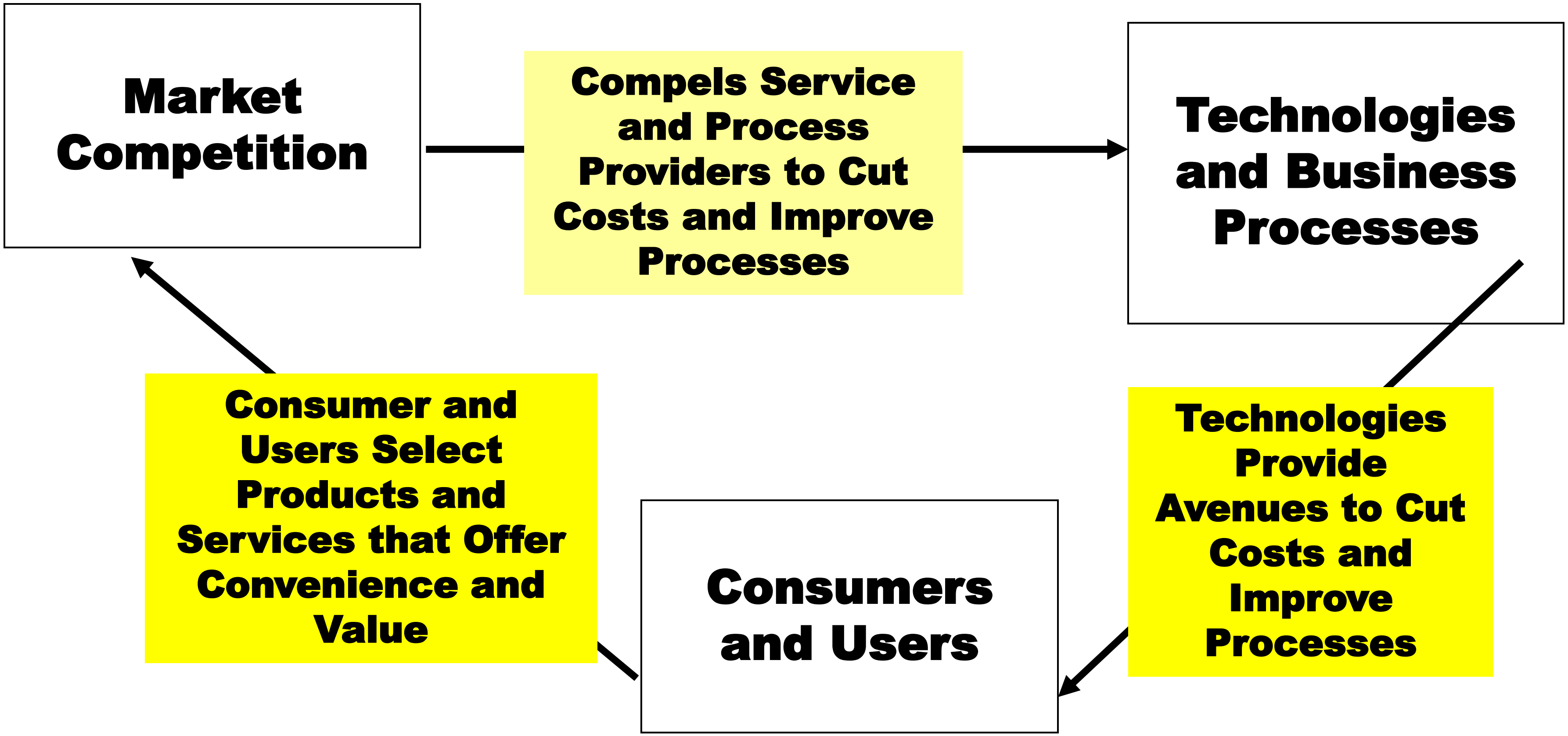
Articulated by: Dr. S. K. Majumdar

Entrepreneurial Skills

Each entrepreneur requires a different ‘game plan’

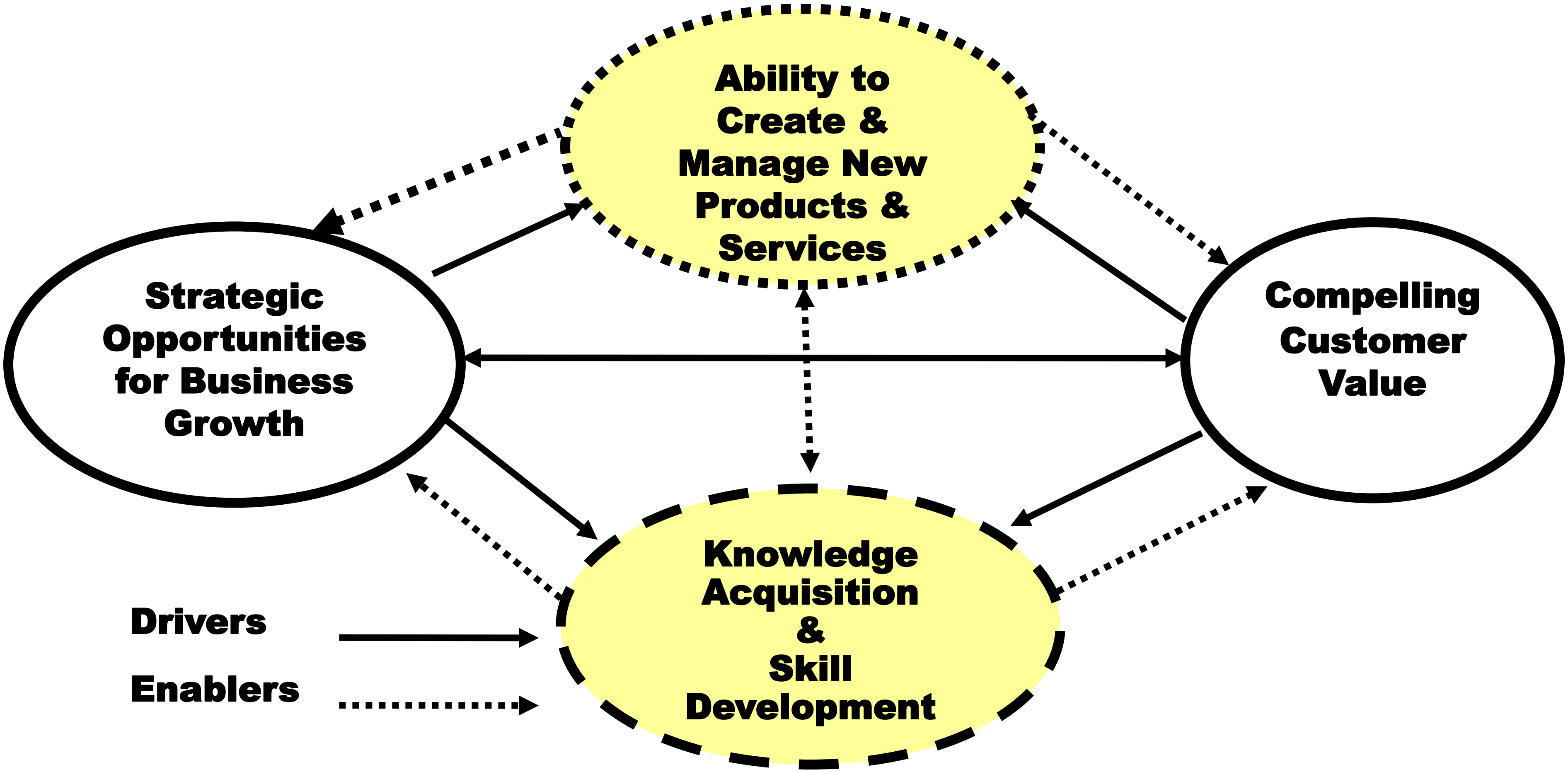
Four main dimensions of skill identified: (1) Technical, (2) Managerial, (3) Entrepreneurial, and (4) Personal Maturity

Drivers of Market Economy



Source: Dr. S. K. Majumdar

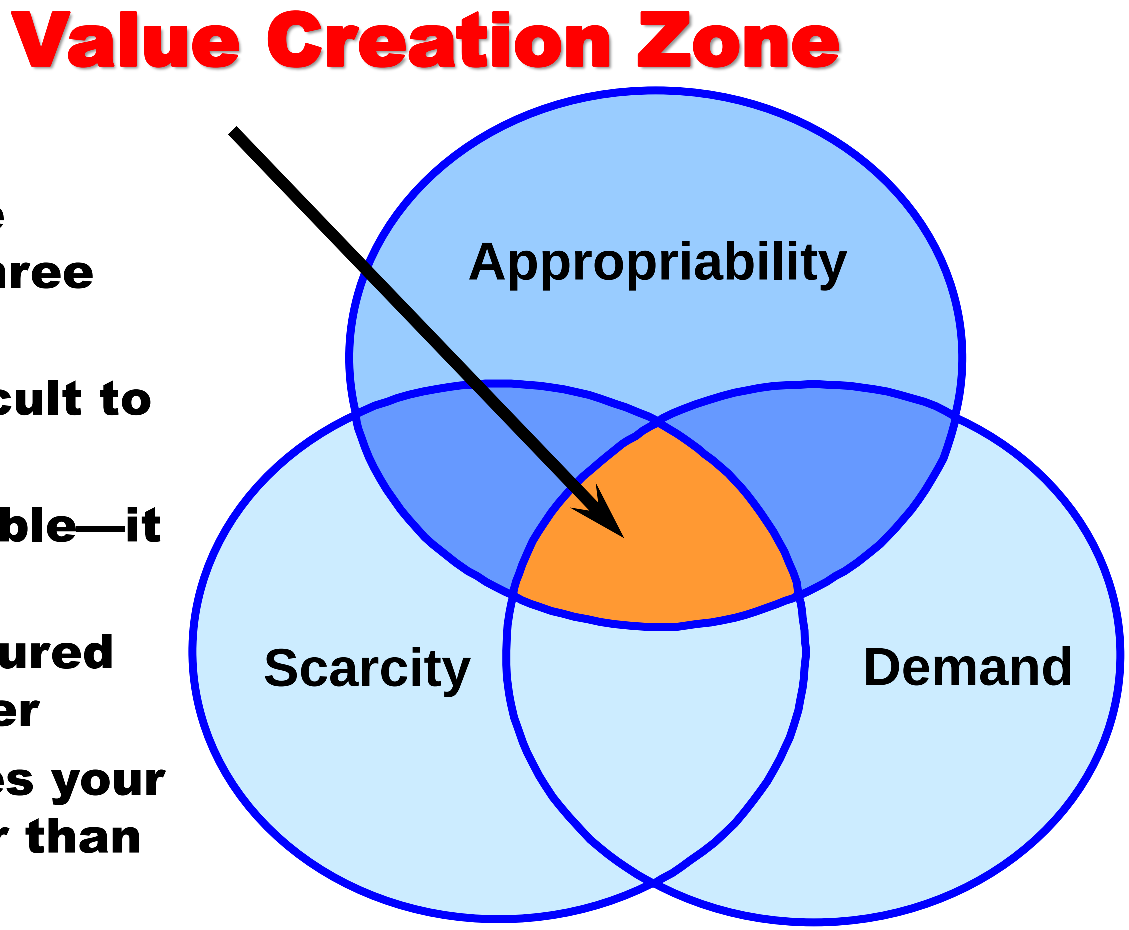
Drivers and Enables of Business



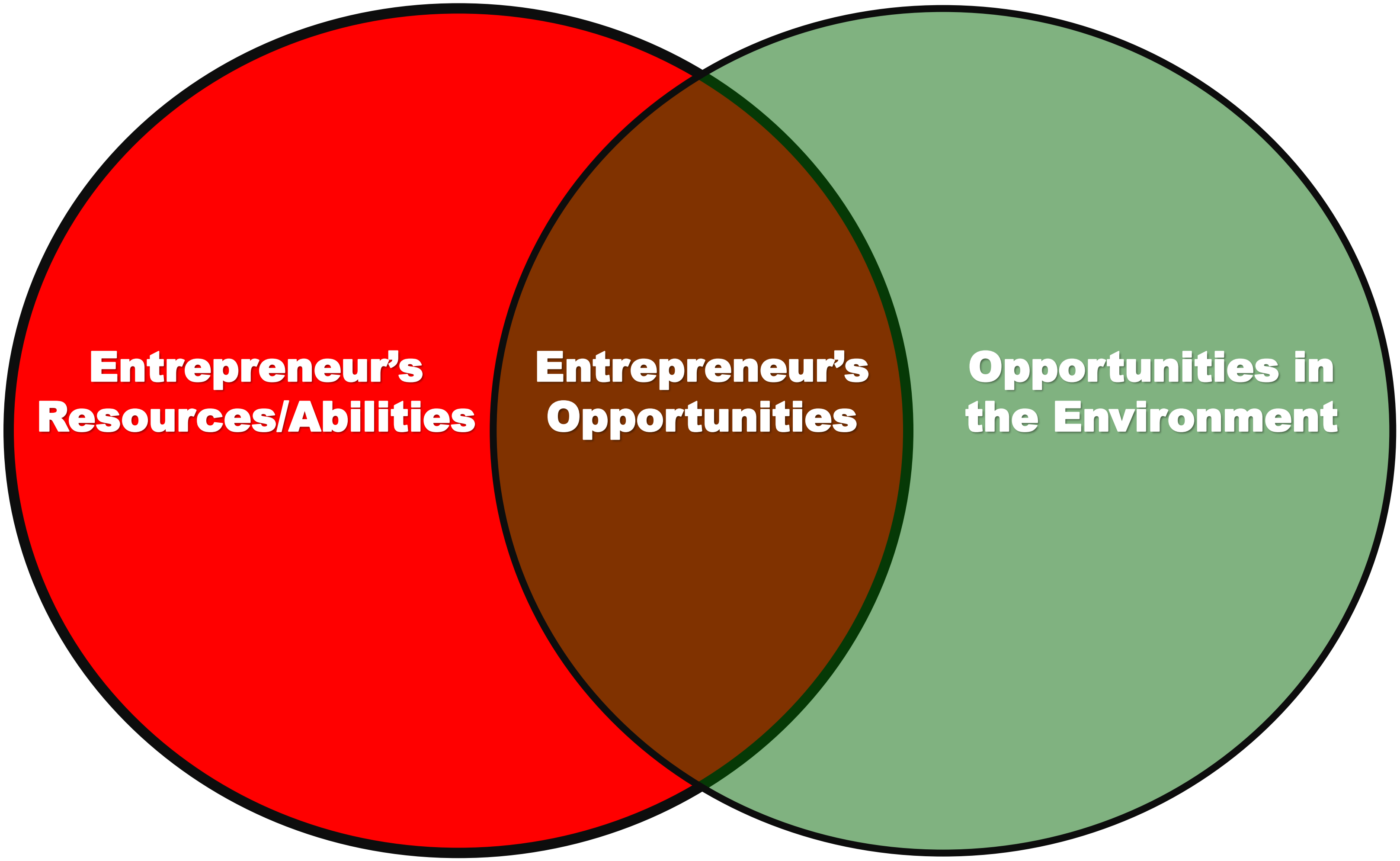
Source: Dr. S. K. Majumdar

Creating Lasting Value

1. True value lies at the intersection of the three circles
2. Lasting value is difficult to imitate
3. Lasting value is durable—it does not depreciate
4. Lasting value is captured by the resource owner
5. Lasting value requires your resource to be better than competitors

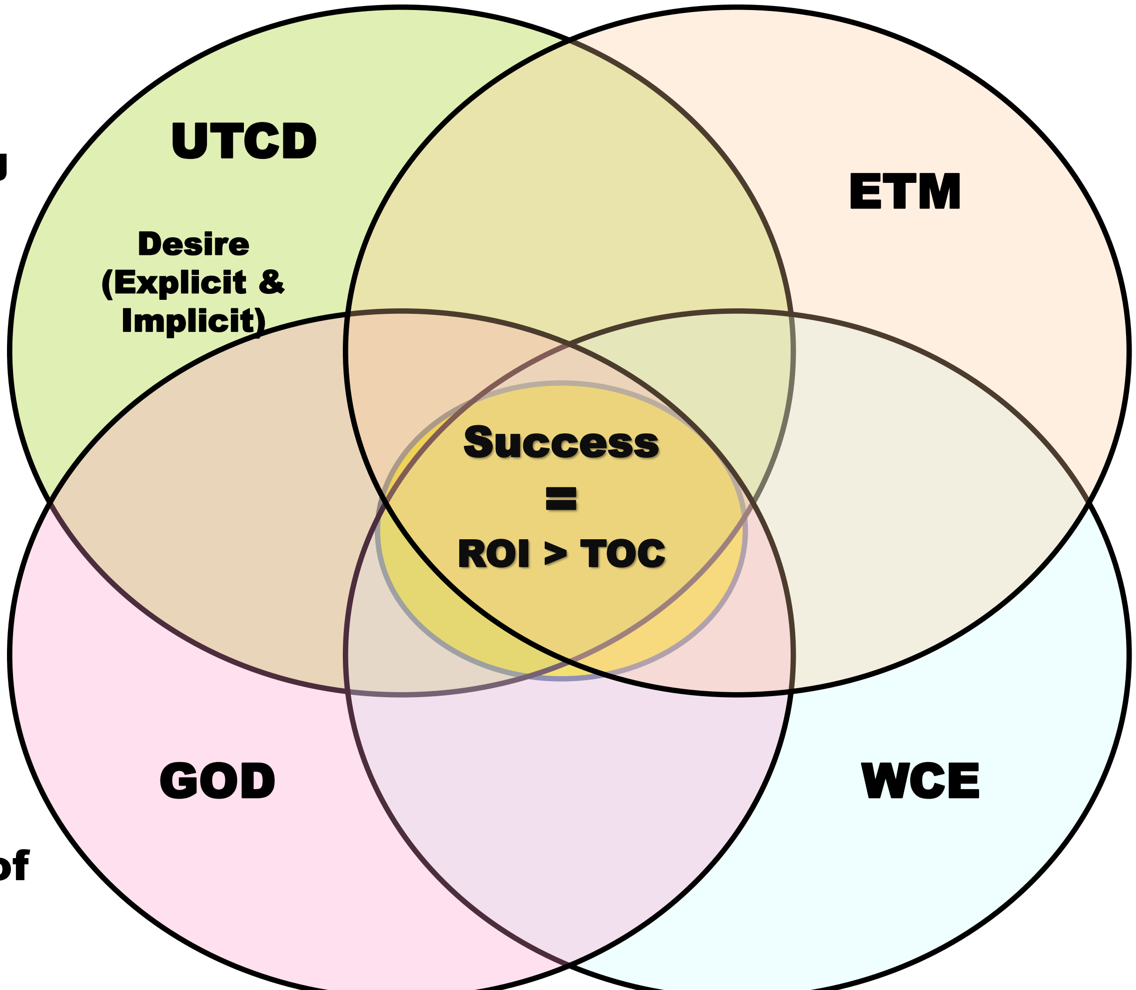


Identifying the Entrepreneur's Opportunities



Cornerstones of Entrepreneurship

UTCD =
Understanding Target Customers' Desire



ETM =
Effective and Transparent Management*

Understanding > Knowing

*** People, Process, Technology, Money, Materials & Markets**

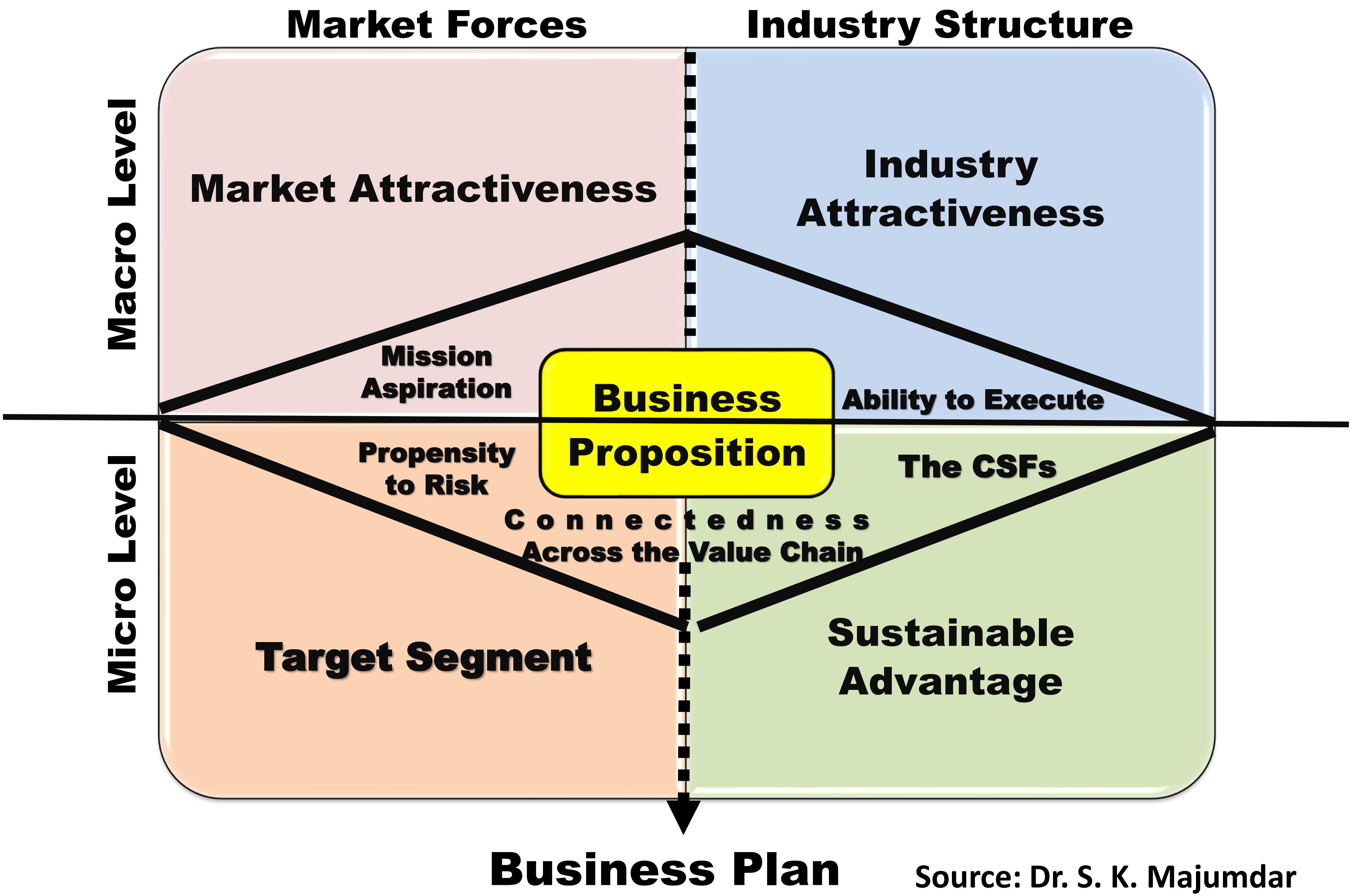
GOD =
Goodness of Design

WCE =
World Class Execution

Goodness > Correctness

Source: Dr. S. K. Majumdar

TOC = Total Operation Cost



Source: Dr. S. K. Majumdar

Market Analysis

5 Cs	5 Ps	Contribution Analysis	Size and Segmentation
• Customer • Company • Competitors • Costs (Prod.) • Collaborators	• Product • Price • People • Place • Promotions	• Unit Contribution • Break-Even Volume • Break-Even Market Share • Total Contribution • Net Profit	• Market Size • Market Share • Market Depth

Customer Analysis Diagram

Define The Market

What Needs are we aiming to Serve?

Decision Making Unit

- Who Uses the Product
- Who Purchases the Product?
- Who Makes the Decision?
- Who Influences the Choice?
- Who Pays for the Product?

Situational Factors

- Nature of Use?
- Purchase Occasion? I Time?
- Stability of Choice Set?
- Any new Information about Existing Alternative?

Decision Making Process

Process Type:

- Low Involvement?
- Utilitarian?
- Technical?

Choice of Sequence?

- What Triggers the need?
- How alternatives are evaluated?
- What impact Information has on the Decision?

Product Use

- How Much?
- How Often?
- When, Where, with Whom?
- What aspects of Product Performance are not Salient?

Nature of the Product

- What is the nature of Relationship and Why?
- Does the Product Meet or Exceeds Expectations?

Why Digital Entrepreneurship?

1. **Digital Technologies are Fostering Disruptive Innovation.**
2. **Enabling Impossible as Possible: Creating Jobs and Wealth.**
3. **Digital Organizations are 26% More Profitable than their Industry Peers. (HBR)**
4. **Digital Platforms Provide Global Reach.**
5. **Velocity, Veracity/Accuracy and Ubiquity of Digital Platforms Have Made the Digital Entrepreneurship as the Foreground of Disruptive Innovation and Development.**
6. **Bangalore Has Best ICT Infrastructure and Ecosystems for Innovation, Entrepreneurship and Digital Transformation.**

Disruptive Innovation

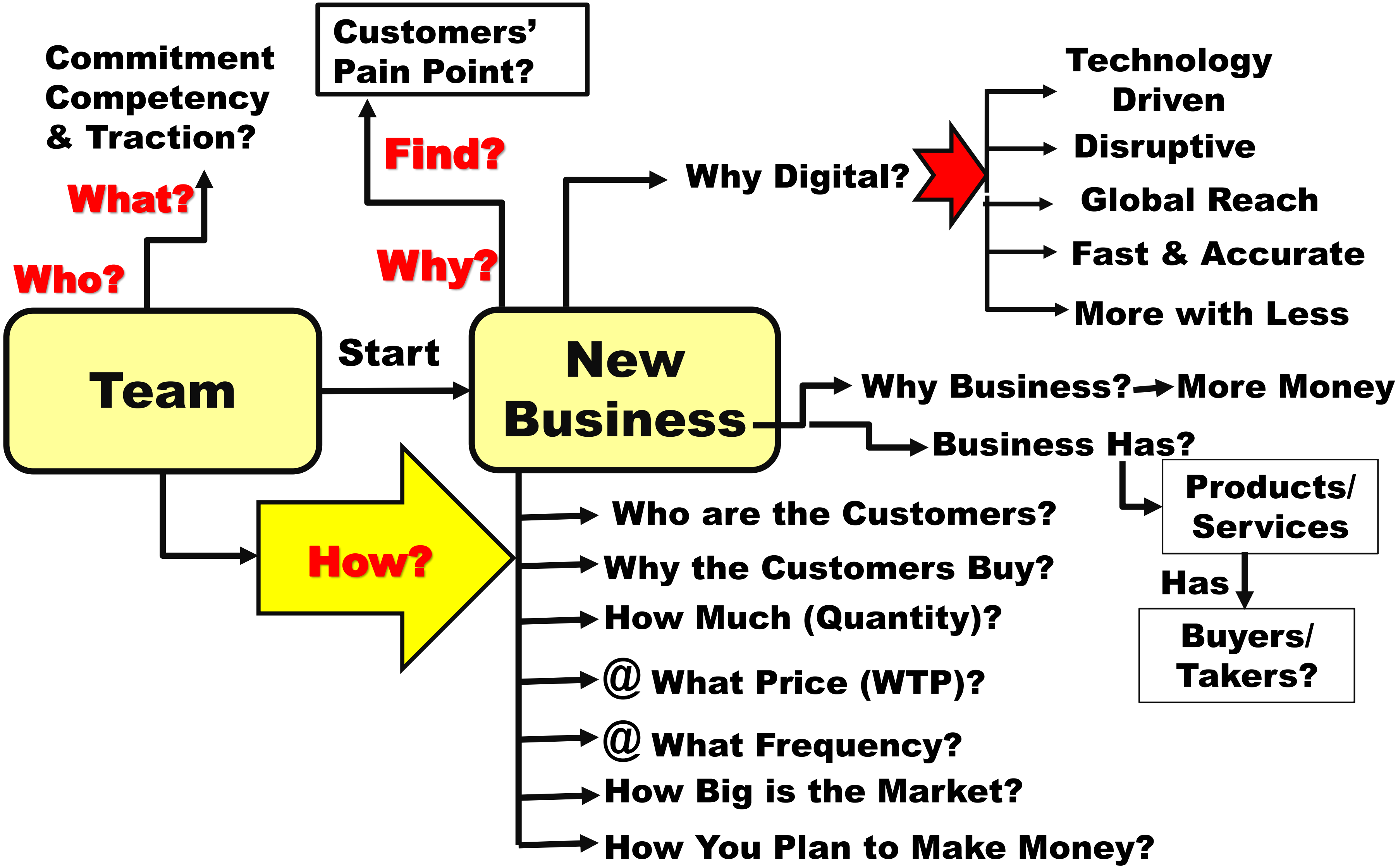
Break the Barrier,
Delight the Customers

Turn Expensive, Difficult, Inaccessible Products and Services into Simpler and More Affordable Ones

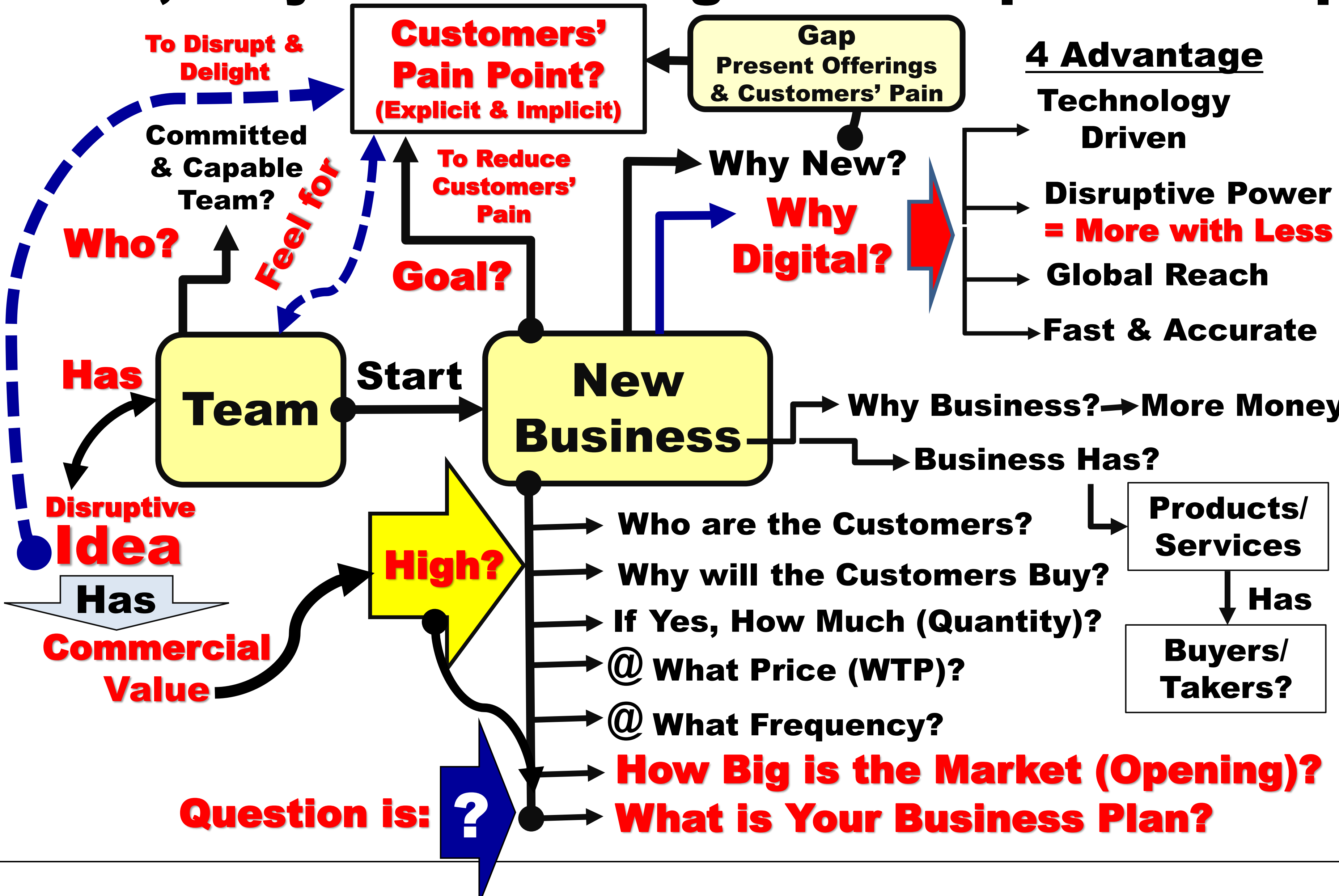
Disruption

- **"Disruption" describes a process whereby a smaller company with fewer resources is able to successfully challenge established incumbent businesses.**
- **Digital Entrepreneurs are Disruptive Entrepreneurs and Make Impossible as Possible.**

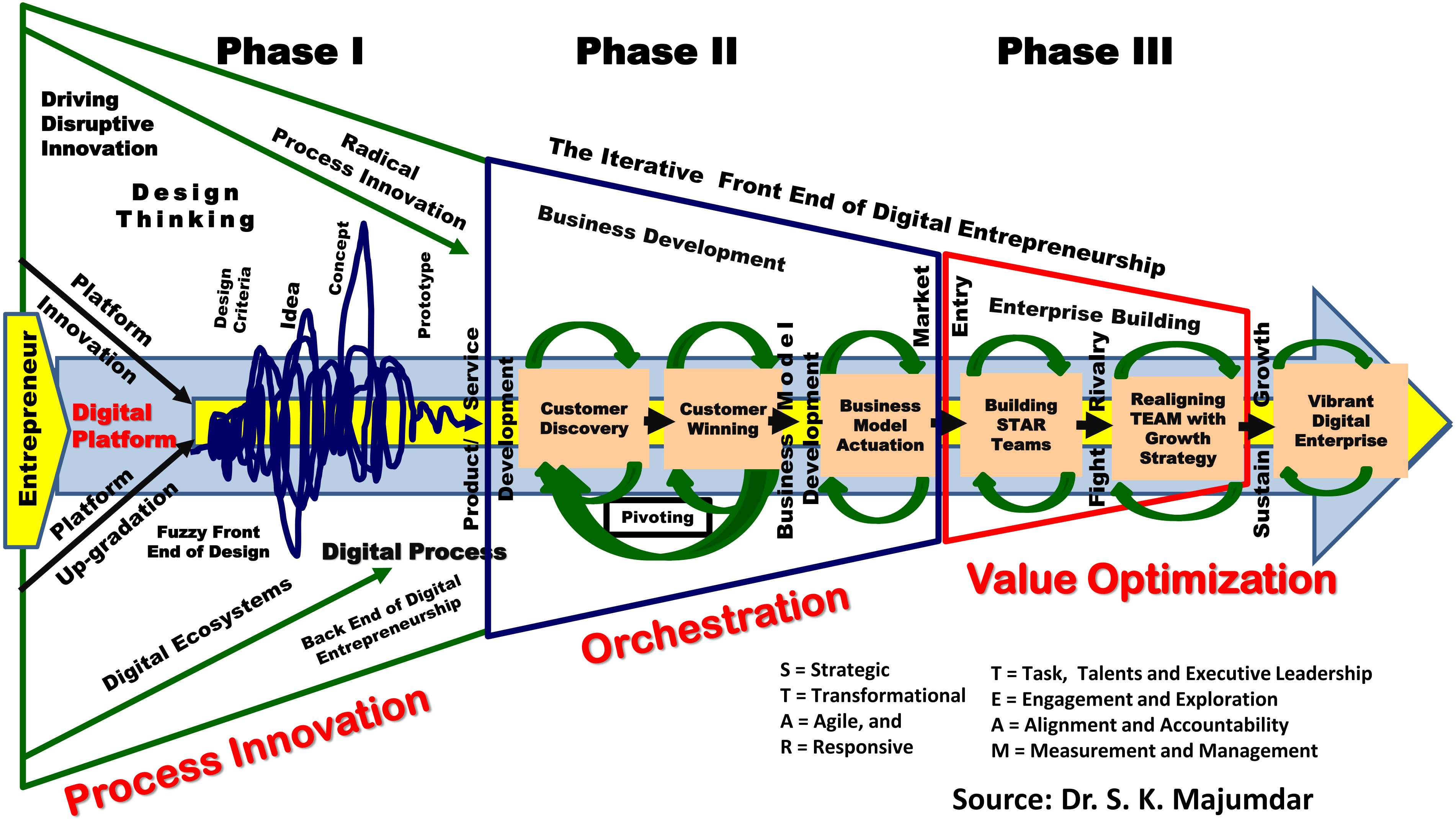
What is Digital Entrepreneurship



Who, Why & How of Digital Entrepreneurship



Lifecycle Model of Digital Entrepreneurship



How?

Phases and KR Each Phase of Digital Entrepreneurship Lifecycle

Three Distinct Phases of Digital Entrepreneurship Lifecycle	The key Responsibility (KR) of the 3 Phases are:
1. Process Innovation, 2. Business Development and 3. Enterprise Building	1. Innovation, 2. Orchestration and 3. Value-Optimization

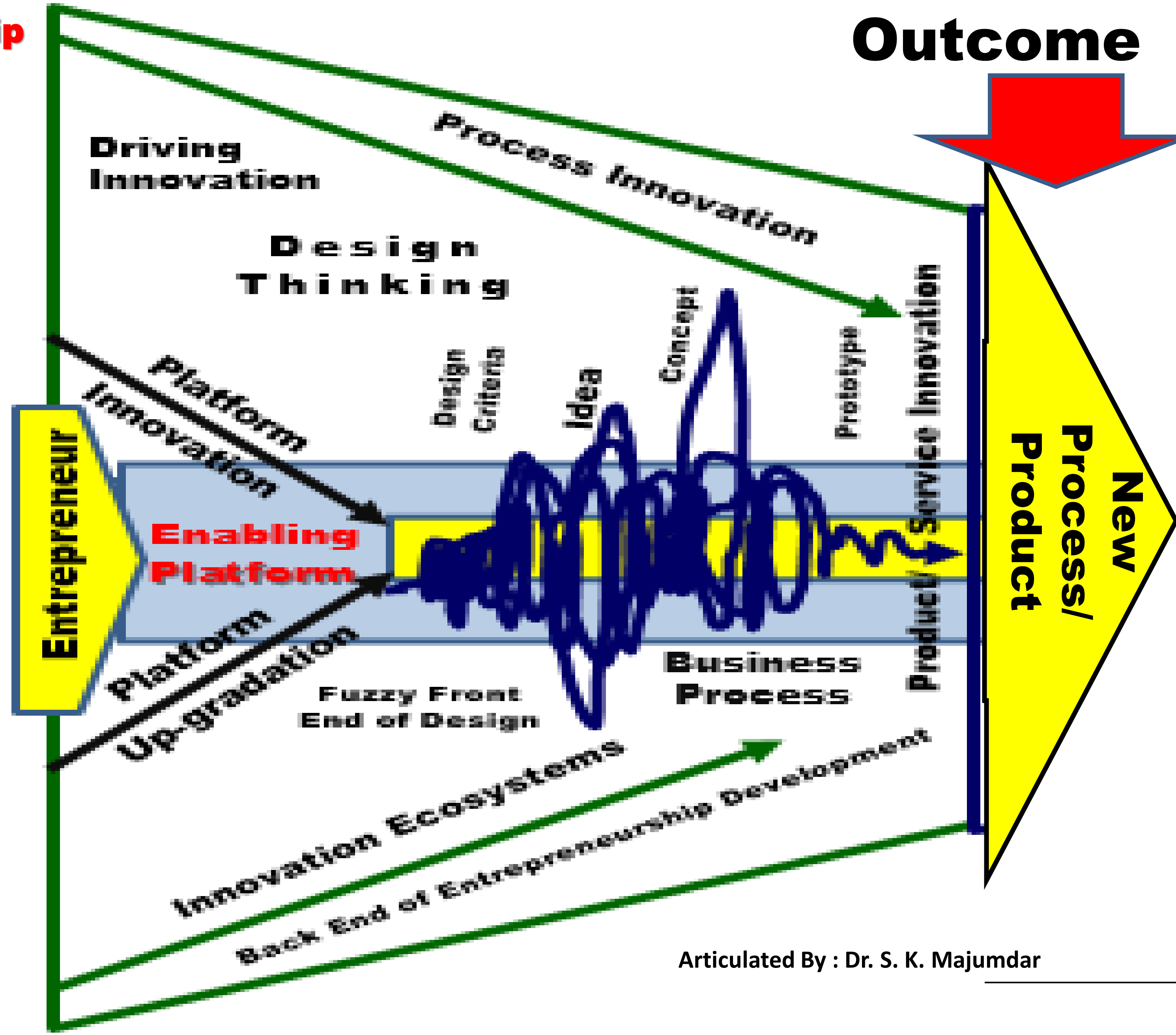
Orchestration is to plan and organize something carefully and secretly in order to achieve a desired result

Value optimization is Maximization of Stakeholders' Value and Minimization of Waste

Source: Dr. S. K. Majumdar

Entrepreneurship Development Lifecycle

Phase I



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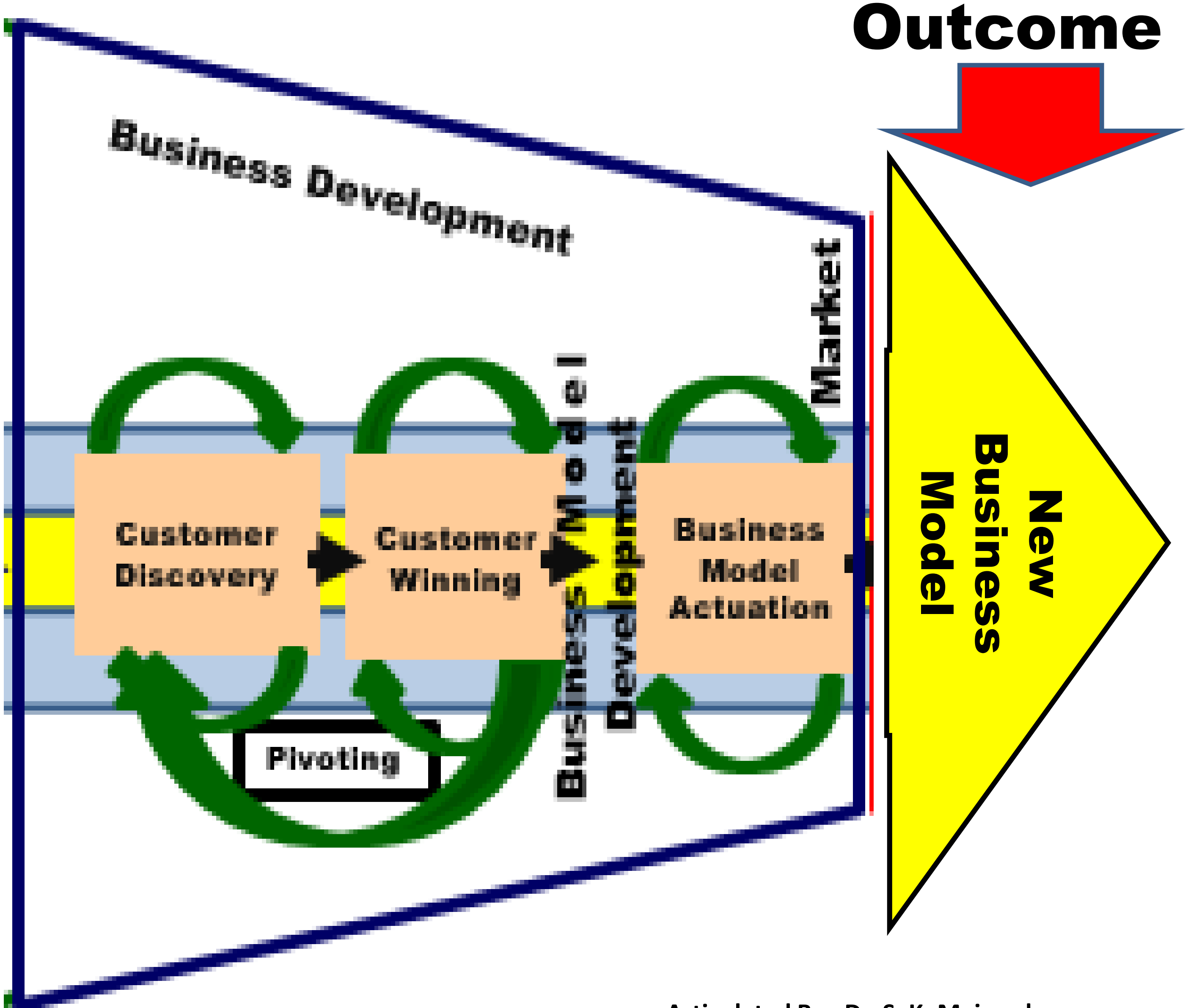
Entrepreneurship Development Lifecycle

Phase II

Outcome



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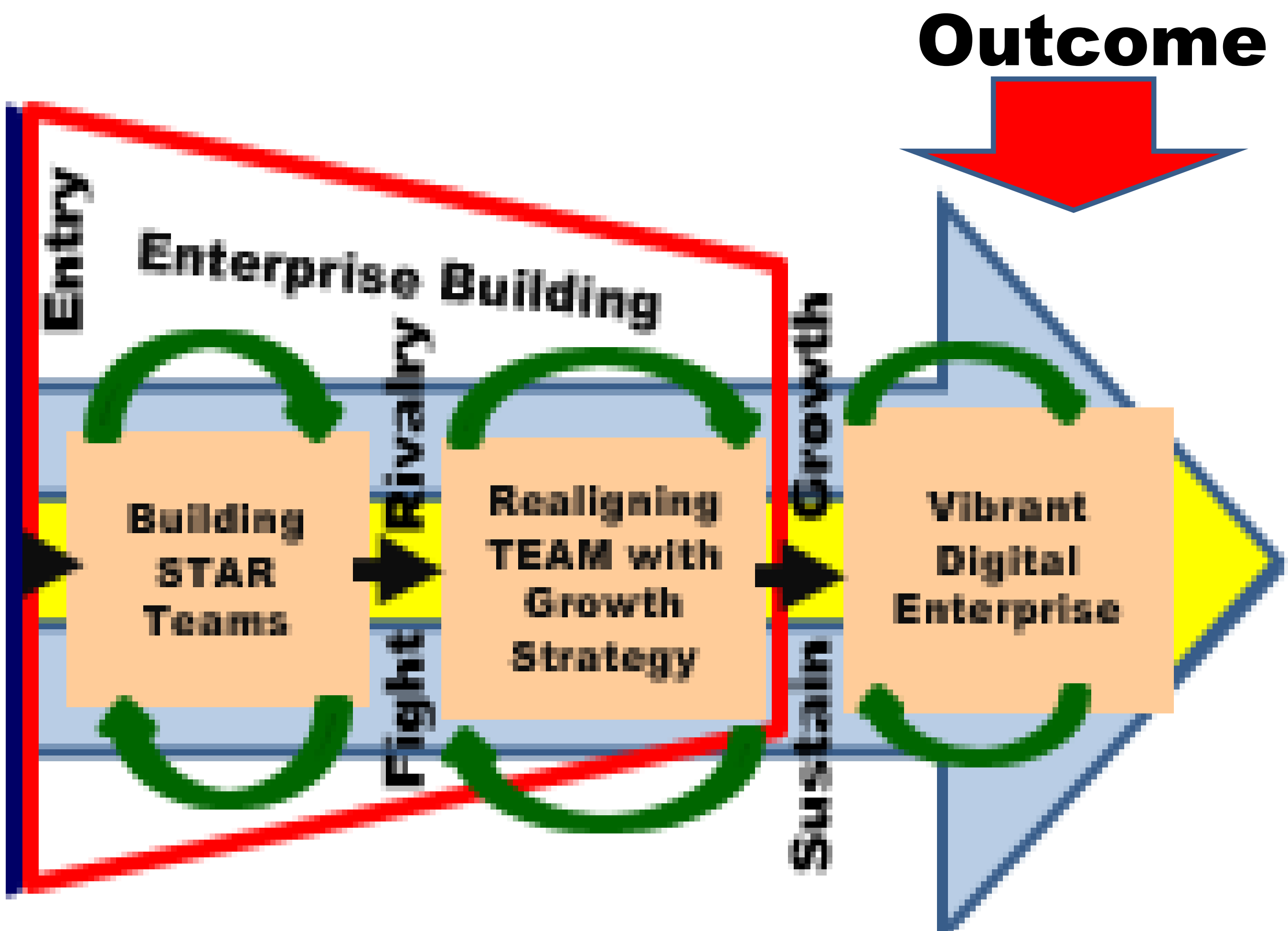
Entrepreneurship Development Lifecycle

Phase III



S = Strategic
T = Transformational
A = Agile, and
R = Responsive

T = Task, Talents and Executive Leadership
E = Engagement and Exploration
A = Alignment and Accountability
M = Measurement and Management

Important MAP Features

(MAP = Market, Actor and Product)

GCC = Growth, Complexity & Connectivity
TOTC = Traits of Target Customers
KSF = Key Success Factors

PCPD = Process Characters & Product Durability
CSU = Class, UtiCritical Function Metricslity, Sensitivity
CFM = **USP** = Unique Selling Proposition

External

Market

Size, Value & Pains + GCC of Target Market
•Limit to 2-3 most important Pain Factors

Industry (KSF):
•Limit to 2-3 most important

Competition (5 Forces & its Scale) + Opportunities (Unmet Demand/ Growth Potentials):
•Limit to 3-4 most important

Customers TOTC (Needs + Desires + Concerns):
•Limit to 2-3 most important

What is Really Important?

Product

(Actor's Value Proposition for Customers)

The PCPD + CSU+ CFM + USP of the Product
•Limit to 3-4 most important

Internal

Actor

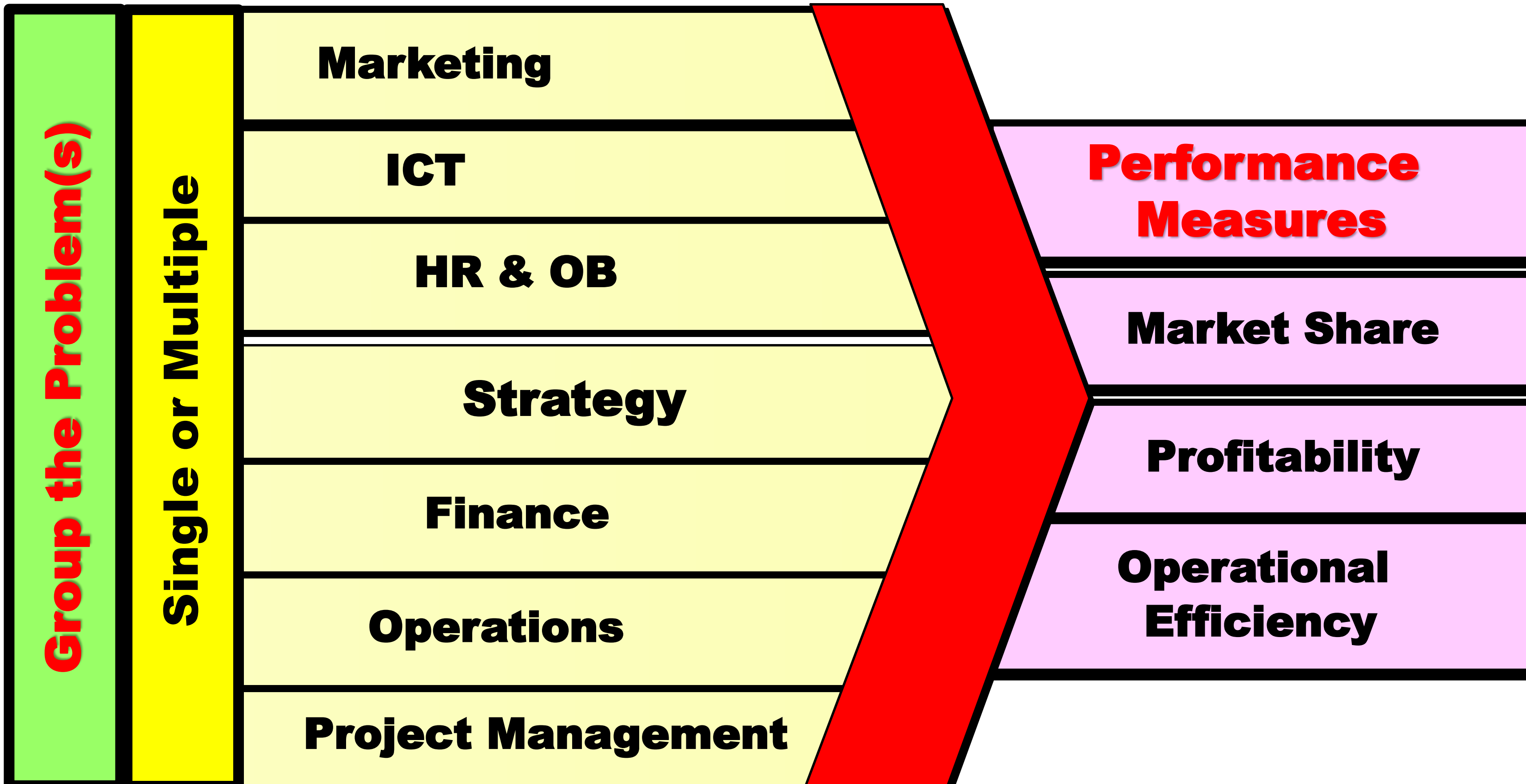
TWOS + Competitive Advantage of the Actor:
•Limit to 3-4 most important

Capabilities + Resources + Constraints (CRC) of Actor:
•Limit to 3-4 most important

TWOS = Threats, weakness, Opportunity and Strengths
CRC = Capabilities, Resources and Constraints

Source: Dr. S. K. Majumdar

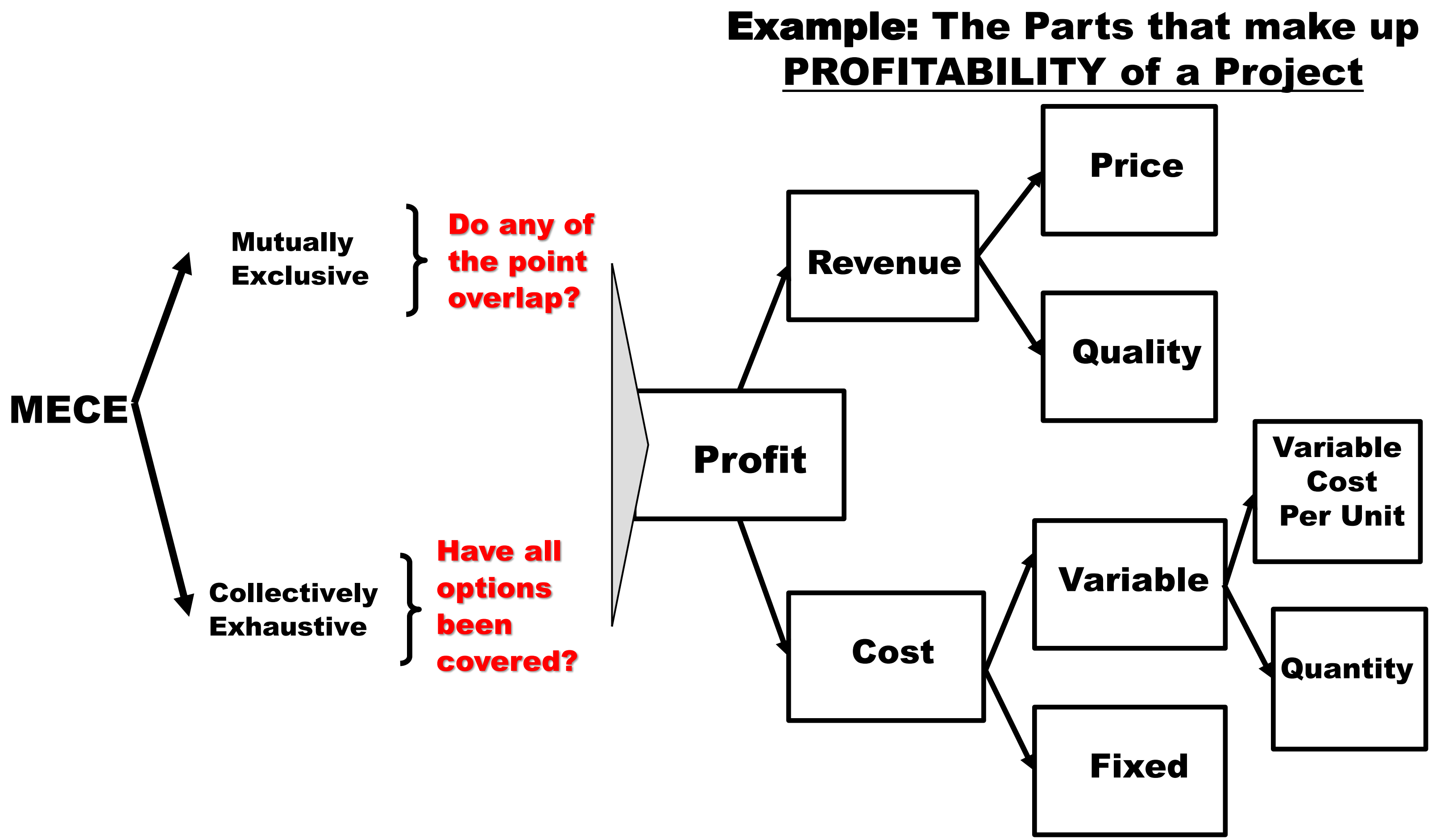
Define Problem Type



Source: Dr. S. K. Majumdar

MECE Issue Tree

(MECE = Mutually Exclusive, Collectively Exhaustive)



Issues Across the Branches of the Issue Tree should be MECE

Source: Dr. S. K. Majumdar

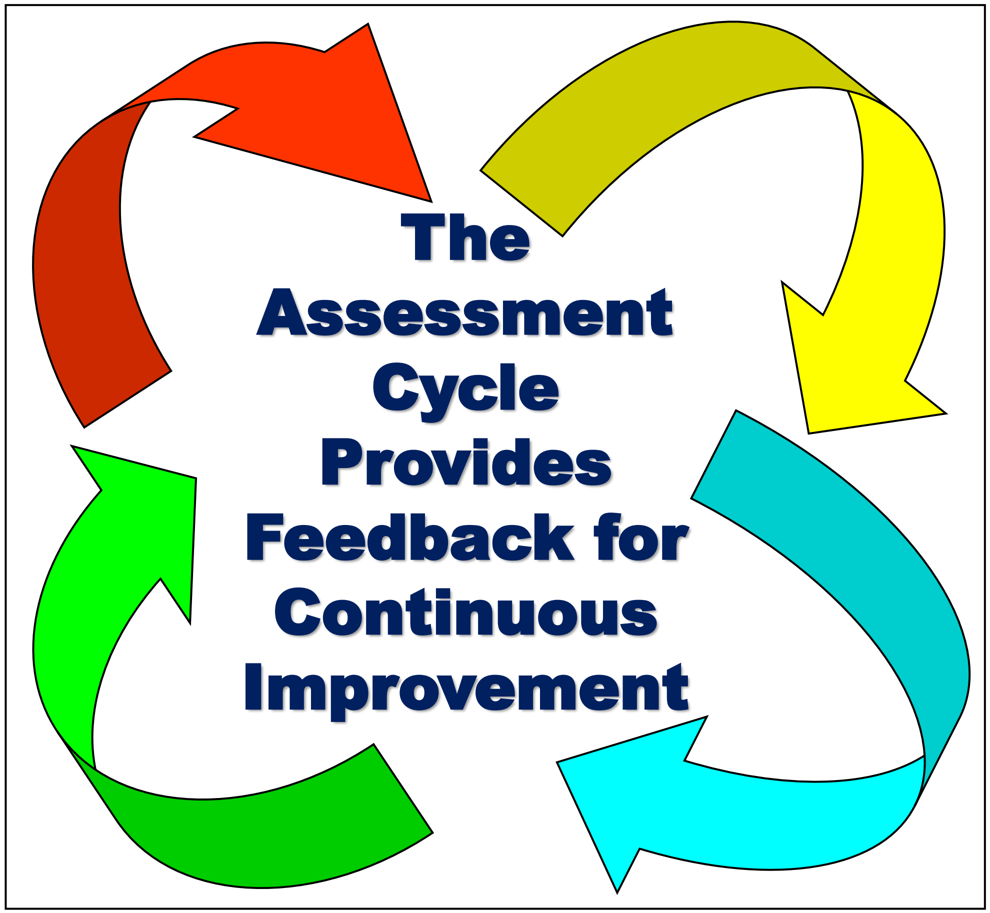
Review, Revisit and Find The Gap; Fill The Gap

Use…

Results…
To improve Processes and Practices

Assess…

Achievement against those goals or outcomes



Plan…

Develop Action Plan And Goal Measuring Matrix

Implement…

Provide Opportunities for to achieve those goals

Source: Dr. S. K. Majumdar

Be Aware of the 4 Barriers of Improvement

- **Amnesia-Industry**
- **Fantasia-Market**
- **Inertia-Product**
- **Nostalgia-Customer**

-- Shulman

Six Hats of Effective Entrepreneurship


White: Objective Facts & Figures


Red: Emotions & Feelings

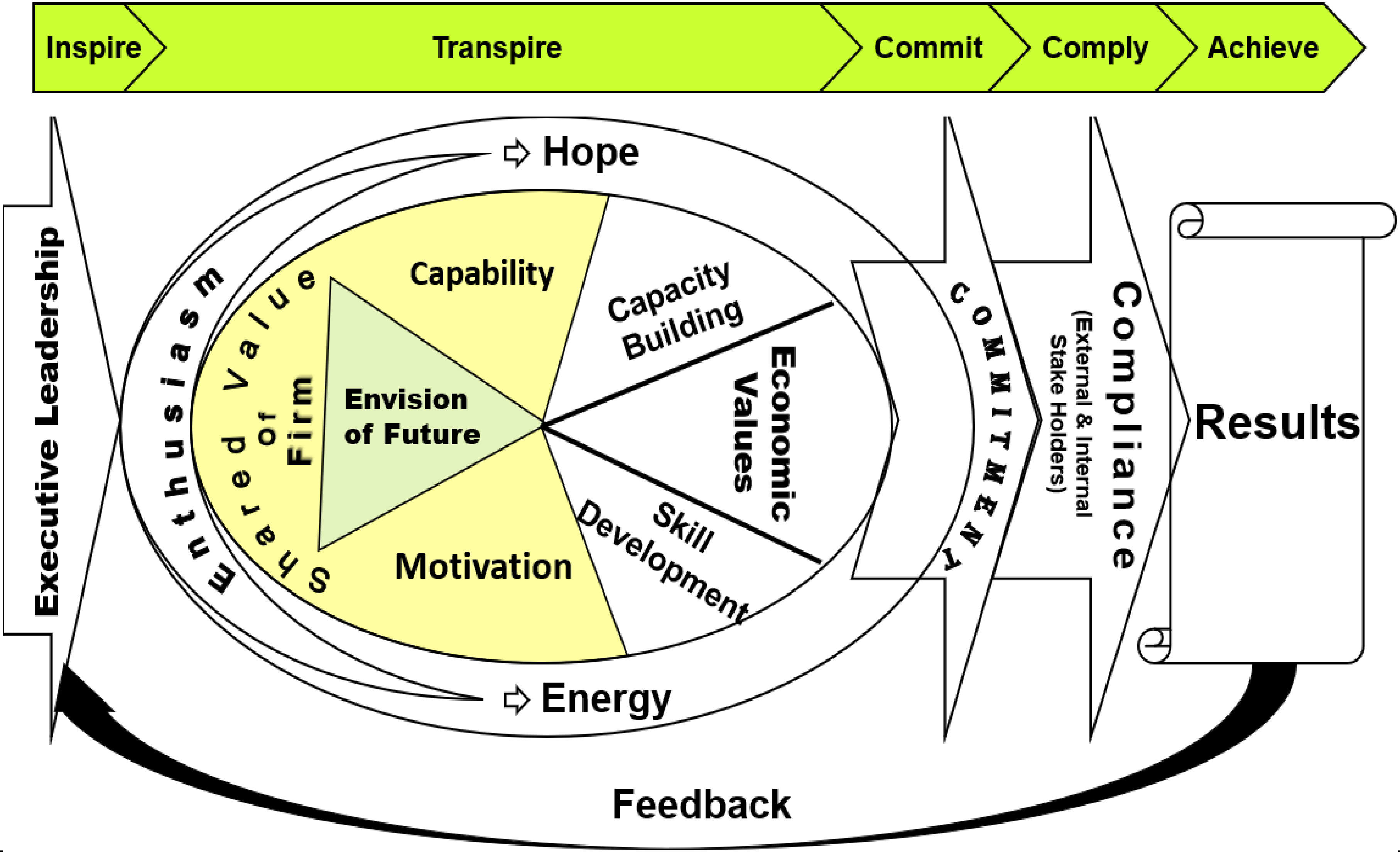

Black: Cautious & Careful


Yellow: Hope, Positive & Speculative


Green: Creativity, Ideas & Lateral Thinking


Blue: Control & Organization of Thinking

Transforming the Ideas Into Reality

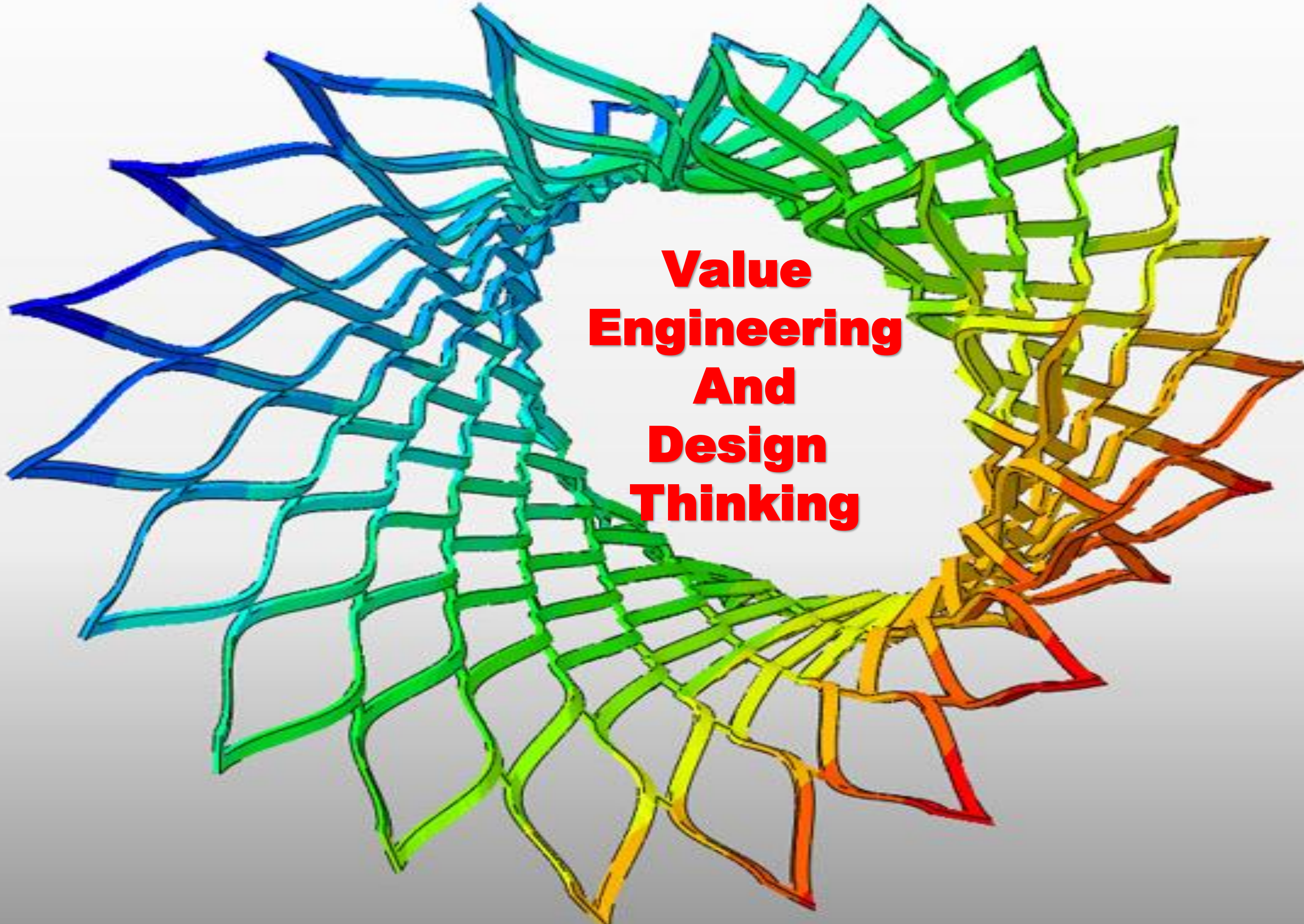


Mantras of Success

"Never give in, never give in, never, never, never, never– in nothing, great or small, large or petty– never give in except to convictions of honour and good sense."

QUESTIONS

Thank You

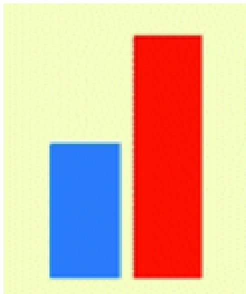


Value Engineering And Design Thinking

Dr Swapan Kumar Majumdar

Note: This Teaching Notes contains many of my own work as well as it has adapted slides from variety of sources.

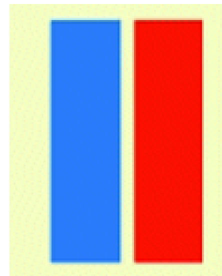
What is Value?



Worth < Cost

Low Value

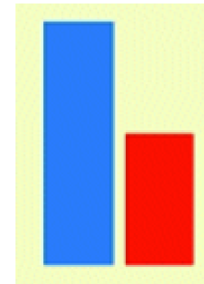
Low Appeal



Worth = Cost

Medium Value

Medium Appeal



Worth > Cost

High Value

High Appeal

Value Is:

V A L U E = W O R T H

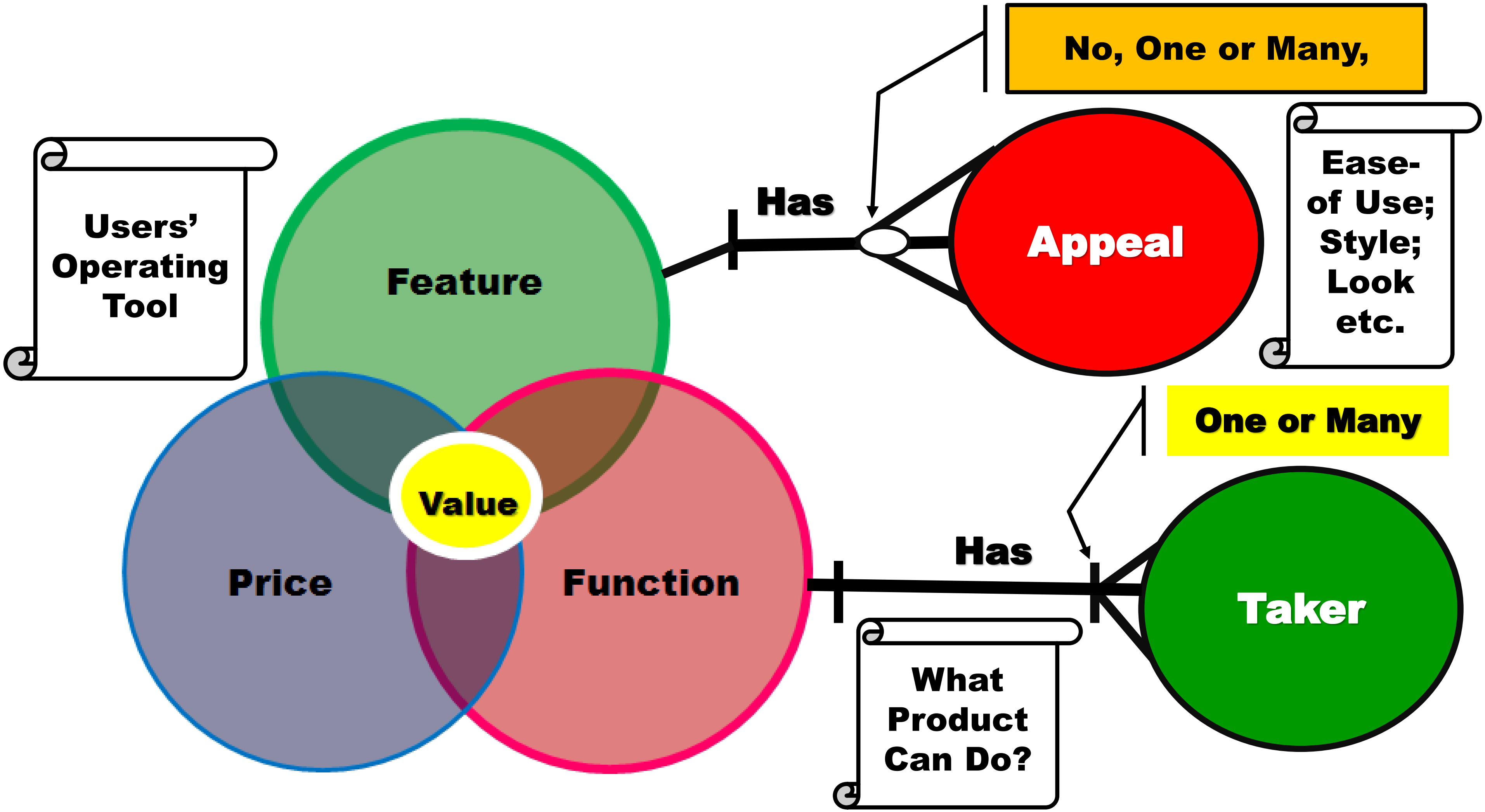
- **VALUE = Worth, Merit, Usefulness or Importance.**

Value = $\dfrac{\textbf{Worth To User}}{\textbf{Price User Pay}}$

Value Perception Varies from User 2 User

- **PRODUCT = Things Fit for Use.**

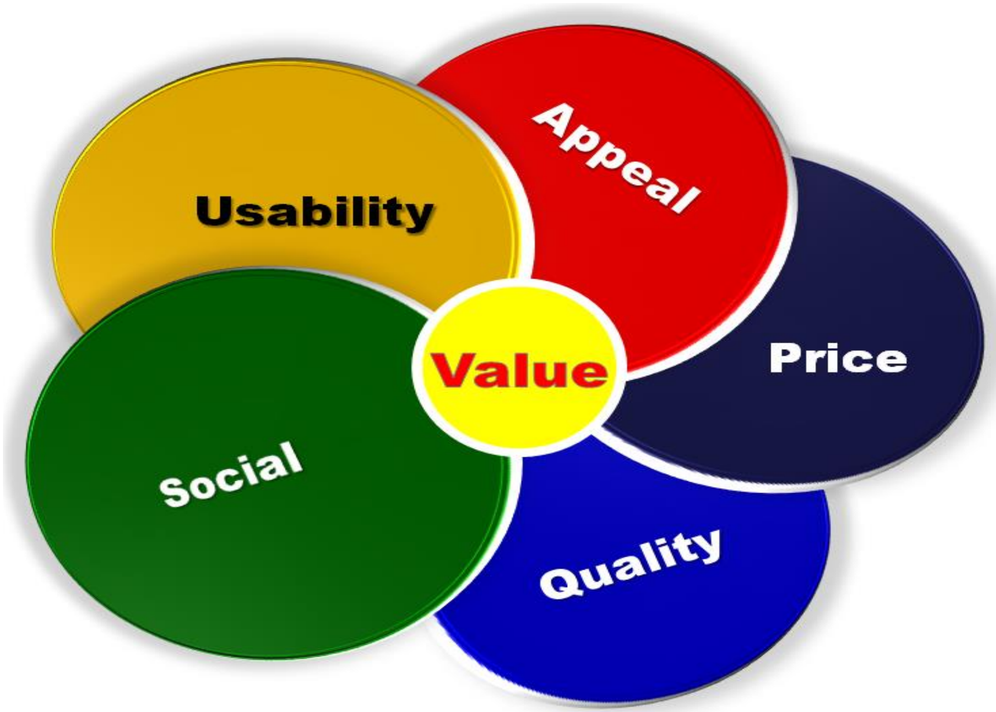
Marketable Product Has



If User = Person, Then Product = <u>Domestic Product</u>

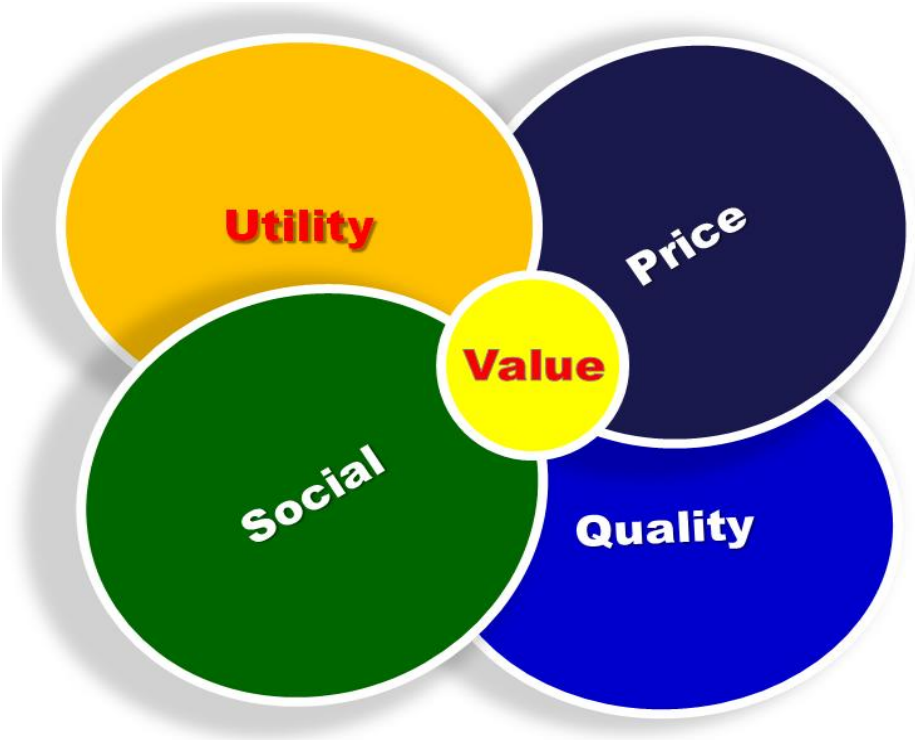
If User = Machine, Then Product = <u>Industrial Product</u>

Worth of Domestic Products



- **Value =** $\dfrac{\text{Usability + Quality + Appeal + Environment Friendliness}}{\text{Price User Pay}}$

Worth of Industrial Products

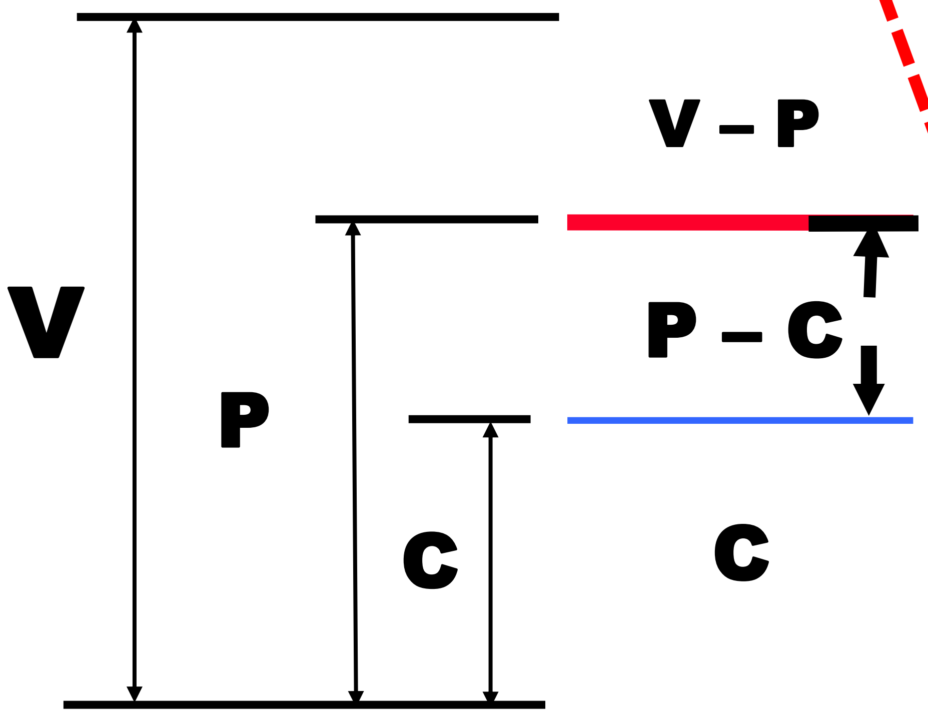


- **Value =** $\dfrac{\text{Utility + Quality + EF}}{\text{Price User Pay}}$ **= Value 4 Money**

Business = Creating & Delivering Value for Customers

- **On Time**
- **On Budget**
- **On Value**

Goal of Business



V = Perceived Customers' Value

P = Price (What Customer is WTP)

C = Costs (Total Costs)

V – P = Customer Surplus

P – C = Profit Margin

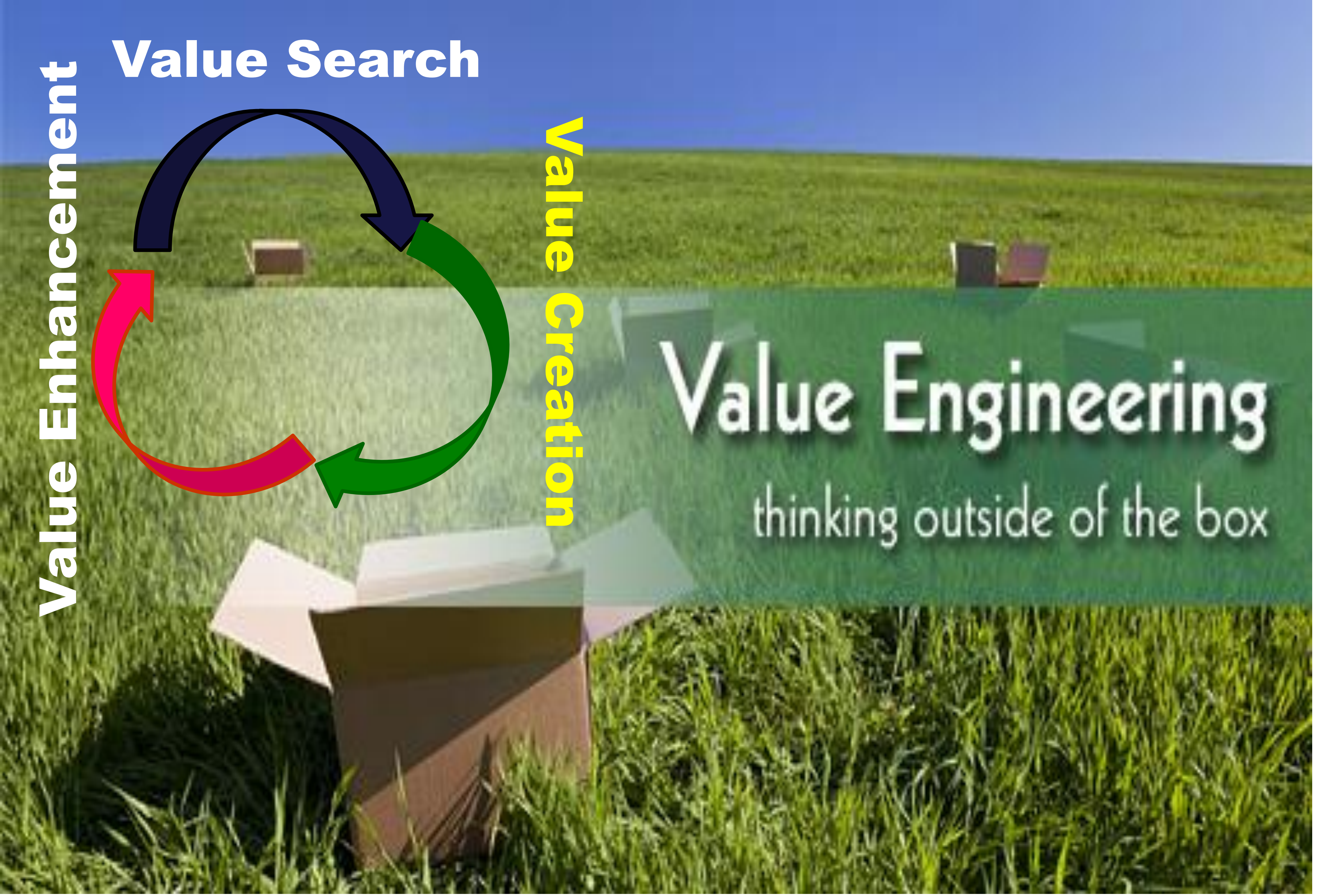
Creation and Delivery of Customers' Value

P – Controlled by Market & Completion, can not be easily increased

C – Can be decreased by efficient & innovate Production & Distribution Processes

V – P: Attracts customers ↓P – C = Decreased Profitability.

Strategy = ↑V, ↑P, ↓C to ↑Profitability


Value Search
Value Creation
Value Enhancement
Value Engineering
thinking outside of the box

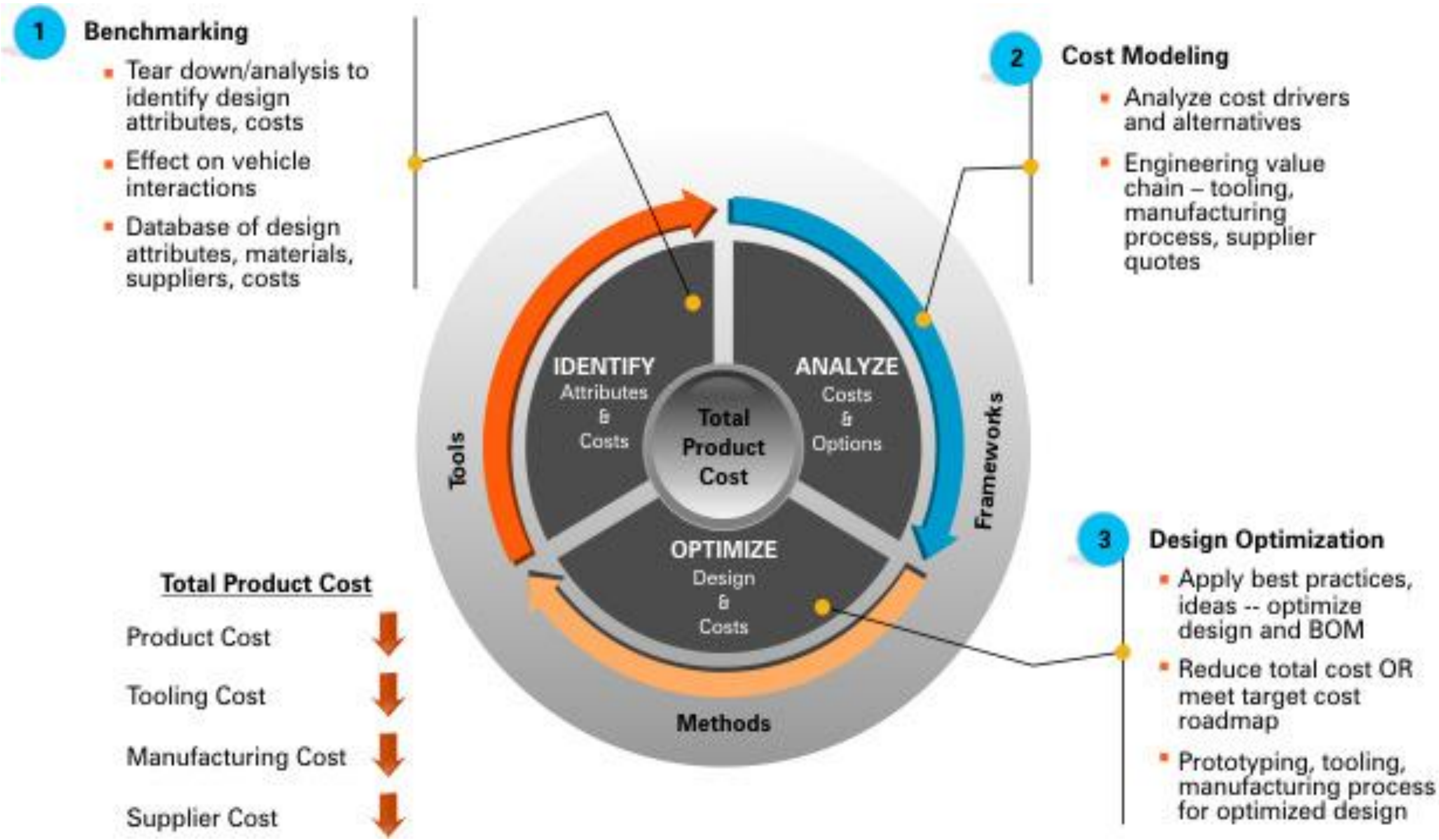
What is Value Engineering?

- **Value Engineering (VE) is defined as an organized effort directed at analyzing the functions of systems, equipment, facilities, services, and supplies for the purpose of achieving the desirable functions at the lowest life-cycle cost consistent with required performance, quality, reliability and safety.**
- **VE is focused on the design stage**

Source: OMB Circular A-131, Value Engineering, May 23, 1993

Consider the Usability, Appeal & Value For Money

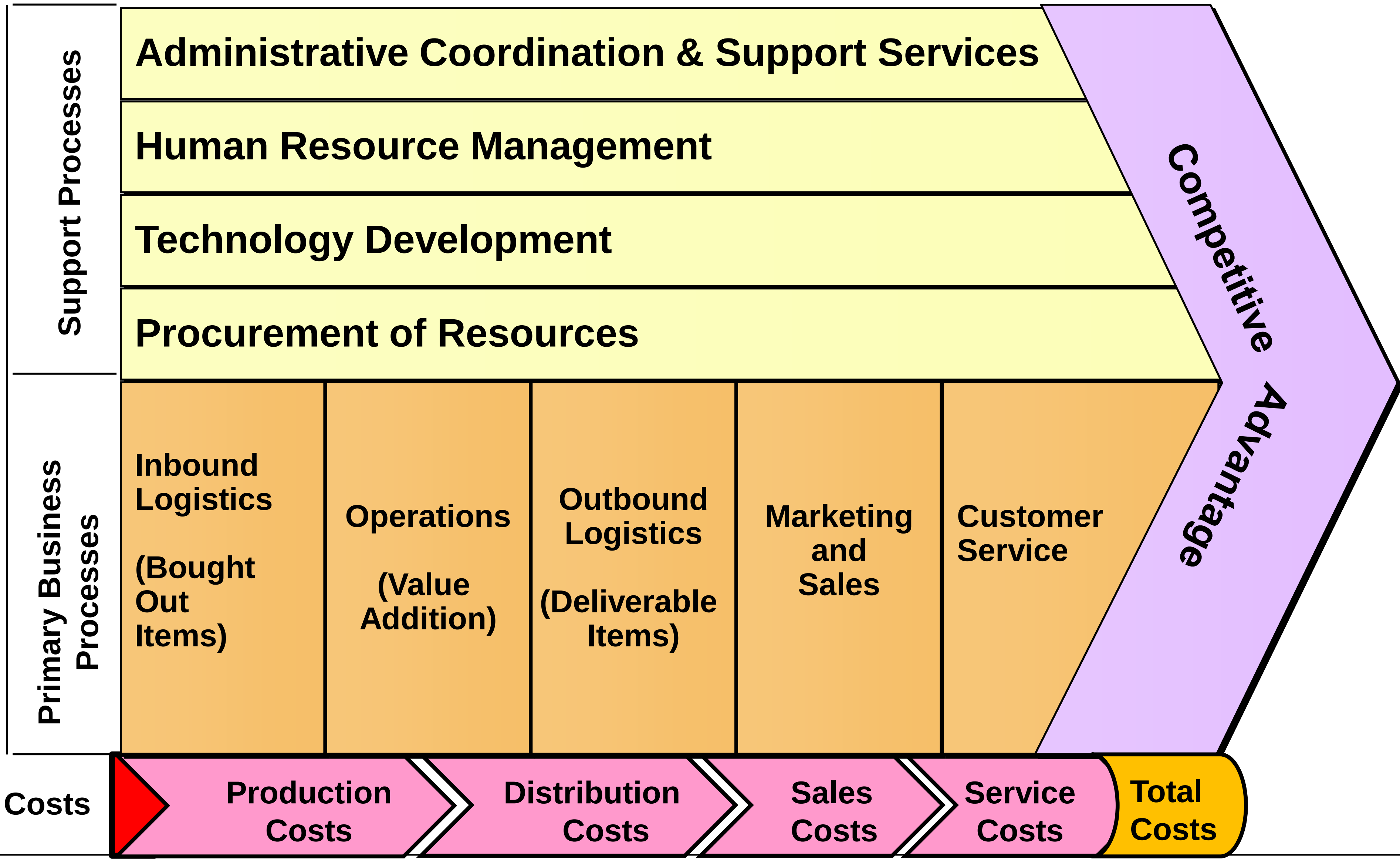
Value Creation



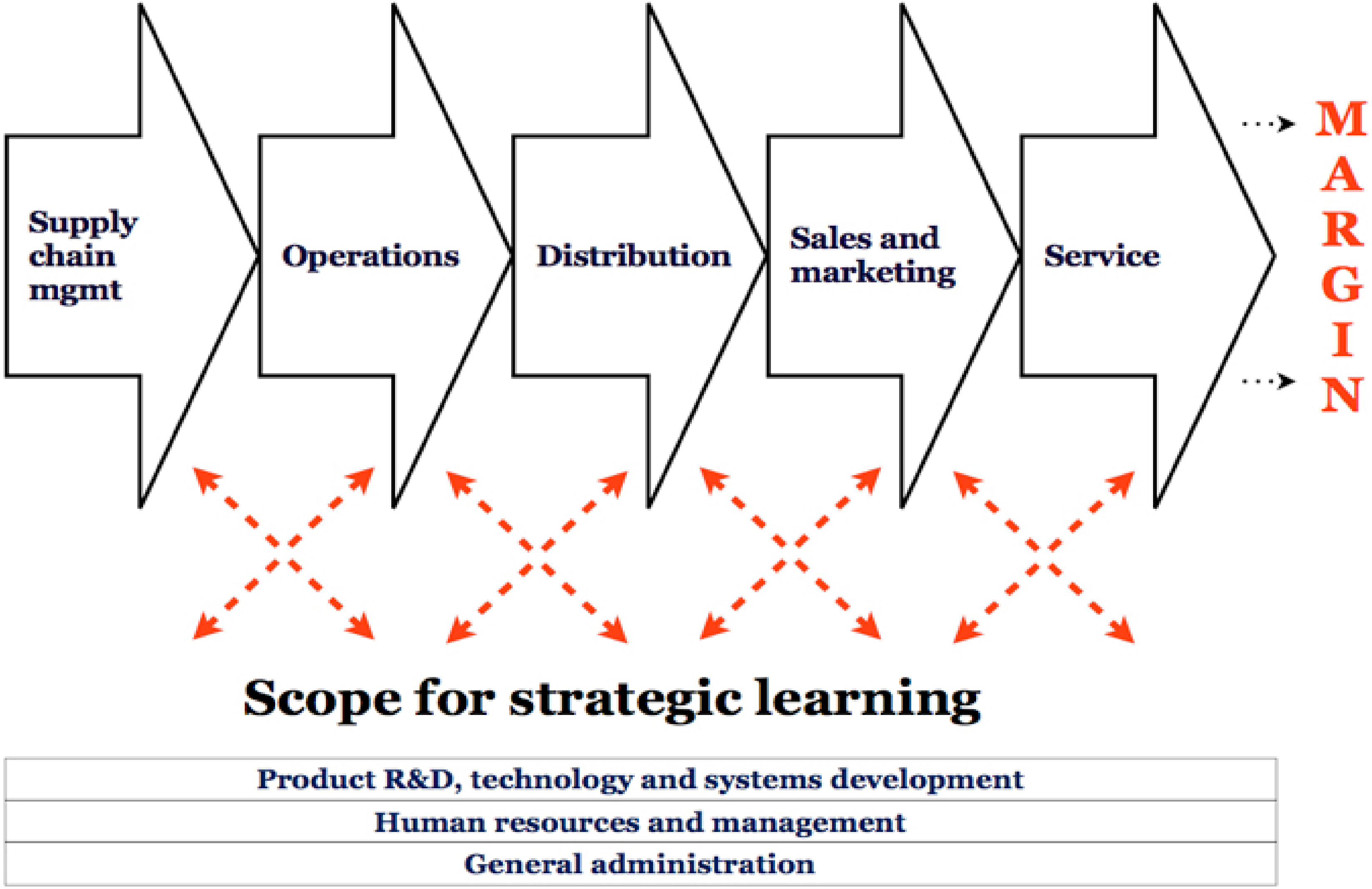
Case: Koo The Indian Social Networking Platform

- **The homegrown micro-blogging website, Koo, has become the best alternative to Twitter.**
- **The platform was started by Aprameya Radhakrishna and Mayank Bidawatka in March 2020. Koo is giving a voice to a billion Indians.**
- **It is currently available in four Indian languages including Hindi, Kannada, Tamil and Telugu. Just like Twitter, Koo allows users to express themselves through 400 characters of text or 1-minute short audio or video "Koos."**
- **The users have the option to follow others and send them 1-1 direct messages and use hyper local hash tags on Koo.**
- **Discussion Questions:**
  1. **How Koo adds value to its Customers?**
  2. **Figure out the challenges of Koo w.r.t Tweeter.**

Business Value Chain



The value chain shows *where* to learn

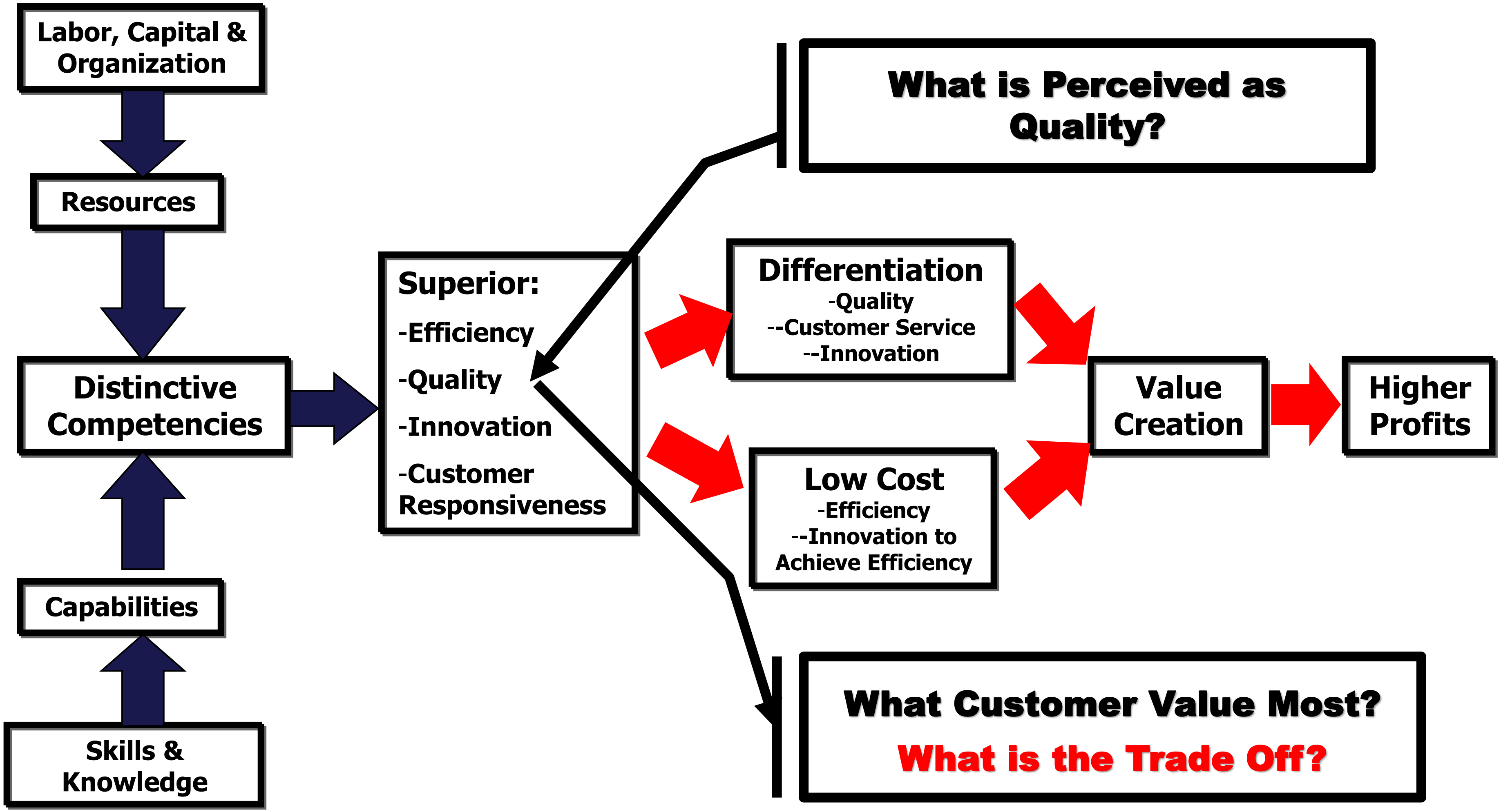


Competitive Advantage

- **An advantage over competitors gained by offering consumers greater value than competitors' offer**

The Roots of Competitive Advantage

(Hill, pp. 138, Nelson & Winter, & Dranov, et al.)



Design Thinking is Thinking for Customers' Value Creation

Dr. Swapan Kumar Majumdar

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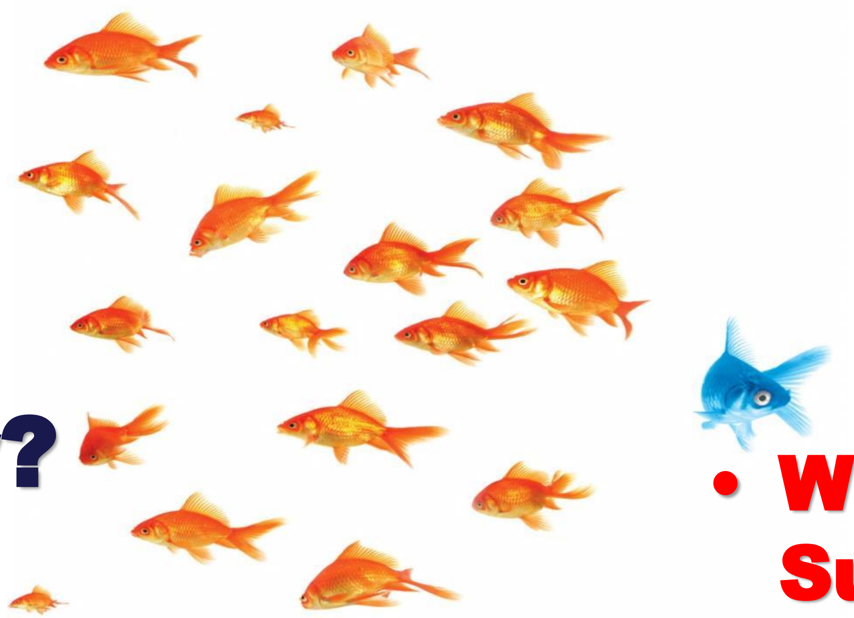
Many Aspire To Be Successful

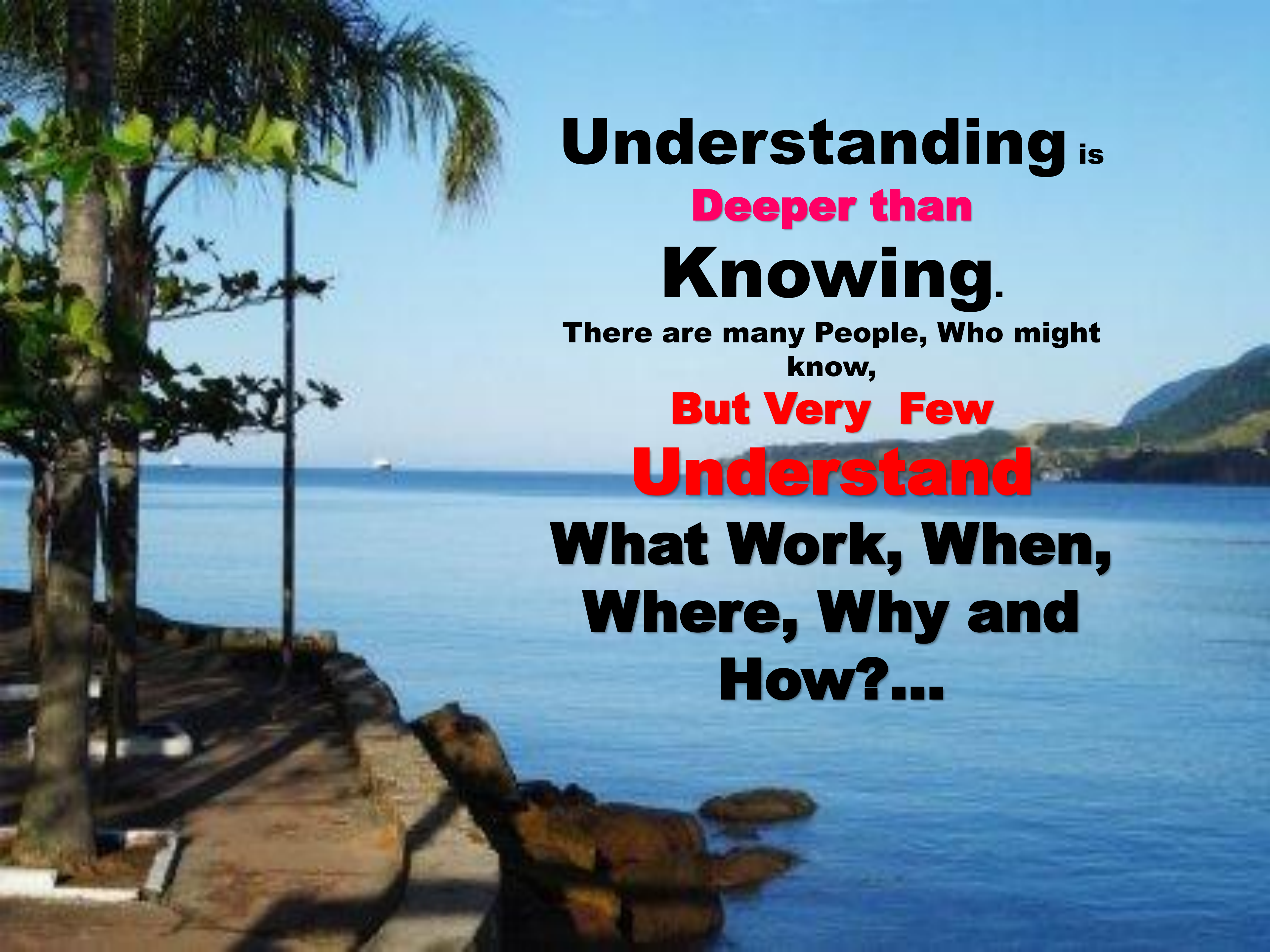
- Only 1 or 2 Succeed?



- Why?

- Who Succeeds?

One Who is Critical, has Deeper Understanding of What Works, Where, When, Why and How and Does Things Differently?


Understanding is
Deeper than
Knowing.
There are many People, Who might
know,
But Very Few
Understand
What Work, When,
Where, Why and
How?...

3 Grand Global Challenges for the 21st Century

1. **Freedom from Want,**
2. **Freedom from Fear, and**
3. **Freedom from Constraints (Time, Geography & Choice)**

– Adapted from UN Secretary General Kofi Annan

Entrepreneurs Need to Think Differently

Engage in Rigorous Dialogue and Debate

Think Critically, Objectively and Inclusively

Learn the System, Don't be Selective

"From Either-Or" To "Both-And"

MECE

(Mutually Exclusive Collectively Exhaustive)

ICE

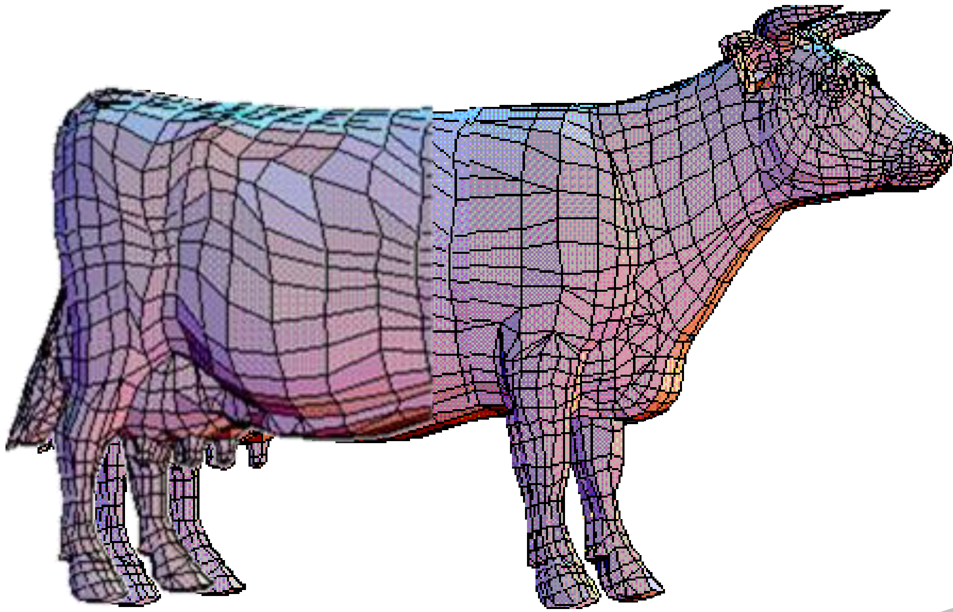
(Inclusive & Holistic)

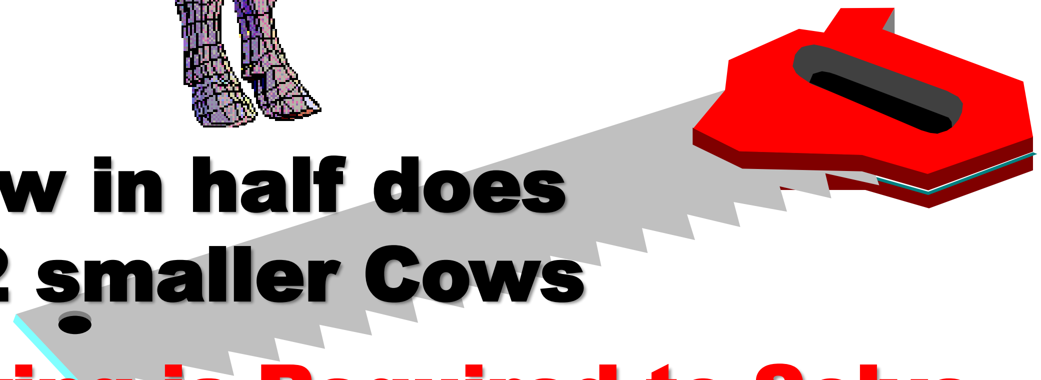
Understand the System

Uncover the Causal Loops & Decision Chains

What is System?

- A system is any group of interacting, interrelated, or interdependent parts that form a complex and unified whole that has a specific purpose





Dividing a Cow in half does not give you 2 smaller Cows

Integrative Thinking is Required to Solve Complex Problems

Understanding of Causal Loops of All Sub-Systems of the Total System and their Interactions

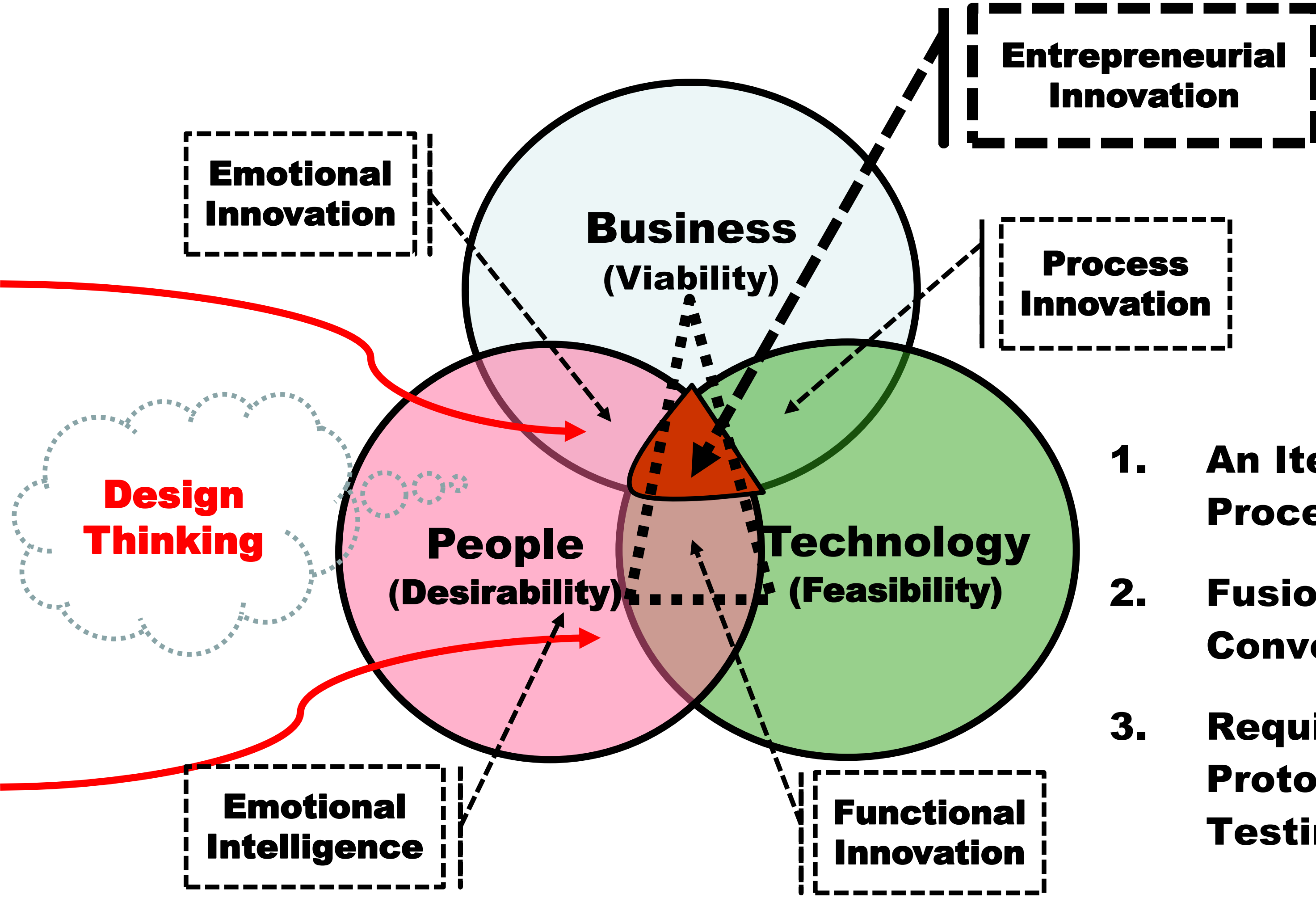
What is Design Thinking?

- **'Design thinking is a human-centered approach to innovation that integrates the needs of people, the possibilities of technology, and the requirements for business success.'**
    - ***- Tim Brown, CEO, IDEO***

Design Thinking

- **A Method of Designing Products and Services that are based on:**
  - **What people need and want**
  - **What people like or dislike**
    - **In regards to production, packaging, marketing, retailing, support, or all of them**
- **A skill that allows a designer to align what people want with what can be done, and produce a viable business strategy that creates customer value and market opportunity**

21st Century Entrepreneurship is Customer–Centric Technology Driven Creative Pursuits



1. **An Iterative Learning Process**
2. **Fusion of Diverse and Converse Phases**
3. **Requires Repeated Prototyping and Testing**

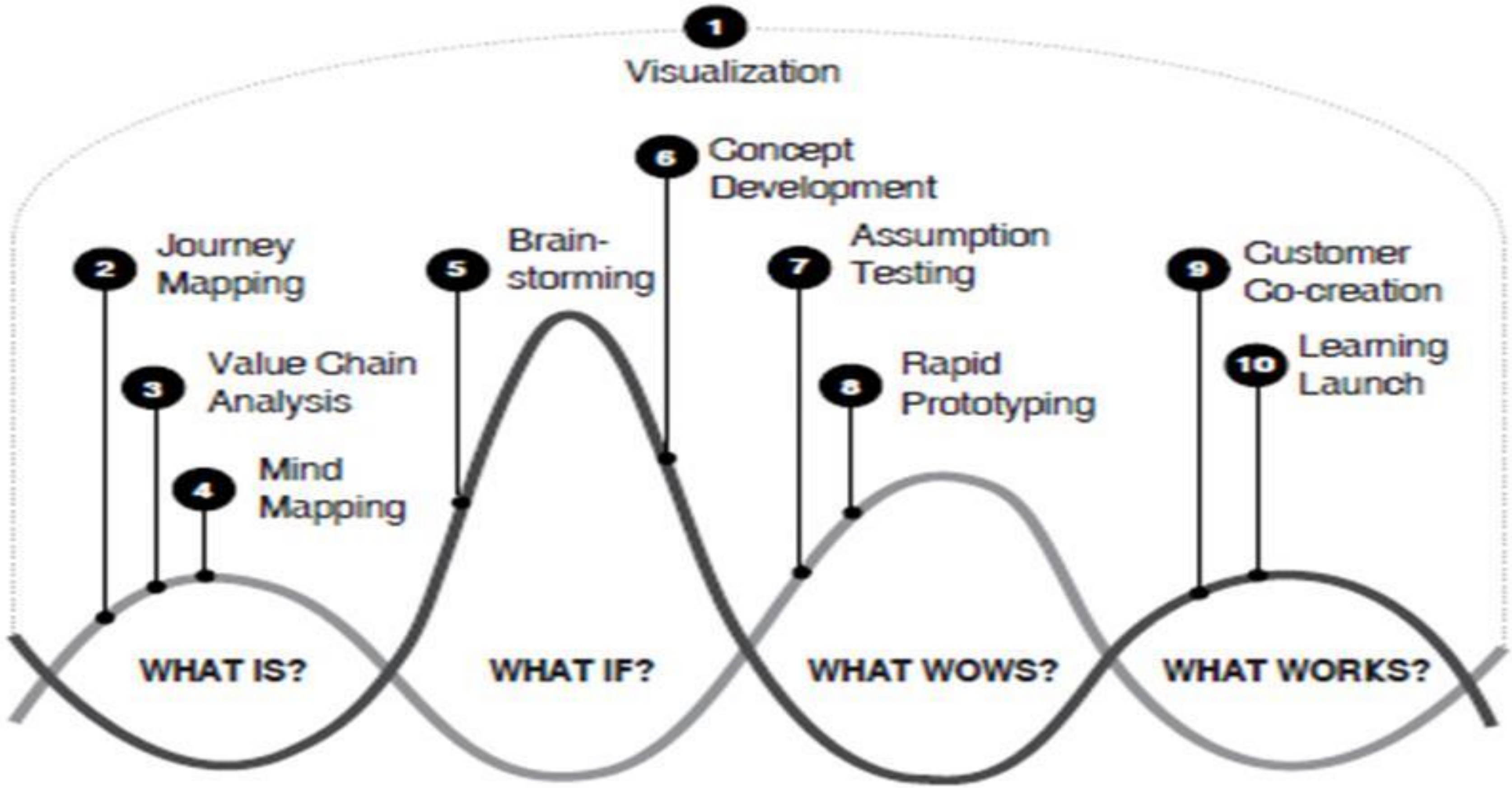
DVFA = Desirability, Viability and Feasibility Analysis

Design Thinking Mindsets, Tools & Templates

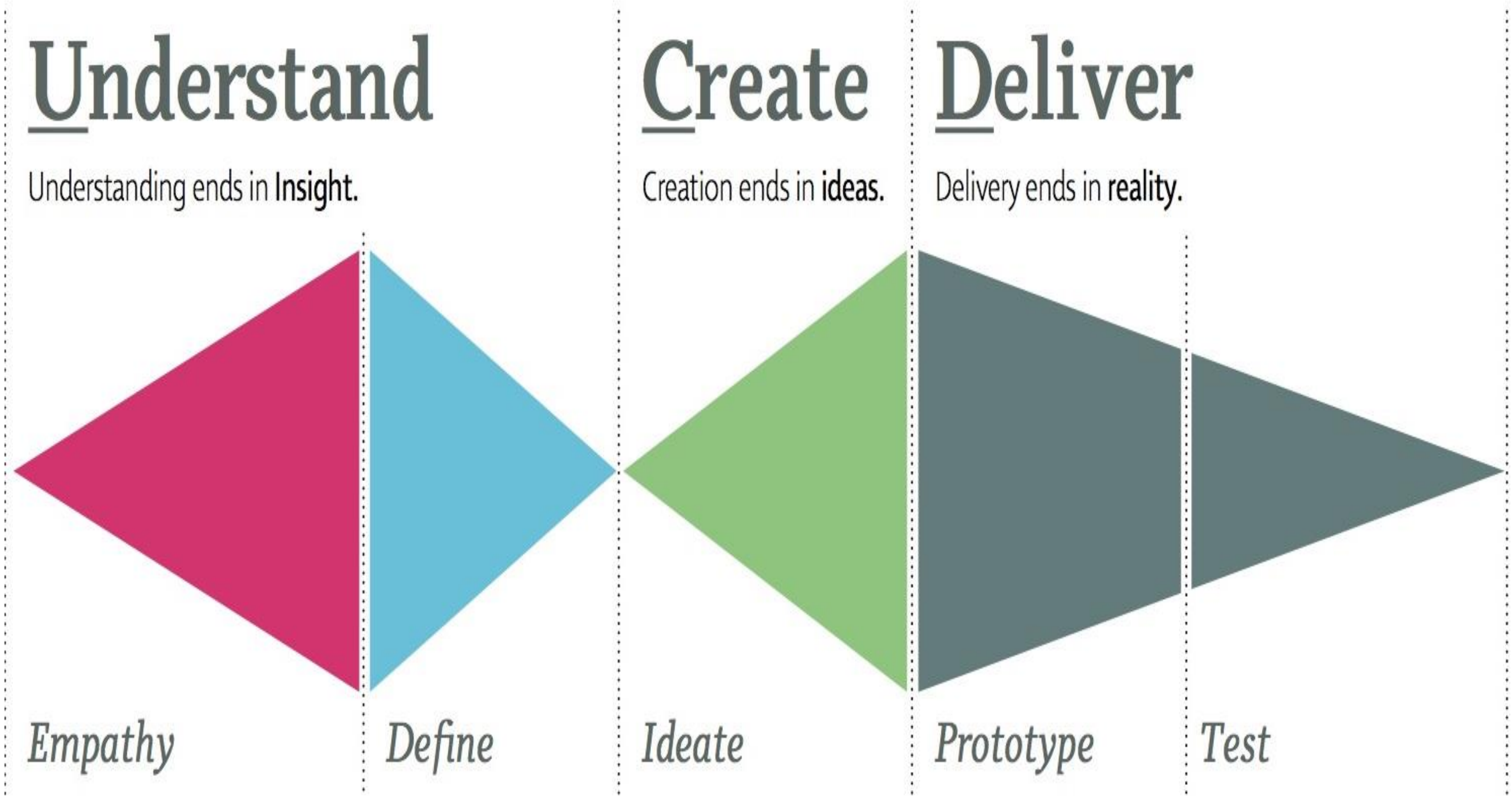
1. **Think users first**
2. **Ask the right questions**
3. **Believe you can draw/ visualize**
4. **Commit to explore**
5. **Prototype to test**

3 GEARS OF BUSINESS DESIGN

Visualization to Valuation

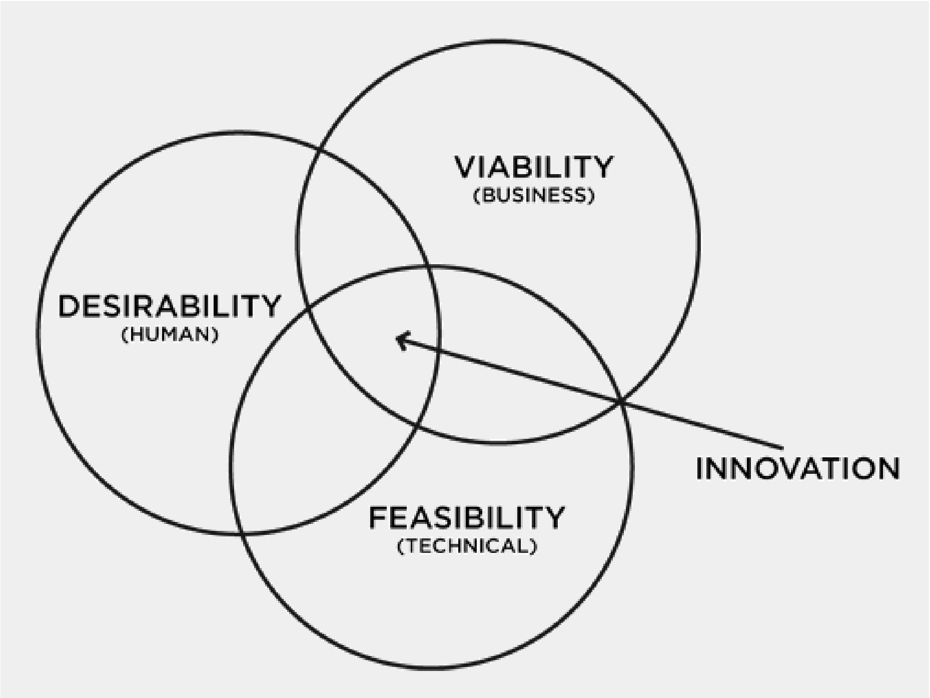


Design Process



Design Principle

- **Phases:**
  0) **Understand/observe**
  1) **Visualize/Realize**
  2) **Evaluating/Refining**
  3) **Implement (detailed engineering)**
  4) **Implement (manufacturing liaison)**



Inspiration

- Identify a problem
  - When something isn't perfect, there is opportunity for design thinking
  - Example: A Medical Group had issues with information flow between nurses during shift change
    - Problem: patient care wasn't perfect; nurses had no system for cataloging patient information, inefficient, and incomplete.

Phase 0: Understand/Observe

- **Study current market**
  - **Current users**
    - **Likes**
    - **Dislikes**
  - **Current techniques**
  - **History**
  - **Cost structure**
- **Understand how things are**
  - **Create feasibility record**
  - **Other creative firms avoid this process**

Phase 1: Visualize/Realize

- **Begin creating prototypes for potential solutions**
  - **Rough**
  - **Rapid**
  - **Right**
- **Constant contact with client**
- **Full context of product use**
  - **Storyboarding of characters using potential idea**
  - **Brainstorming**
    - **Focused**
    - **Encourage wild ideas**
    - **No judgment**
    - **Build on others ideas**
    - **Go for quantity**

Ideation

- **Prototyping**
  - **Does not have to be complex or expensive**
    - **`Must be physical**
      - **Intangibles can be taped**
      - **Visualizing helps review**
    - **True prototypes beg for improvement**
      - **A “finished” prototype isn’t necessarily the best prototype**
  - **Used to identify strengths and weaknesses of an idea and direct the next prototype in the best possible direction**
  - **Test, re-prototype, test, re-prototype, test, re-prototype…**

Phase 2: Evaluating/Refining

- **Begin turning rough prototypes of foam into functional prototypes**
  - **Shift from human factors/needs to engineering**
  - **Resolve technical issues**
- **Concurrent engineering**
  - **Engineer functionality**
  - **Design aesthetically pleasing product**

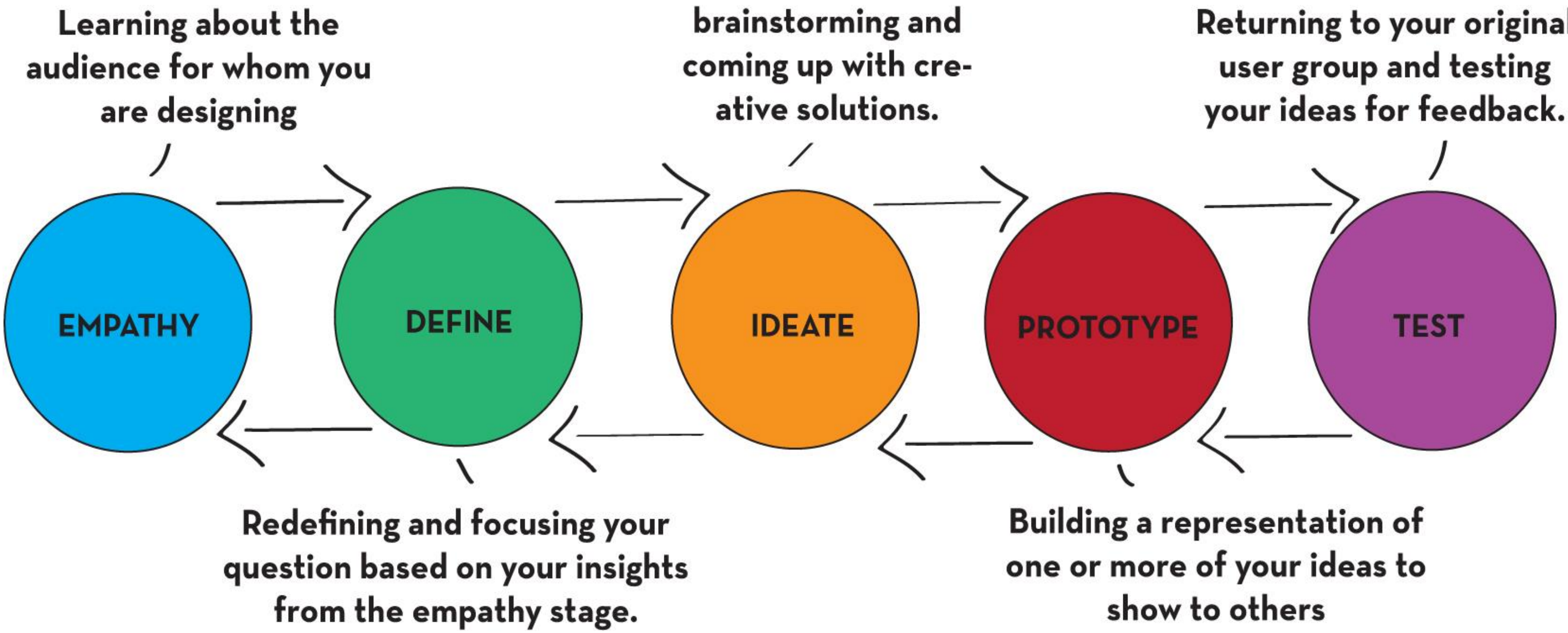
Phase 3: Implement (Detailed Engineering)

- **Verify the final product works**
  - **Successfully does what you set out to do**
  - **Meets regulations**
  - **Stress test**
- **Manufacturing protocols**

Phase 4: Implement (Manufacturing Liaison)

- **Move product from shop floor to client's manufacturing facility**
  - **Supervise production tooling**
  - **Regulatory approvals**

5 Steps of Design Thinking



Five Action Phases of Design Thinking

1. **Empathize - understand your customers/users' Pain Points**
2. **Define - outline clear project/business objectives**
3. **Ideate - explore ideas and solutions**
4. **Prototype - build and visualize ideas and solutions**
5. **Test - review and decide**

Conclusion

- **The World of Business is Constantly Changing**
  - **Technology shifts**
  - **Shifting demographics**
  - **Market shifts**
- **Design thinking helps to find solutions**
  - **Innovate**
  - **Human-centered Ideas that Creates and Delivers Value to Their Customers**
  - **Inspire**

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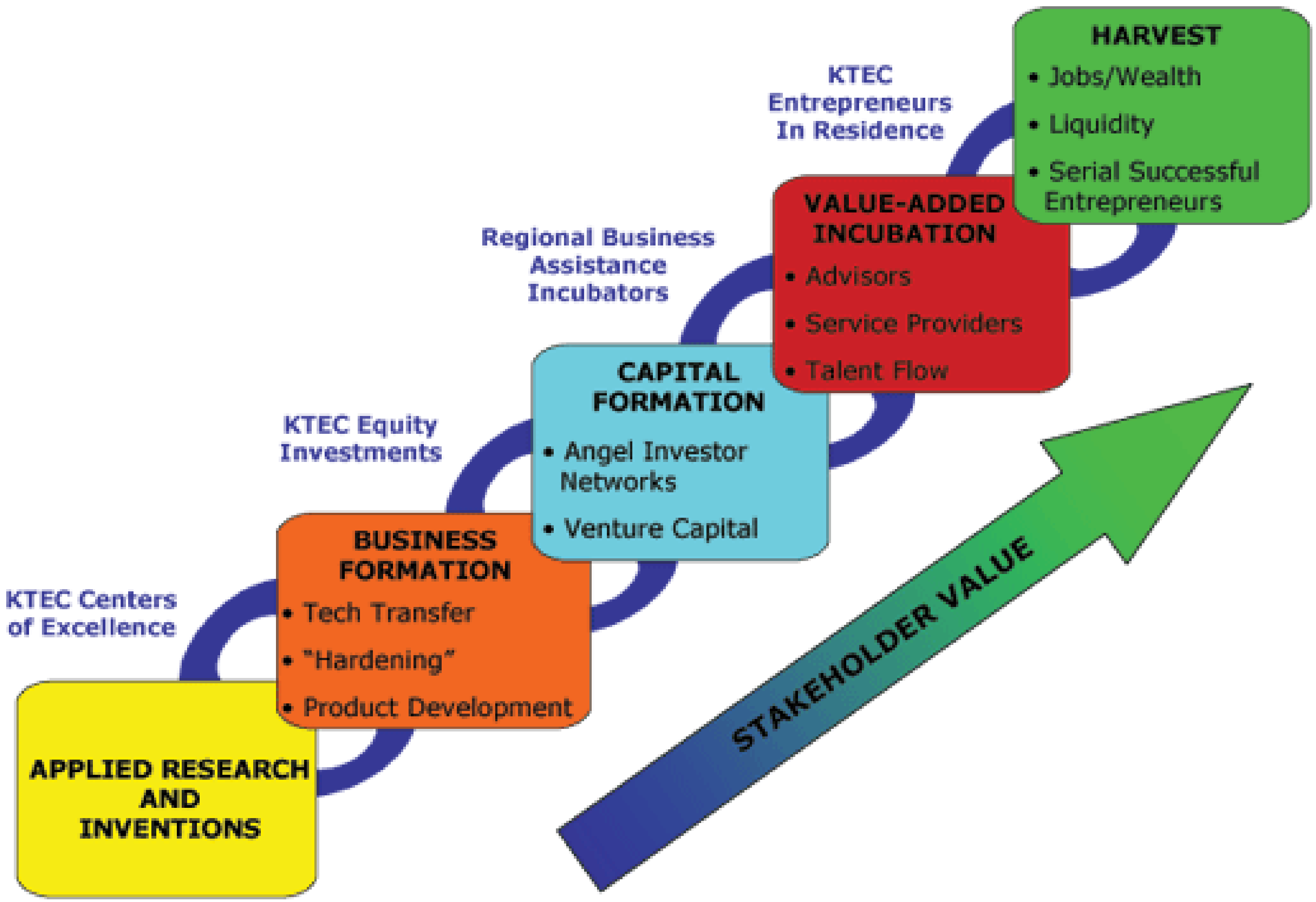
Thanks You For Your Attention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The Questions Every Entrepreneur Must Answer
by Amar Bhidé

Lean Strategy
by David Collis

The Global Entrepreneur
by Daniel J. Isenberg

Launch a Start-Up That Lasts

FROM THE

EDITORS

Don't Self-Combust

START-UPS ARE USUALLY HOTBEDS of innovation. They buzz with an energy and excitement that only fresh ideas and new possibilities can bring. They also are full of risk, which is why many never truly get off the ground. The qualities that entrepreneurial souls bring to their ventures—passion, courage, and tenacity—are not enough to propel them into orbit, or to keep them there.

After observing hundreds of start-ups, Amar Bhidé distills his advice in the article "The Questions Every Entrepreneur Must Answer": What are my goals, for myself and for my business? Do I have the right strategy for the trajectory I envision? Can I execute the strategy with the resources I've got? These three questions are critical for helping entrepreneurs analyze their unique situations, prioritize among numerous opportunities and problems, and make rational, future-oriented decisions. They also owe it to themselves and the people around them to identify everyone's sources of fulfillment and frustration.

Once you understand the business you're in and the particular traits you and your team bring to the table, you have to start planning for growth. That is often where start-ups fumble. In "Start-Ups That Last," Ranjay Gulati and Alicia DeSantola provide a framework for founders to get their heads—and their operations—geared for the mechanics of effective scaling. These include hiring functional experts and creating a management structure that does not constrain informal relationships. Entrepreneurs who don't have a corporate bent may balk at this idea, but the authors' research shows that without some form of organization and discipline, chaotic operations and unpredictable performance ensue.

To guard against the extremes of rigid systems on the one hand and unchecked experimentation on the other, David Collis's article "Lean Strategy" recommends combining the best of strategic planning and the opportunism of entrepreneurship. By identifying boundaries in which to innovate, a lean strategy provides direction and alignment for the young organization without stunting it. It helps to both filter and measure the success of experiments, thereby preventing the growing venture from self-combusting midway through the process.

To take a start-up past the launch phase and into the stratosphere, entrepreneurs don't have to squash their pioneering nature, but they must know themselves and their long-term goals—and then hire and manage accordingly. It's much easier to command a ship, as Ranjay Gulati notes, "when you don't have to worry that someone forgot to fill the tank."

—The Editors

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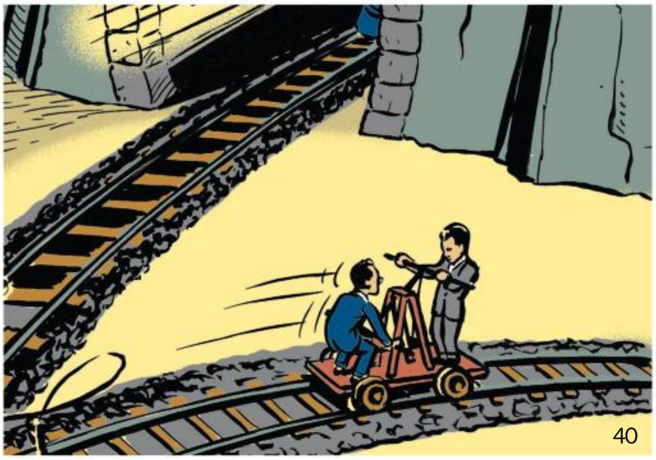
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Culled by the editors of *Harvard Business Review* from the magazine's rich archives, these articles are written by some of the world's leading management scholars and practitioners. They are accompanied by "Article at a Glance" summaries, plus suggestions for further reading.

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MANAGING YOURSELF

The Three Roles of Great Entrepreneurs

by Anthony K. Tjan

EVERY START-UP ENTREPRENEUR has an overwhelming amount to get done—the "to dos" are constantly outrunning the "dones." It is easy to get caught up in the day-to-day tasks and forget that running really hard does not necessarily equate with running in the right direction. To paraphrase one of my partners, the good news is that you're making good time; the bad news is that you're lost.

To stay focused, early-stage CEOs should remember that a business needs to do just three important things—planning, selling, and executing—and that these tasks require three different mindsets. Some entrepreneurs can excel in all three roles, but the best ones are aware of their strengths and weaknesses—and they build their teams accordingly.

The first step is knowing which role your talents match most closely.

THE ARCHITECT
Big-Picture Planning

Entrepreneurs set the vision, romance, and culture for the company around a big, daring goal. To do so, they must have a general plan for where they want to go, but they shouldn't get hung up on developing the perfect plan. They should think like an architect in the concept- and design-development phase rather than the detailed schematic phase. The details of every initiative should change with new customer and market feedback. That is why the best venture capitalists bet first and foremost on the people and second—and it's a distant second—on the plan. It's easier to adjust a plan than it is to adjust people. At the start-up stage, plans need a clear purpose and the top few priorities for achieving them; many others can wait to be fully developed.

Ivan-Pushkin

THE STORYTELLER
Researching and Selling

Great entrepreneurs need to be constantly selling the story of their vision, as well as researching how it should evolve. Whether raising funds, evangelizing the vision among employees, recruiting top new talent, or selling the product itself, an entrepreneur must constantly pitch—like a salesman out of *Glengarry Glen Ross*—and act as the company's chief storyteller. More business schools should integrate the art and science of communications and selling into their curriculum. People can learn and develop many aspects of effective selling. Even if they turn out to be only moderately good at it, they'll realize that by selling on the front lines, they gain access to invaluable customer and product research. These customer interactions help turn a directional vision into one with a more precise focus, especially in the digital world where strategies are iterative with more-frequent version releases. Selling slightly ahead of the perfect product cycle can help you test cheaply and make any required adjustments.

An entrepreneur must act as the company's chief storyteller.

THE DISCIPLINARIAN
Executing

Excellent execution comes from adhering to a tight set of controls and operating principles. The starting point is having the appropriate operating metrics to measure the progress you are trying to achieve. Across our portfolio companies, we work with CEOs to establish the right priorities and then set the right operating metrics in a dashboard, which we review at regular intervals. This dashboard might include, for example, customer counts, recurring customers, and online usage patterns. The key to delivering what you want to deliver is to know how to pick the customer and operating metrics that can serve as leading indicators for the financial metrics you ultimately desire.

Planning, selling, and executing sound straightforward, but playing all three roles at once can be challenging for early-stage CEOs. At times these aspects of the job can seem the antitheses of one another, and few people possess the talent to do all three equally well. Fortunately, you don't need to if you build a strong team.

To assess your own entrepreneurial aptitude and effectiveness, take a hard look at your recent tasks, meetings, and other activities. How do they fit into these three buckets? Once you understand which of these areas you are strongest in, focus on the priorities that match your skills and quickly fill the gaps with the best talent you can find.

Originally published on HBR.org
June 16, 2010

Anthony K. Tjan is the CEO, managing partner, and founder of the venture capital firm Cue Ball and a coauthor, with Richard J. Harrington and Tsun-Yan Hsieh, of the *New York Times* bestseller *Heart, Smarts, Guts, and Luck: What It Takes to Be an Entrepreneur and Build a Great Business* (Harvard Business Review Press, 2012).

How Your Leadership Has to Change as Your Start-Up Scales

by Jeffrey W. Hull

WHEN IT COMES TO new tricks, sometimes new dogs are just as hard to teach as old ones. At least, that's what I was thinking when I recently sat in on a senior team meeting at a fast-growing, two-year-old e-commerce company. I winced when Daniel, the 32-year-old CEO, said, "Come on, guys, I need you all to focus more on execution. If we're going to scale successfully at the pace we've laid out, we've got to execute faster and delegate more. I want you pushing hard on your teams. Get them to step up and execute! That's why we've brought Jeff in, to coach all of us on how to motivate the troops." I smiled sheepishly. *Really?* I thought. *That's not what I had in mind.*

Don't get me wrong—Daniel's intentions were good. Many start-up CEOs adopt this "visionary entrepreneur" leadership style. They set out a broad vision, provide lofty goals, and model an ambitious work ethic (for recent college grads, it's not a big leap from "all-nighters" to "all-weekenders"). And at this stage in a company's growth, it generally works. Just being close to the founders—working alongside them, being in meetings where there is a personal connection—tends to motivate and inspire young staff. Early employees feel that they belong to a special "club."

Yet maintaining that enthusiasm as the company grows is difficult, especially as the direct link between founders and employees becomes less tangible or less possible (for example, when opening remote offices). As a result, many start-ups that experience 0% turnover during the first year or two suddenly find themselves dealing with as much as 40% turnover in year three.

To address the engagement problem, leaders like Daniel need to recognize that the methods for leading and motivating staff they used in the start-up phase may no longer work. According to Self-Determination Theory, intrinsic drivers such as autonomy (the ability to "self-author" one's work), competency (the sense of continued growth in skills and abilities), and relatedness (the sense of connection, inclusion, and belonging) are crucial factors in building an engaged, committed workforce.

To scale the business successfully and keep his employees on board, Daniel needed to focus on these motivational drivers and shift his mindset from "start up" to "scale up." The latter requires balancing the "push" mode of leadership (tell, direct, delegate) with a "pull" approach (empower, collaborate, coach), which has been shown to generate greater commitment and creativity in staff members regardless of their age or the size of the company.

Here are four things leaders and their organizations can do to move from start-up mode to scale-up mode:

• **Listen more.** First, you need to shift from directing to coaching, which is all about listening rather than telling. Ask thoughtful, open-ended questions; pay attention (no texting or distractions); maintain eye contact and receptive body language; and let silence be OK (so that employees can gather their thoughts). Many harried leaders may balk, insisting they have no time for this. Keep in mind that it's not the quantity of time you set aside that matters—it's the *quality*.

• **Align employee and business goals.** Shift from purely directive goal setting to a reciprocal process that links the growth of the business with the growth of the individual. When people feel that business goals are tied directly to their development, they are much more likely to go the extra mile. Ask employees to reflect on their personal goals and find ways to incorporate them into business initiatives. For example, a digital marketing director at Daniel's company wanted to gain greater visibility and impact beyond her area of focus. So she and her boss agreed to have her lead the development of a pop-up store, which required collaboration with finance, sales, and product teams. Because the temporary retail outlet was a first for the company, it was highly visible and allowed the marketing director to stretch beyond her digital responsibilities. She was excited about the opportunity, it helped her grow, and the project was a success for the organization.

• **Create feedback loops.** Include time for two-way feedback ("How are you doing, and how am I doing?") in weekly or biweekly one-on-one meetings with staff members. That way, feedback will become embedded in the culture instead of happening ad hoc in out-of-the-blue "gotcha" sessions or too infrequently at annual review time.

• **Build peer-to-peer networks.** Even in small companies, big-company programs such as cross-functional quality assurance groups or employee resource groups (ERGs) can help deepen the sense of inclusion and relatedness that's lost when the company grows beyond the start-up phase. (ERGs are groups formed around staff affinities, such as volunteering or support for women, or communities of LGBTQ people or people of color.) These groups bring together staff from different functional areas to share lessons learned from completed projects and to brainstorm potential quality improvements or innovations. They help break down silos, broaden awareness and sensitivity to other groups' goals and needs, and avoid building a finger-pointing culture. Research into the benefits of ERGs at large companies such as American Express, Accenture, and Merck has shown them to improve retention and engagement. In some cases, acting like a big company may help you become one.

For Daniel, it was a challenge to become a good listener, to set aside time for brainstorming sessions with employees who were two or even three levels below him. However, he's now a big fan of what he calls his monthly "listening tour"—regular breakfast meetings with employees from across the company. Staff members appreciate the opportunity to connect, and Daniel regularly comes away with ideas that might never have bubbled up otherwise.

Daniel and his cofounders also began to sponsor and provide time for a cross-functional, volunteer QVC (quality, values, culture) group, where staffers meet and brainstorm how to make the company's values statement real. Just as Daniel can see tangible benefits from listening more, he and the other executives see an upside from the ideas and enthusiasm generated by this peer-group interaction. The head of HR is working to institute a simple online checklist for leaders to track their two-way feedback interactions with staff. She is optimistic that these conversations will become embedded in the fabric of the organization, as she plans to provide training on

Acting like a big company may help you become one.

feedback best practices and to monitor use of the checklist.

These kinds of initiatives, which balance CEO or founder directives with cross-functional interactions and two-way dialogue, can go a long way toward addressing employees' needs for relatedness, autonomy, and personal growth. If Daniel and other leaders hope to grow their companies past the start-up phase, they need to scale with a balanced leadership approach, one that pulls the best from good people instead of unintentionally pushing them out the door.

Originally published on HBR.org
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Jeffrey W. Hull is the director of education and business development at the Institute of Coaching (a Harvard Medical School affiliate), a clinical instructor in psychology at Harvard Medical School, and an adjunct professor of leadership at NYU. For more than 20 years, he has served as a coach and consultant to hundreds of organizations around the world, specializing in leadership development and organizational strategy, design, and transformation.

READER COMMENTS

Organizations tend to develop dysfunctional behaviors in a predictable manner based on their state of organizational maturity, such as the "32-year-old CEO" who needs to "shift his mindset from 'start up' to 'scale up.'" Early-stage firms are most damaged by a failure to clearly define purpose; midstage firms by a lack of consistent, predictable performance; and late-stage firms by a lack of engagement of staff.

—Larry Mandelberg, principal, Mandelberg Consulting

In the beginning of a start-up, the organization is often a single person, possibly a handful at most, who weighs his interests against those of the customers. As an organization grows, new employees often do not experience the same direct benefit for extra effort as executive management, and the leaders must now account for an increasing number of stakeholders. The people who work for the organization become the customers who should be getting your extra time and effort, because they are working to build the dream you started.

—Ned Keitt-Pride, marketing product manager of power controls, ETC

Laura Schneider

How Decision Making Evolves as a Start-Up Grows

by Brian Halligan

AS I APPROACH the 10-year anniversary of HubSpot, the marketing and sales software firm of which I'm CEO, I've been reflecting on the decisions I've made—both right and wrong. I've also been considering how my decision-making process evolved as the company moved from an early-stage start-up to a growth-stage scale-up. Understanding my own evolution in decision making and the tools I use today may help spare other scale-up leaders some unwanted headaches.

Flip-Flopping Will Cost You

In start-up mode, I changed my mind all the time. Most of my decisions didn't affect many people, so I didn't hesitate to change course often. This became problematic in scale-up mode: Every time I changed my mind, it impacted hundreds of employees and typically involved retooling lots of processes and systems. Over time, I learned that the cost of changing your mind becomes huge as your start-up scales up.

Optionality Will Also Cost You

A closely related bad behavior is not making up my mind and keeping my options open. It's hard to see at the time, but optionality has a hidden tax. Here's an example. In the start-up days of HubSpot, we argued for years about which target persona to pursue. Target personas go beyond the demographics and psychographics normally associated with target markets. Personas focus more on the specific needs, pain points, and buying process of your ideal prospects and customers. In HubSpot's case, we were toggling between focusing on marketing-manager types at midsize businesses and focusing on small-business owners wearing multiple hats, including marketing.

I just didn't make the call. My indecision meant that the marketing and product teams had to serve multiple personas—and ended up creating middling solutions for each of them. Once we ripped off the Band-Aid and decided on one persona, the marketing and product teams could focus their efforts and craft the perfect solution. We delighted customers more, and our close and growth rates went through the roof.

As the company has grown, I've learned to listen carefully to all the inputs, engage in healthy debate with my team, take my time, make a decision, and "sail the ship." Sailing the ship means that decisions are final. We put the sails up, send the boat out of the harbor, and there's no turning around. I tell my team that I've heard their point of view and if someone disagrees, I'm sorry, but we're ready to sail. The worst thing that can happen is people continuing to debate the issue when they're on the losing side. It's not always easy, but you need to make final decisions and not field arguments from the losing side.

Choose Right Versus Fast

In start-up mode everything comes at you quickly, and you tend to react fast. If you're a manager and make a wrong decision, you just roll it back. Simple. In scale-up mode, however, you have a choice: You can do things fast, or you can do things right. There's always a balance, but in scale-up mode you need to shift toward doing things right more often than doing things fast.

If you do everything fast in a scale-up, you end up with "shortcut debt"—a close cousin to "tech debt." (For the non-IT types, this common phrase refers to the extra development work that arises when code that is easy to implement in the short term is used instead of applying the best overall solution.) Shortcut debt will leave you in the same predicament. If you take the easy way out the first time around, you're left spending time cleaning up messes that never should have occurred. And what if too much shortcut debt racks up? It cripples your ability to manage. Your whole team will be too preoccupied with having their fingers in the dam, holding back the water.

In scale-up mode, you can do things fast, or you can do things right.

Stop Making Uninspired Compromises

Nothing kills a scale-up like the uninspired compromise. The more managers sitting in the room with strong opinions and good arguments, the more likely you are to come up with an uninspired compromise. Everyone might be happy, but uninspired compromises tend to be conservative by nature.

In the early days, just you and your cofounder make the big decisions. It is relatively easy to persuade one other human being (who probably sees the world in a similar way) to make a risky, bold, counterintuitive call. As your company scales, a lot more people weigh in on decisions. If you did your job well, you hired a diverse group of people on the basis of varied experience and brainpower, and they are likely to have strong convictions and the ability to persuade others. It is infinitely harder to get those 10 people from varied backgrounds to make a risky, bold, counterintuitive call than it was to influence your cofounder. You find yourself making compromise after compromise—and before you know it, you are making the same decisions your competitors are making, you're building the same product your competitors are building, you have the same culture your competitors do, and you and your competitors have the same mediocre results.

As the CEO, it's your job to make the right decision, not the most popular decision. During HubSpot's scale-up period, I often left meetings having disappointed some managers; I could feel it as soon as I stepped out of the room. But uninspired compromises feel much worse. Once decisions are made, it's important to communicate them clearly to the rest of your team. Again, the key to this principle is having a culture of healthy debate and people rallying around the decision—whether they're advocating for it or not.

Focus on the Three Duties of a Leader

Stop me if you've heard this one before, but I find myself using it a lot these days:

A leader has three responsibilities, all of which can be illustrated by a bus trip. First, the leader needs a clear set of directions about where the bus is headed. Second, the leader needs to know whom to pick up and whom to leave at the bus stop along the way, a concept the management writer Jim Collins made famous. The people on the bus need to be excited about the direction and ready to work together en route. Some will hop off along the way, and that's normal. Third, the leader needs to make sure there is enough gas in the tank (cash in the bank account) to get to the destination.

The bus trip analogy is a back-to-basics approach to decision making that I try to use when I look at HubSpot and the leaders on my team. If you stick with the bus analogy, it'll help you with the micromanaging tendencies that most CEOs, including myself, have.

Adopt a Martian's Point of View

Sometimes you get so wrapped up in your own guardrails, your company's set of assumptions, or your industry's conventional wisdom that you lose sight of the forest for the trees. When I'm in a meeting, feeling like I'm stuck in my company's or industry's box, I take an unconventional approach.

I ask: "What if a Martian landed in the room right now and was faced with this decision? What would she say?" More often than not, asking what a total outsider might do—someone with zero knowledge of conventional wisdom or company history—can help pull a discussion out of the weeds and help you make the right decision. At HubSpot, that means solving for long-term enterprise value, not for short-term goals or what an investor wants to hear.

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Vincent Tsui

The Skills Most Entrepreneurs Lack

by Bill J. Bonnstetter

ENTREPRENEURS ARE a unique group of people, but they behave in patterns. In fact, my firm's research shows that most serial entrepreneurs exhibit persuasion, leadership, personal accountability, goal orientation, and interpersonal skills. But in that same study, we also discovered a set of skills they do not possess.

To rehash our methods, we assessed the personal skills of subjects identified as serial entrepreneurs. Then they were compared with a control group of 17,000. As before, this group was assessed on their mastery of 23 practical, job-related skills. We measured whether skills were well developed, developed, moderately developed, or needed developing.

After analyzing the data, we found that most serial entrepreneurs lacked four distinct skills: three statistically significantly and a fourth also noticeably lacking. The statistical significance was derived by comparing the lowest-ranking skills with the entrepreneurs' top skills, as evaluated in the first part of the study.

Key Traits of a Serial Entrepreneur

Empathy. This is one of the qualities serial entrepreneurs lack most. Entrepreneurs build things and solve problems for people, but according to this study, they do this in hopes of a return on investment. Entrepreneurs may have high empathy on an intellectual level in that they want to produce a product or service that will help people. However, entrepreneurs also expect to receive a return for their time and effort, whereas people with high empathy generally do not.

Self-management. Entrepreneurial-minded people are not proficient in managing themselves and their time. In many jobs, managing personal day-to-day tasks might take away from accomplishing larger company goals, which are critical to entrepreneurs. Given that entrepreneurs typically have many projects underway, they simply do not have time to micromanage each one. Often they need assistance managing everyday tasks and should hire or delegate them to someone who has mastered this skill.

Planning and organizing. Similar to self-management, if entrepreneurs spent time planning and organizing every task or meeting, they would never get anything else done. Once again, hiring someone to oversee their calendars, organize meetings and events, keep the office decluttered, and help them stay on schedule can put them at an advantage.

Analytical problem solving. Entrepreneurs have high utilitarian motivators (potential future gains, monetary returns, new products or ideas), so their focus is often on making a quick decision. They have a sense of urgency in decision making, and by nature they do not have time to collect and analyze the data. They see numbers as getting in their way, and they should—everyone who has told them an idea wouldn't pan out has used data and logic to illustrate that point. For example, Martin Luther King Jr. stated, "I have a dream." He did not say, "I have a plan and strategy." Entrepreneurs have the vision but need to employ people to create an executable strategy and carry it through.

Entrepreneurial-minded individuals possess a distinct set of skills that lead to great leadership and ideas. Perhaps the skills they have not mastered are equally important. By understanding those weaknesses, they can compensate for them by surrounding themselves with people who excel in those areas. As a leader, recognizing others' strengths and dovetailing them into your own weaknesses is key to developing a team that will carry out your grand vision and achieve goals.

THE KEY TRAITS OF A SERIAL ENTREPRENEUR

Based on a control group of 17,000 working adults, serial entrepreneurs tested above and below average in the following skills:

SOURCE TARGET TRAINING INTERNATIONAL

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Bill J. Bonnstetter was the chairman of Target Training International.

VOICES FROM HBR.ORG

Being an Entrepreneur When You're Not Extroverted

by Meredith Fineman

"**YOU REALLY** hate people," my former boyfriend said to me as we discussed our weekend plans. He, as always, wanted to get groups of friends together. I wanted, in contrast, a night to ourselves. "I don't hate people," I said, angry and sad that we were having *this* conversation again. "I just don't want to be around them all the time."

I'm an ambivert—both an introvert and an extrovert. As an ambivert, I love being social and participating in social activities, but with active pauses for restorative personal time. Most people are ambiverts.

For anyone with introverted qualities, the above conversation (or some variation of it) might sound familiar—your desire for alone time, one-on-one time, or a little peace and quiet is met with misunderstanding and often judgment. I don't think the guy in question meant harm—it's just that our society, as Susan Cain underscores in her best-selling book *Quiet: The Power of Introverts in a World That Can't Stop Talking* (Crown, 2012), values extroversion more than introversion. But it's not that introverts and ambiverts don't like people. We just find large groups of them, well, a little draining.

This is challenging in your personal life, but as an entrepreneur—the face of your company, consistently pitching your wares whether they be services or a product—it can be downright exhausting.

How can an introvert, ambivert, or anyone with introverted qualities balance social norms against personal needs when it comes to owning your own business? And can introversion even be an advantage?

As Cain explains, in our society, having introverted qualities is often met with shame. I didn't understand why a group vacation would make me anxious or spending a day with a lot of people without any time to myself was unappealing. It's about wiring. To shill your own business, you have to be outgoing, always "on." Endless networking, going to conferences, having dinner with people who might be able to propel your trajectory—this can be exhausting even for an extrovert, but it's even more so when you're not wired to be around people 24/7.

What is an entrepreneur to do? I spoke with Cain candidly about this issue—when you're starting up a business and getting yourself out there, how can you do it so that you aren't overloaded?

Cain suggests a three-pronged approach:

Go deep, not wide. "You don't have to work the room," says Cain. "My career has taken lots of different turns; I didn't have the largest Rolodex, but I had a really deep one. We do people a disservice when we tell them they have to get out there in a wide net-casting way."

Find an extrovert. "Team up with an extrovert," Cain says. "Together you are greater than the sum of your parts. It's the yin and yang." If that's the case, why didn't my yin-and-yang-like relationship with my extroverted ex work out? Cain says that even though introverts and extroverts complement each other, they don't always understand each other. There's a "big misconception of what introversion is," she says. "People assume that the person who wants to stay home on a Saturday is antisocial or misanthropic. Introverts are just as warm and caring, but they would rather lavish those traits on the people they know well. There are still going to be negotiations between introverts and extroverts, but they should at least be conducted from a place of mutual understanding."

Pace yourself. This is especially important for ambiverts like me. I project an extroverted image that is only partially accurate. Cain says that means "you're presenting an extroverted face, and the more you present that, the more people ask of you. It's a blessing to be an ambivert, but you have to pace yourself."

Sometimes introverts or ambiverts feel they need to defend their behaviors. Instead, Cain suggests, just be graceful. "You can say, 'I'm going to my room but can't wait to see you tomorrow at breakfast!' People don't give it as much thought as you think they do."

What if you're in an extroverted business, like public relations or sales? As someone who started her own digital public relations company, it can be hard to compete with those who have no trouble going out every night, attending a constant stream of conferences, or Instagramming every industry party. (Yes, there is both actual and digital FOMO.) What if everyone is hanging out without you?

Cain chocks this up to perception. "You're really not alone, even though it looks that way. Social media needs to be used on your own terms. You don't have to constantly announce whom you're with. Maybe you present your life as one giant party, but you could be using it in a much deeper and more thoughtful way."

Finally, says Cain, introverts are everywhere, and appearances can be deceiving. "In my research, I expected that I would find introverts clustered in more traditionally introverted fields. It's sort of true, but you can find them in many professions where you least expect it: media, public relations. It's all about developing the skills to function."

To borrow from the old adage, "Fake it 'til you make it." And then find time for some peace and quiet.

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MANAGING THE BUSINESS

Surviving a Start-Up's Transition from Projects to Processes

by Derek Lidow

"WHY CHANGE my leadership style? It got us to this point, where we've established a real beachhead in our market."

These are the famous last words of many an entrepreneur. Failing to realize that critical transition points in the growth of an enterprise require leaders to shift emphasis, they blindly stick with what has been working up to that point. The company stalls. Confusion grows among key team members, investors, customers, and suppliers. And ultimately the failure to understand the demands of the transition leads to the failure of the company itself.

One such abrupt transition—from project mode to process mode—occurs once a company launches its initial sales efforts and begins to service its first customers. A project is a one-at-a-time exercise performed by a team assembled specifically for that task. The ad hoc nature of the project requires flexibility and agility to capture the first real customer. If the entrepreneur has recruited the types of people usually attracted to start-ups—people who like fast-paced projects—then they will probably find working as a team in the project mode extremely satisfying.

Entrepreneurs understand that they need to be flexible and agile to figure out how and what potential customers will buy from them. But flexibility and agility must begin to make way for reliability and efficiency if the company is to

David Fransolet

consistently deliver the kind of product or service that maintains happy customers and wins new ones. Reliability and efficiency require that work be performed in the process mode, where tasks are accomplished repetitively in a prescribed fashion, resulting in minimal variation and cost.

Most entrepreneurs instinctively resist switching from the project mode to the process mode. They use excuses like, "We can do a few more things to make our product even better" or "We are working well as a team; why change how we work?" The teams that have been recruited to successfully create a new company, product, or service also resist this change. They wonder why they need to change from the "fun" mode into what most project-loving people despairingly and naively call the "bureaucratic" mode.

Staying in project mode too long opens up opportunities for competitors.

The dangers of staying in a pure project mode for too long are many. Projects, no matter how well led, produce inconsistent results. Entrepreneurs cannot afford disappointed customers, and most won't forgive poor products or services just because they were experiments.

Staying in project mode too long also opens up opportunities for competitors. How many entrepreneurs have seen their great ideas copied by a more cost-effective competitor, destroying all the value they had created up to that point—regardless of patents? It also makes the enterprise too reliant on the founder. No enterprise can become self-sustaining if the skills of its founder have not been replicated in an effective process. And remaining in project mode too long frustrates the employees the entrepreneur will need to rely on to manage effective processes. People who enjoy the challenge of constantly improving something make good process managers; they typically like organization and feel uncomfortable with the change and disorganization that often accompany project mode.

Strong, savvy leaders with a sense of the enterprise's needs understand that this transition is essential for creating a more competitive, self-sustaining company. Savvy leadership is also required to know how to lead both the experimental, creative, project-loving people recruited to help capture the first customer and the organized process-loving people required to implement efficient, reliable processes. Also, effective leaders will want to develop processes that do not require their unique talents.

The first step toward successfully making the transition is to explain why the shift from projects to processes is critical to the well-being of the enterprise. A compelling explanation gets the team comfortable with the shift—and it preempts cries of "bureaucracy."

Although work in a maturing enterprise is progressively dominated by processes, projects never go away entirely. After all, you need projects to create or even improve processes. Leaders who understand the differences between projects and processes assign the project-loving people to project work while the process-loving people focus on helping the enterprise become increasingly efficient and reliable.

The transitions required in a rapidly growing and maturing start-up are unforgiving, and for many entrepreneurs the project-to-process change is particularly tricky. It's one of the reasons entrepreneurs have such a high rate of failure and why those who understand it greatly increase their odds of survival.

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READER COMMENT

Realizing the need for the transition is crucial, but managing this transition is vital. People with an innovative, revolutionary attitude (required for the first phase) are usually unable to cope with this transformation. The resistance to switching from project mode to process mode can exist on several levels. The most critical is when the founders are unable to pass on management responsibilities to new senior managers who are more experienced in process-mode operation. The other is when key personnel feel caged by processes. Usually that leads to explosions or, if managed better, the departure of these employees.

—TheSolopreneurM

Build Your Bench Strength Without Breaking the Bank

by Kirk Kramer

MANY SOCIAL enterprises start small and grow fast. This puts a premium on the need to develop, or recruit, talented people who can take on evolving roles and responsibilities. Yet planning for future leadership needs falls between the cracks at most social enterprises. Leaders plead a lack of time and money to make development a priority. If you are among them, be aware that neither excuse holds up under close scrutiny. What you really need is a change in mindset.

That change begins with answering three key questions:

- What is your organization's strategy for the near term, and how will you fulfill it?
- What kinds of people do you need to make the strategy a reality?
- How do you develop, or hire, the staff you will need?

You are far from alone if your organization hasn't grappled with these questions. Only 37% of respondents to The Bridgespan Group's Leadership Diagnostic Survey said they have "a clear understanding" of the leadership skills, roles, and number of individuals needed over the next three to five years to achieve their strategic goals. Only 39% indicated that they had identified potential successors for key positions.

Taking a hard look at strategy and figuring out how it affects staffing needs—answering the first two questions—is something every organization, large or small, can and should do, but it's especially important if your organization is fast-growing. For example, if you are planning to add new sites, you'll probably need to develop a cadre of site directors, and possibly a vice president for field operations. If you plan to focus a strategy shift more on community engagement, you may need to enhance the skills involved in working effectively with community leaders.

Once you've mapped your organization's near-term talent needs, you're ready to assess whether members of your current staff have the potential to grow into those new roles.

In our survey, about half the respondents say they consider staff potential as part of their evaluation process, but we found that few actually have tools or approaches that help them do this systematically.

Here's where a simple tool, called the Performance-Potential Matrix, comes in handy. The matrix draws on past performance, plotted on the horizontal axis, and judgments about an employee's potential to take on more responsibility, plotted on the vertical axis. The upper-right quadrant—high performance and high potential—is the sweet spot for future leaders. Using the tool, you can plot current and future leaders on one page and determine whether you will have the internal talent to meet your needs.

Year Up, a nonprofit that helps urban young adults develop professional careers and pursue higher education, began using the matrix when it had only one site, a small staff, and annual revenue of about $1 million. But it was growing fast. Today Year Up is a $30 million organization with multiple sites, and it still uses the matrix.

SAMPLE PERFORMANCE-POTENTIAL MATRIX A simple tool to evaluate your leadership pipeline.

POTENTIAL			
High	May be new to role; ensure support is available May be in wrong role; consider reassignment	Continue to develop in current role; consider providing test assignment in more senior role	Consider providing significant new assignments or reassign to a more senior role
Growth	May be in the wrong role or at the wrong level; consider providing test assignment in different role	Continue to develop in current role	Gradually expand current role
Limited	Consider replacing if support has not improved performance	Continue to develop in current role; periodically reassess potential for growth	Retain in current role; periodically reassess potential for growth
	Below expectations	**Meets expectations**	**Exceeds expectations**
	PERFORMANCE		

SOURCE KEMP & WATSON, OMIDYAR NETWORK

Now that you have identified employee strengths and weaknesses, it's time to craft individual development plans. This is where capital-constrained enterprises feel the pinch of time and money most severely. We heard comments from nonprofit leaders such as: "In order to lead, you need time to lead" and "We have inadequate financial resources to cover training and development costs."

Research has shown that leadership is best learned on the job.

Leadership development doesn't need to be a separate initiative or an expensive training program added on to the organization's core work. In fact, research by the Center for Creative Leadership has shown that leadership is best learned on the job. The Center's 70-20-10 model, now widely used in the corporate world, calls for 70% on-the-job learning, 20% coaching and mentoring, and 10% formal training. The model is gaining appeal among nonprofits of all sizes.

The Performance-Potential Matrix and the 70-20-10 model are simple, straightforward tools to break through the falsely perceived time and money barriers. The potential payoff is huge. By developing a cadre of up-and-coming leaders, you can delegate more, which frees up the time you need to focus on strategic priorities. More important, by changing your organization's leadership development mindset, you can create momentum to build a talent pipeline that will keep your organization strong as you grow, and grow fast.

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VC Funding Can Be Bad for Your Start-Up

by John Mullins

MORE THAN two generations ago, the venture capital community—VCs, business angels, incubators, and others—persuaded the entrepreneurial world that writing business plans and raising venture capital constituted the twin centerpieces of entrepreneurial endeavor. They did so for two good reasons: the sometimes astonishing returns they've delivered and the incredibly large and valuable companies that their ecosystem has created.

But the vast majority of successful entrepreneurs *never* take any venture capital.

Consider Claus Moseholm, cofounder of GoViral, a Danish company created in 2005 to harness the then-emerging power of the internet to deliver advertisers' video content in a viral fashion. Funding his company's steady growth with the proceeds of one successful viral video campaign after another, Moseholm and his partners built GoViral into Europe's leading platform to host and distribute such content. In 2011 GoViral was sold for $97 million, having never taken a single krone or dollar of investment capital. The business had been funded and grown entirely by its customers' cash.

In fact, venture capital financing may even be detrimental to your start-up's health. As venture capital investor Fred Wilson of Union Square Ventures puts it, "The amount of money start-ups raise in their seed and Series A rounds is inversely correlated with success. Yes, I mean that. Less money raised leads to more success. That is the data I stare at all the time."

Wilson's observation reflects the fact that raising capital too early has a number of serious drawbacks that have profound implications at all stages of the investment cycle:

1. Pandering to VCs is a distraction. Trying to get a fledgling venture off the ground is a full-time job, and then some. But so is raising capital, which demands a lot of time and energy on its own. It will distract the entrepreneur from doing the more important work of getting the venture onto a productive path. As Connect Ventures founder Bill Earner argues, "Finding the right customers and getting them to fund your business constitutes a great step-by-step guide to raising venture capital—build the business first and the investments will follow."

Why spend your time trying to persuade investors to invest when you could spend the same time enticing prospective customers to buy—or perhaps learning why they won't—*before* you burn somebody else's money? Besides, as customer-funded entrepreneur and investor Erick Mueller recalls, "It's a lot more fun dealing with customer needs than pandering to investors."

2. Term sheets and shareholders' agreements can burden you. Investors don't like risk any better than you do. If you're raising money before traction is in hand, so-called market risk is higher than if demand has already been proven. To protect their downside, investors will require what entrepreneurs often see as onerous terms. And when the concise prose of the term sheet is fleshed out in the fine print of the shareholders' agreement, the terms get even worse.

3. The advice VCs give isn't always that good. According to an analysis of venture fund returns by Harvard Business School's Josh Lerner, more than half of all VC funds delivered no better than low single-digit returns on investment. Worse, only 20% of funds achieved 20% returns (or better), a figure they might be expected to deliver. Incredibly, nearly one in five funds actually delivered below-zero returns. Given this performance, you would be forgiven if you wondered just how helpful most VCs' support or "value-add" is likely to be! Unfortunately, you will probably be obliged to follow their sage "advice."

4. The stake you keep is small—and tends to get smaller. When you raise angel or venture capital early, as Jobs did to fund Apple, you start giving away a portion of the company—often a substantial portion—in exchange for the capital you are given. And that portion grows over time, as additional rounds of capital are raised. Michael Dell, in contrast, used his customers' prepayments for their PCs to fund his start-up and its early growth. Moseholm and his partners, who managed to go the distance at GoViral without *ever* raising outside investment, retained their stakes in the business (bar one cofounder, who sold his stake to a growth capital investor) until they eventually sold.

But here's the best news: If you raise money at a somewhat later stage of your entrepreneurial journey, you'll find that many of the drawbacks have largely disappeared. Why? Because with customer traction in hand, you'll be in the driver's seat, and the queue of investors outside your door will have to compete for your deal.

5. The odds are against you. Even worse, perhaps, than the difficult terms, the questionable advice you may get, and the dilution you incur if you raise capital too early are the difficult odds faced by companies that do win VC backing. In the typical *successful* fund, on average only one or two in 10 of the portfolio companies—the Googles, Facebooks, and Twitters of the world—will actually have delivered attractive, and occasionally stunning, returns. Facebook alone accounted for more than 35% of the *total* VC exit value in the United States in 2012. A few more portfolio companies may have paid back the capital that was invested in them, but most of the rest are wipeouts. In the VC game the very few winners pay for the losers, so most VCs are playing a high-stakes all-or-nothing game. Are these the kind of odds with which you'd like to put your new venture into play?

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READER COMMENT

There is no such thing as a start-up that does not require funds for growth. All businesses that start without a penny reach a threshold that requires investment. Banks were once able to do that, but they are not interested in doing so anymore. Some people are born from money, but if you are not, then at one point or another, you must be able to raise capital for expansion. VCs are good if you are a good negotiator and are able to identify the VC. The most important requirement is to get investors with experience in your arena.

—*omphali*

Build the business first, and the investments will follow.

Getty Images

The Go-to-Market Approach Start-Ups Need to Adopt

by Ron Ashkenas and Patrick Finn

AN ESTIMATED 100,000 technology start-ups reach the basic funding stage every year. Angel investors (including friends and family members) help about half of these companies with their initial development. Fewer than 10% (about 4,000) are then able to show enough promise to actually receive a first round of capital from venture or private equity sources.

If you are an entrepreneurial manager who has reached this milestone, it's a major achievement—your technology has progressed from an interesting concept to a promising commercial opportunity. You've probably demonstrated your product's potential with a subset of customers, and now experienced investors are willing to place a bet on you.

The challenge becomes how to sell your product and create a sustainable revenue stream so that you can further develop your product offerings, build your infrastructure, repay your investors, and pay yourself. Unfortunately, many tech start-ups get stuck at this stage because they can't quite figure out a scalable way to go to market. Often, this is because they've been founded by technologists, and sales is not an area of expertise. Or perhaps it's because the only person who is passionate enough to sell the product is the person who developed it. Or people may believe their invention

is good enough to sell itself, so sales doesn't become a focus of attention until cash starts to burn.

Figuring out a go-to-market approach is no trivial exercise—it separates the companies that will be successful and sustainable from those that won't. In our work with start-ups during the past several years, we've heard dozens of questions related to how to start thinking about sales: Should we put together a direct sales force or sell indirectly through others? If we sell directly, should we organize salespeople by market, industry, geography, company size, or some other principle? Will our salespeople require technical support and work in teams? Should we bundle maintenance and other services into our sales approach or sell them separately? Can we get our product to market through other channels, such as social media or advertising? What about pricing? The list goes on.

The problem is that these are fundamentally the wrong questions to begin with. They all focus on the perspective of the start-up and the technology, but start-ups need to take on their customers' perspective to understand how to approach the market. They should think about what the customers are trying to achieve and what problems they need to solve—and then think about how the product can help them be successful.

For example, earlier this year a five-year-old software company asked us to help its sales team do a better job of selling to large enterprise organizations. The company was already breaking even operationally after two rounds of funding. But despite some successes in pilot projects, the salespeople had not been able to expand their deals from "interesting trials" into ongoing revenue streams.

After talking with the VP of sales, the CEO, and several of the account managers, we realized we had heard a lot about the software's virtues but much less about the customer problems and pain points that the software was meant to address. Eventually we asked this team to focus on three large enterprises and to describe the business challenges these potential customers were facing. Once they developed this context, the salespeople were able to identify a number of very large opportunities where their software could help.

For instance, they learned that one strategic objective of the customer was growing its data center hardware business. They then saw that their software, which could help data centers reduce operational costs, could be incorporated into the customer's equipment just like word-processing software is embedded into personal computers. This led them to see that one way to bring their product to market was to partner with this customer (and others like it) instead of selling directly to data centers. In this way their "customer" could actually be an important part of the go-to-market strategy.

Veteran salespeople might recognize this "consultative selling" approach and dismiss it as old hat. The point, however, is that the consultative selling mindset needs to start before the go-to-market approach is developed, and it must evolve as the sales strategy evolves. Figuring out how you go to market is not a onetime exercise for a new company; it should be an ongoing process, constantly informed by a deepening understanding of customer needs and how your product can meet them.

If you are part of a start-up or a relatively new company that needs to accelerate revenue growth, consider how this approach might apply to you. Start by identifying a small number of very specific customers—either companies (if you are a B2B player) or desired consumer segments (e.g., urban professionals with specific characteristics). Then put yourself in the shoes of these customers by thinking about their issues and by talking to them not about your product but about their challenges and pain points. (Start-up expert Steve Blank, for example, suggests that you talk to dozens of potential users as part of a "customer development" process.)

Once you've taken these steps, you can begin to experiment with a go-to-market approach with the expectation that you'll continue to refine and change it as you gain experience and insight.

Figuring out an approach for going to market is one of the toughest things for a start-up to do. But without understanding the customers' issues, it's almost impossible to get right.

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Start-ups need to take on their customers' perspective.

Ron Ashkenas is a partner emeritus at Schaffer Consulting. His latest book is *Simply Effective: How to Cut Through Complexity in Your Organization and Get Things Done* (Harvard Business Review Press, 2009). **Patrick Finn** leads Finn Advisors, which helps technology companies accelerate success. Before starting his own firm, he held a number of senior sales leadership roles at Cisco.

READER COMMENT

One of the biggest tools we had as a robotics start-up were the crowdfunding platforms. Not only did they enable us to do presales and marketing of the product, but our dialogue with the early adapter community allowed us to refine our target demographic. By understanding the people putting in the money to buy the product, we could develop our go-to-market strategy.

—Ansh Verma, product development engineer, ZeroUI

ENTREPRENEURSHIP

The Questions Every Entrepreneur Must Answer

What are my goals? Do I have the right strategy? Can I execute the strategy?

by Amar Bhidé

OF THE HUNDREDS of thousands of business ventures that entrepreneurs launch every year, many never get off the ground. Others fizzle after spectacular rocket starts.

A six-year-old condiment company has attracted loyal customers but has achieved less than $500,000 in sales. The company's gross margins can't cover its overhead or provide adequate incomes for the founder and the family members who participate in the business. Additional growth will require a huge capital infusion, but investors and potential buyers aren't keen on small, marginally profitable ventures, and the family has exhausted its resources.

Another young company, profitable and growing rapidly, imports novelty products from the Far East and sells them to large U.S. chain stores. The founder, who has a paper net worth of several million dollars, has been nominated for entrepreneur-of-the-year awards. But the company's spectacular growth has forced him to reinvest most of his profits to finance the business's growing inventories and receivables. Furthermore, the

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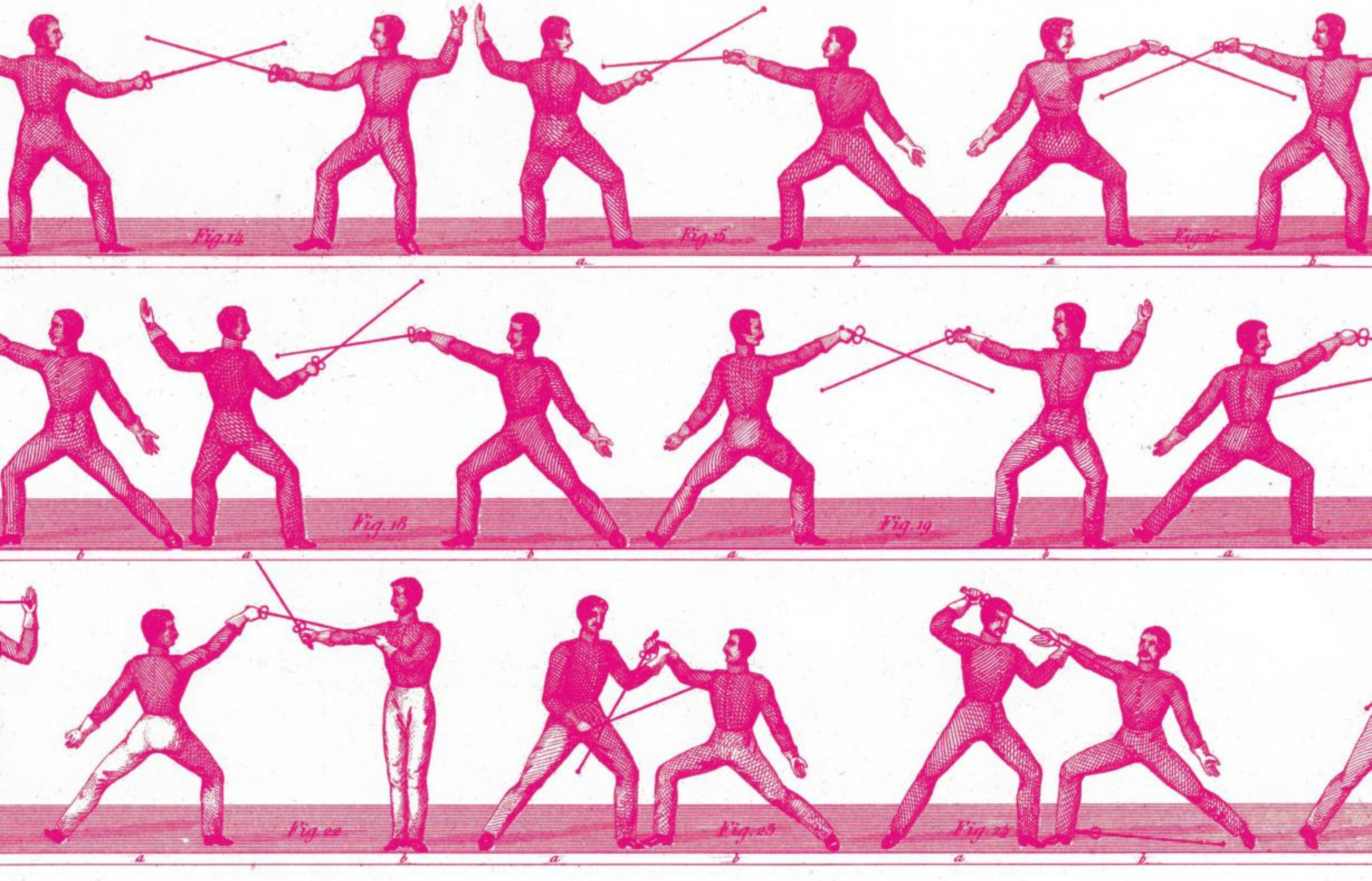


company's profitability has attracted competitors and tempted customers to deal directly with the Asian suppliers. If the founder doesn't do something soon, the business will evaporate.

Like most entrepreneurs, the condiment maker and the novelty importer get plenty of confusing counsel: Diversify your product line. Stick to your knitting. Raise capital by selling equity. Don't risk losing control just because things are bad. Delegate. Act decisively. Hire a professional manager. Watch your fixed costs.

Why all the conflicting advice? Because the range of options—and problems—that founders of young businesses confront is vast. The manager of a mature company might ask, What business are we in? or How can we exploit our core competencies? Entrepreneurs must continually ask themselves what business they *want* to be in and what capabilities they would *like* to develop. Similarly, the organizational weaknesses and imperfections that entrepreneurs confront every day would cause the managers of a mature company to panic. Many young enterprises simultaneously lack coherent strategies, competitive strengths, talented employees, adequate controls, and clear reporting relationships.

The entrepreneur can tackle only one or two opportunities and problems at a time. Therefore, just as a parent should focus more on a toddler's motor skills than on his or her social skills, the entrepreneur must distinguish critical issues from normal growing pains.

Entrepreneurs cannot expect the sort of guidance and comfort that an authoritative child-rearing book can offer parents. Human beings pass through physiological and psychological stages in a more or less predetermined order, but companies do not share a developmental path. Microsoft, Lotus, WordPerfect, and Intuit, although competing in the same industry, did not evolve in the same way. Each of those companies has its own story to tell about the development of strategy and organizational structures and about the evolution of the founder's role in the enterprise.

The options that are appropriate for one entrepreneurial venture may be completely inappropriate for another. Entrepreneurs must make a bewildering number of decisions, and they must make the decisions that are right for them. The framework I present here and the accompanying rules of thumb will help entrepreneurs analyze the situations in which they find themselves, establish priorities among the opportunities and problems they face, and make rational decisions about the future. This framework, which is based on my observation of several hundred start-up ventures over eight years, doesn't prescribe answers. Instead, it helps entrepreneurs pose useful questions, identify important issues, and evaluate solutions. The framework applies whether the enterprise is a small printing shop trying to stay in business or a catalog retailer seeking hundreds of millions of dollars in sales. And it works at almost any point in a venture's evolution. Entrepreneurs should use the framework to evaluate their companies' position and trajectory often—not just when problems appear.

The framework consists of a three-step sequence of questions. The first step clarifies entrepreneurs' current goals, the second evaluates their strategies for attaining those goals, and the third helps them assess their capacity to execute their strategies. The hierarchical organization of the questions requires entrepreneurs to confront the basic, big-picture issues before they think about refinements and details. (See the exhibit "An Entrepreneur's Guide to the Big Issues.") This approach does not assume that all companies—or all entrepreneurs—develop in the same way, so it does not prescribe a one-size-fits-all methodology for success.

Clarifying Goals: Where Do I Want to Go?

An entrepreneur's personal and business goals are inextricably linked. Whereas the manager of a public company has a fiduciary responsibility to maximize value for shareholders, entrepreneurs build their businesses to fulfill personal goals and, if necessary, seek investors with similar goals.

Before they can set goals for a business, entrepreneurs must be explicit about their personal goals. And they must periodically ask themselves if those goals have changed. Many entrepreneurs say that they are launching their businesses to achieve independence and control their destiny, but those goals are too vague. If they stop and think about it, most entrepreneurs can identify goals that are more specific. For example, they may want an outlet for artistic talent, a chance to experiment with new technology, a flexible lifestyle, the rush that comes from rapid growth, or the immortality of building an institution that embodies their deeply held values. Financially, some entrepreneurs are looking for quick profits, some want to generate a satisfactory cash flow, and others seek capital gains from building and selling a company. Some entrepreneurs who want to build sustainable institutions do not consider personal financial returns a high priority. They may refuse acquisition proposals regardless of the price or sell equity cheaply to employees to secure their loyalty to the institution.

Only when entrepreneurs can say what they want personally from their businesses does it make sense for them to ask the following three questions:

What kind of enterprise do I need to build? Long-term sustainability does not concern entrepreneurs looking for quick profits from in-and-out deals. Similarly, so-called lifestyle entrepreneurs, who are interested only in generating enough of a cash flow to maintain a certain way of life, do not need to build businesses that could survive without them. But sustainability—or the perception thereof—matters greatly to entrepreneurs who hope to sell their businesses eventually. Sustainability is even more important for entrepreneurs who want to build an institution that is capable of renewing itself through changing generations of technology, employees, and customers.

To set meaningful goals, entrepreneurs must reconcile what they want with what they are willing to risk.

Entrepreneurs' personal goals should also determine the target size of the businesses they launch. A lifestyle entrepreneur's venture needn't grow very large. In fact, a business that becomes too big might prevent the founder from enjoying life or remaining personally involved in all aspects of the work. In contrast, entrepreneurs seeking capital gains must build companies large enough to support an infrastructure that will not require their day-to-day intervention.

What risks and sacrifices does such an enterprise demand? Building a sustainable business—that is, one whose principal productive asset is not just the founder's skills, contacts, and efforts—often entails making risky long-term bets. Unlike a solo consulting practice—which generates cash from the start—durable ventures, such as companies that produce branded consumer goods, need continued investment to build sustainable advantages. For instance, entrepreneurs may have to advertise to build a brand name. To pay for ad campaigns, they may have to reinvest profits, accept equity partners, or personally guarantee debt. To build depth in their organizations, entrepreneurs may have to trust inexperienced employees to make crucial decisions. Furthermore, many years may pass

ARTICLE AT A GLANCE

THE IDEA IN BRIEF

Of the hundreds of thousands of business ventures launched each year, many never get off the ground. Others fizzle after spectacular rocket starts.

Why such dismal odds? Entrepreneurs—with their bias for action—often ignore ingredients essential to business success. These include a clear strategy, the right workforce talent, and organizational controls that spur performance without stifling employees' initiative.

Moreover, no two ventures take the same path. Thus entrepreneurs can't look to formulas to navigate the myriad choices arising as their enterprise evolves. A decision that's right for one venture may prove disastrous for another.

How to chart a successful course for *your* venture? Bhidé recommends asking yourself these questions:

- **Where do I want to go?** Consider your goals for the business: Do you want the rush that rapid growth delivers? A chance to experiment with new technology? Capital gains from selling a successful company?
- **How will I get there?** Is your strategy sound? Does it clarify what your company will and won't do? Will it generate sufficient profits and growth?
- **Can I do it?** Do you have the right talent? Reliable sources of capital?

Improvisation takes a venture only so far. *Successful* entrepreneurs keep asking tough questions about where they want to go—and whether the track they're on will take them there.

THE IDEA IN PRACTICE

A closer look at Bhidé's three questions:

WHERE DO I WANT TO GO?

To articulate your goals for the enterprise, clarify:

- **What you want personally from your business:** An outlet for artistic talent? A flexible lifestyle? The immortality of building an institution that embodies your values? Quick profits?
- **The kind of enterprise required:** For example, if you want to sell your business eventually, you'll need to build a sustainable enterprise—one that can renew itself through changing generations of technology, employees, and customers. And you'll need a company big enough to support an infrastructure that won't require your daily intervention.
- **Your risk tolerance:** For example, building a sustainable business entails risky long-term bets—including trusting inexperienced employees, personally guaranteeing debt, and tolerating delayed payoffs. Are your goals worth the attendant risks?

HOW WILL I GET THERE?

Successful strategies:

- **Provide clear direction:** Articulate the enterprise's policies, geographic reach, capabilities, and decision-making framework—in concise terms that employees, investors, and customers can understand.
- **Generate sufficient profits and growth:** Ensure that your strategy will produce desired business results. For example, Mothers Work—which sells maternity clothing to professional women—took off only when its founder revised her strategy from mail order (which generated low profits owing to stiff competition) to retail stores.
- **Serve the enterprise long-term:** Anticipate future market saturation, intensified competition, and major technological change; then ensure that your strategy accommodates those future scenarios.
- **Establish the right growth rate:** Plan for a growth rate that will attract customers and capital without causing excessive stress for you and your employees.

CAN I DO IT?

A great strategy is worthless unless you can execute it. To do so, you'll need the right:

- **Resources:** Augment your workforce with employees possessing the skills, knowledge, and values needed to implement your strategy. A strong workforce attracts customers and investment capital.
- **Infrastructure:** Establish the organizational systems needed to execute your strategy. For example, suppose you want to build a geographically dispersed business, grow rapidly, and eventually go public. In this case, you'll need to invest heavily in mechanisms for delegating tasks, specializing job roles, forecasting and monitoring availability of funds, and maintaining financial records.
- **Role flexibility:** To grow your business, your role must shift from doing the "real work" to teaching others to do it, prescribing desired results, and managing the work environment.

before any payoff materializes—if it materializes at all. Sustained risk taking can be stressful. As one entrepreneur observes, "When you start, you just do it, like the Nike ad says. You are naïve because you haven't made your mistakes yet. Then you learn about all the things that can go wrong. And because your equity now has value, you feel you have a lot more to lose."

Entrepreneurs who operate small-scale, or lifestyle, ventures face different risks and stresses. Talented people usually avoid companies that offer no stock options and only limited opportunities for personal growth, so the entrepreneur's long hours may never end. Because personal franchises are difficult to sell and often require the owner's daily presence, founders may become locked into their businesses. They may face financial distress if they become sick or just burn out. "I'm always running, running, running," complains one entrepreneur, whose business earns him half a million dollars per year. "I work 14-hour days, and I can't remember the last time I took a vacation. I would like to sell the business, but who wants to buy a company with no infrastructure or employees?"

It's easy to knock off an innovative product, but an innovative business system is much harder to replicate.

Can I accept those risks and sacrifices? Entrepreneurs must reconcile what they want with what they are willing to risk. Consider Joseph Alsop, cofounder and president of Progress Software Corporation. When Alsop launched the company in 1981, he was in his mid-thirties, with a wife and three children. With that responsibility, he says, he didn't want to take the risks necessary to build a multibillion-dollar corporation like Microsoft, but he and his partners were willing to assume the risks required to build something more than a personal service business. Consequently, they picked a market niche that was large enough to let them build a sustainable company but not so large that it would attract the industry's giants. They worked for two years without salaries and invested their personal savings. In ten years, they had built Progress into a $200 million publicly held company.

Entrepreneurs would do well to follow Alsop's example by thinking explicitly about what they are and are not willing to risk. If entrepreneurs find that their businesses—even if very successful—won't satisfy them personally, or if they discover that achieving their personal goals requires them to take more risks and make more sacrifices than they are willing to, they need to reset their goals. When entrepreneurs have aligned their personal and their business goals, they must then make sure that they have the right strategy.

Setting Strategy: How Will I Get There?

Many entrepreneurs start businesses to seize short-term opportunities without thinking about long-term strategy. Successful entrepreneurs, however, soon make the transition from a tactical to a strategic orientation so that they can begin to build crucial capabilities and resources.

Formulating a sound strategy is more basic to a young company than resolving hiring issues, designing control systems, setting reporting relationships, or defining the founder's role. Ventures based on a good strategy can survive confusion and poor leadership, but sophisticated control systems and organizational structures cannot compensate for an unsound strategy. Entrepreneurs should periodically put their strategies to the following four tests:

Is the strategy well defined? A company's strategy will fail all other tests if it doesn't provide a clear direction for the enterprise. Even solo entrepreneurs can benefit from a defined strategy. For example, deal makers who specialize in particular industries or types of transactions often have better access to potential deals than generalists do. Similarly, independent consultants can charge higher fees if they have a reputation for expertise in a particular area.

An entrepreneur who wants to build a sustainable company must formulate a bolder and more explicit strategy. The strategy should integrate the entrepreneur's aspirations with specific long-term policies about the needs the company will serve, its geographic reach, its technological capabilities, and other strategic considerations. To help attract people and resources, the strategy must embody the entrepreneur's vision of where the company is going instead of where it is. The strategy must also provide a framework for making the decisions and setting the policies that will take the company there.

The strategy articulated by the founders of Sun Microsystems, for instance, helped them make smart decisions as they developed the company. From the outset, they decided that Sun would forgo the niche-market strategy commonly used by Silicon Valley start-ups. Instead, they elected to compete with industry leaders IBM and Digital by building and marketing a general-purpose workstation. That strategy, recalls cofounder and former president Vinod Khosla, made Sun's product-development choices obvious. "We wouldn't develop any applications software," he explains. This strategy also dictated that Sun assume the risk of building a direct sales force and providing its own field support—just like its much larger competitors. "The Moon or Bust was our motto," Khosla says. The founders' bold vision helped attract premier venture-capital firms and gave Sun extraordinary visibility within its industry.

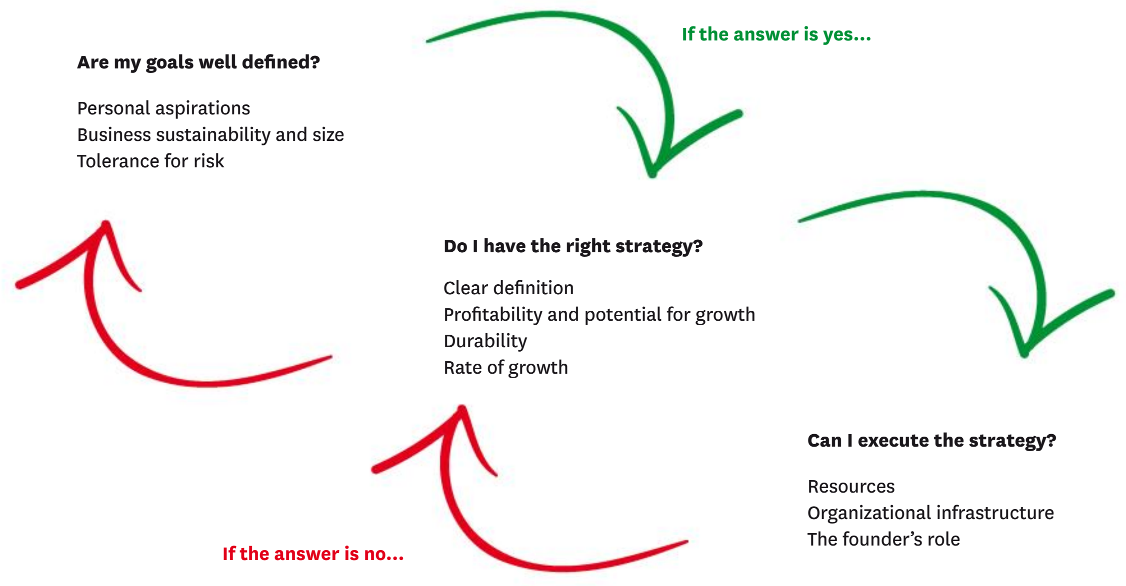
To be useful, strategy statements should be concise and easily understood by key constituents such as employees, investors, and customers. They must also preclude activities and investments that, although they seem attractive, would deplete the company's resources. A strategy that is so broadly stated that it permits a company to do anything is tantamount to no strategy at all. For instance, claiming to be in the leisure and entertainment business does not preclude a tent manufacturer from operating casinos or making films. Defining the venture as a high-performance outdoor-gear company provides a much more useful focus.

Can the strategy generate sufficient profits and growth? Once entrepreneurs have formulated clear strategies, they must determine whether those strategies will allow the ventures to be profitable and to grow to a desirable size. The failure to earn satisfactory returns should prompt entrepreneurs to ask tough questions: What's the source, if any, of our competitive edge? Are our offerings really better than our competitors'? If they are, does the premium we can charge justify the additional costs we incur, and can we move enough volume at higher prices to cover our fixed costs? If we are in a commodity business, are our costs lower than our competitors'? Disappointing growth should also raise concerns: Is the market large enough? Do diseconomies of scale make profitable growth impossible?

No amount of hard work can turn a kitten into a lion. When a new venture is faltering, entrepreneurs must address basic economic issues. For instance, many people are attracted to personal service businesses, such as laundries and tax-preparation services, because they can start and operate those businesses just by working hard. They don't have to worry about confronting large competitors, raising a lot of capital, or developing proprietary technology. But the factors that make it easy for entrepreneurs to launch such businesses often prevent them from attaining their long-term goals. Businesses based on an entrepreneur's willingness to work hard usually confront other equally determined competitors. Furthermore, it is difficult to make such companies large enough to support employees and infrastructure. Besides, if employees can do what the founder does, they have little incentive to stay with the venture. Founders of such companies often cannot have the lifestyle they want, no matter how talented they are. With no way to leverage their skills, they can eat only what they kill.

Entrepreneurs who are stuck in ventures that are unprofitable and cannot grow satisfactorily must take radical action. They must find a new industry or develop innovative economies of scale or scope in their existing fields. Rebecca Matthias, for example, started Mothers Work in 1982 to sell maternity clothing to professional women by mail order. Mail-order businesses are easy to start, but with tens of thousands of catalogs vying for consumers' attention, low response rates usually lead to low profitability—a reality that Matthias confronted

An Entrepreneur's Guide to the Big Issues



Finding the Right Growth Rate

Finding the optimal growth rate for a new enterprise is a difficult and critical task. To set the right pace, entrepreneurs must consider many factors, including the following:

Economies of scale, scope, or customer network. The greater the returns to a company's scale, scope, or the size of its customer network, the stronger the case for pursuing rapid growth. When scale causes profitability to increase considerably, growth soon pays for itself. And in industries in which economies of scale or scope limit the number of viable competitors, establishing a favorable economic position first can help deter rivals.

The ability to lock in customers or scarce resources. Rapid growth also makes sense if consumers are inclined to stick with the companies with which they initially do business, either because of an aversion to change or because of the expense of switching to another company. Similarly, in retail, growing rapidly can allow a company to secure the most favorable locations or dominate a geographic area that can support only one large store, even if national economies of scale are limited.

Competitors' growth. If rivals are expanding quickly, a company may be forced to do the same. In markets in which one company generally sets the industry's standard, such as the market for personal-computer operating-system software, growing quickly enough to stay ahead of the pack may be a young company's only hope.

Resource constraints. A new venture will not be able to grow rapidly if there is a shortage of skilled employees or if investors and lenders are unwilling to fund an expansion that they consider reckless. A venture that is growing quickly, however, will be able to attract capital as well as the employees and customers who want to go with a winner.

Internal financing capability. When a new venture is not able to attract investors or borrow at reasonable terms, its internal financing capability will determine the pace at which it can grow. Businesses that have high profit margins and low assets-to-sales ratios can fund high growth rates. A self-funded business, according to the well-known sustainable growth formula, cannot expand its revenues at a rate faster than its return on equity.

Tolerant customers. When a company is young and growing rapidly, its products and services often contain some flaws. In some markets, such as certain segments of the high-tech industry, customers are accustomed to imperfect offerings and may even derive some pleasure from complaining about them. Companies in such markets can expand quickly. But in markets in which buyers will not stand for breakdowns and bugs, such as the market for luxury goods and mission-critical process-control systems, growth should be much more cautious.

Personal temperament and goals. Some entrepreneurs thrive on rapid growth; others are uncomfortable with the crises and fire fighting that usually accompany it. One of the limits on a new venture's growth should be the entrepreneur's tolerance for stress and discomfort.

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after three years in the business. In 1985, she borrowed $150,000 to open the first retail store specializing in maternity clothes for working women. By 1994, Mothers Work was operating 175 stores generating about $59 million in revenues.

One alternative to radical action is to stick with the failing venture and hope for the big order that's just around the corner or the greater fool who will buy the business. Both hopes are usually futile. It's best to walk away.

Is the strategy sustainable? The next issue entrepreneurs must confront is whether their strategies can serve the enterprise over the long term. The issue of sustainability is especially significant for entrepreneurs who have been riding the wave of a new technology, a regulatory change, or any other change—exogenous to the business—that creates situations in which supply cannot keep up with demand. Entrepreneurs who catch a wave can prosper at the outset just because the trend is on their side; they are competing not with one another but with outmoded players. But what happens when the wave crests? As market imbalances disappear, so do many of the erstwhile high fliers who had never developed distinctive capabilities or established defensible competitive positions. Wave riders must anticipate market saturation, intensifying competition, and the next wave. They have to abandon the me-too approach in favor of a new, more durable business model. Or they may be able to sell their high-growth businesses for handsome prices in spite of the dubious long-term prospects.

Consider Edward Rosen, who cofounded Vydec in 1972. The company developed one of the first stand-alone word processors, and as the market for the machines exploded, Vydec rocketed to $90 million in revenues in its sixth year, with nearly 1,000 employees in the United States and Europe. But Rosen and his partner could see that the days of stand-alone word processors were numbered. They happily accepted an offer from Exxon to buy the company for more than $100 million.

Such forward thinking is an exception. Entrepreneurs in rapidly growing companies often don't consider exit strategies seriously. Encouraged by short-term success, they continue to reinvest profits in unsustainable businesses until all they have left is memories of better days.

Entrepreneurs who start ventures not by catching a wave but by creating their own wave face a different set of challenges in crafting a sustainable strategy. They must build on their initial strength by developing multiple strengths. Brand-new ventures usually cannot afford to innovate on every front. Few start-ups, for example, can expect to attract the resources needed to market a revolutionary product that requires radical advances in technology, a new manufacturing process, and new distribution channels. Cash-strapped entrepreneurs usually focus first on building and exploiting a few sources of uniqueness and use standard, readily available elements in the rest of the business. Michael Dell, the founder of Dell Computer, for example, made low price an option for personal computer buyers by assembling standard components in a college dormitory room and selling by mail order without frills or much sales support.

Strategies for taking the hill, however, won't necessarily hold it. A model based on one or two strengths becomes obsolete as success begets imitation. For instance, competitors can easily knock off an entrepreneur's innovative product. But they will find it much more difficult to replicate *systems* that incorporate many distinct and complementary capabilities. A business with an attractive product line, well-integrated manufacturing and logistics, close relationships with distributors, a culture of responsiveness to customers, and the capability to produce a continuing stream of product innovations is not easy to copy.

Entrepreneurs who build desirable franchises must quickly find ways to broaden their competitive capabilities. For example, software start-up Intuit's first product, Quicken, had more attractive features and was easier to use than other personal-finance software programs. Intuit realized, however, that competitors could also make their products easy to use, so the company took advantage of its early lead to invest in a variety of strengths. Intuit enhanced its position with distributors by introducing a family of products for small businesses, including QuickBooks, an accounting program. It brought sophisticated marketing techniques to an industry that "viewed customer calls as interruptions to the sacred art of programming," according to the company's founder and chairman, Scott Cook. It established a superior product-design process with multifunctional teams that included marketing and technical support. And Intuit invested heavily to provide customers with outstanding technical support for free.

Are my goals for growth too conservative or too aggressive? After defining or redefining the business and verifying its basic soundness, an entrepreneur should determine whether plans for its growth are appropriate. Different enterprises can and should grow at different rates. Setting the right pace is as important to a young business as it is to a novice bicyclist. For either one, too fast or too slow can lead to a fall. The optimal growth rate for a fledgling enterprise is a function of many interdependent factors. (See the sidebar "Finding the Right Growth Rate.")

Executing the Strategy: Can I Do It?

The third question entrepreneurs must ask themselves may be the hardest to answer because it requires the most candid self-examination: Can I execute the strategy? Great ideas don't guarantee great performance. Many young companies fail because the entrepreneur can't execute the strategy; for instance, the venture may run out of cash, or the entrepreneur may be unable to generate sales or fill orders. Entrepreneurs must examine three areas—resources, organizational capabilities, and their personal roles—to evaluate their ability to carry out their strategies.

Entrepreneurs who hope to turn underqualified employees into star performers are almost always disappointed.

Do I have the right resources and relationships? The lack of talented employees is often the first obstacle to the successful implementation of a strategy. During the start-up phase, many ventures cannot attract top-notch employees, so the founders perform most of the crucial tasks themselves and recruit whomever they can to help out. After that initial period, entrepreneurs can and should be ambitious in seeking new talent, especially if they want their businesses to grow quickly. Entrepreneurs who hope that they can turn underqualified and inexperienced employees into star performers eventually reach the conclusion, along with Intuit founder Cook, that "you can't coach height." Moreover, after a venture establishes even a short track record, it can attract a much higher caliber of employee.

In determining how to upgrade the workforce, entrepreneurs must address many complex and sensitive issues: Should

Investing in Organizational Infrastructure

Few entrepreneurs start out with both a well-defined strategy and a plan for developing an organization that can achieve that strategy. In fact, many start-ups, which don't have formal control systems, decision-making processes, or clear roles for employees, can hardly be called organizations. The founders of such ventures improvise. They perform most of the important functions themselves and make decisions as they go along.

Informality is fine as long as entrepreneurs aren't interested in building a large, sustainable business. Once that becomes their goal, however, they must start developing formal systems and processes. Such organizational infrastructure allows a venture to grow, but at the same time, it increases overhead and may slow down decision making. How much infrastructure is enough and how much is too much? To match investments in infrastructure to the requirements of a venture's strategy, entrepreneurs must consider the degree to which their strategy depends on the following:

Delegating tasks. As a young venture grows, its founders will probably need to delegate many of the tasks that they used to perform. To get employees to perform those tasks competently and diligently, the founders may need to establish mechanisms to monitor employees and standard operating procedures and policies. Consider an extreme example. Randy and Debbi Fields pass along their skills and knowledge through software that tells employees in every Mrs. Fields Cookies shop exactly how to make cookies and operate the business. The software analyzes data such as local weather conditions and the day of the week to generate hourly instructions about such matters as which cookies to bake, when to offer free samples, and when to reorder chocolate chips.

Telling employees how to do their jobs, however, can stifle initiative. Companies that require frontline employees to act quickly and resourcefully might decide to focus more on outcomes than on behavior, using control systems that set performance targets for employees, compare results against objectives, and provide appropriate incentives.

Specializing tasks. In a small-scale start-up, everyone does a little bit of everything, but as a business grows and tries to achieve economies of scale and scope, employees must be assigned clearly defined roles and grouped into appropriate organizational units. An all-purpose workshop employee, for example, might become a machine tool operator, who is part of a manufacturing unit. Specialized activities need to be integrated by, for example, creating the position of a general manager, who coordinates the manufacturing and marketing functions, or through systems that are designed to measure and reward employees for cross-functional cooperation. Poor integrative mechanisms are why geographic expansion, vertical integration, broadening of product lines, and other strategies to achieve economies of scale and scope often fail.

Mobilizing funds for growth. Cash-strapped businesses that are trying to grow need good systems to forecast and monitor the availability of funds. Outside sources of capital such as banks often refuse to advance funds to companies with weak controls and organizational infrastructure.

Creating a track record. If entrepreneurs hope to build a company that they can sell, they must start preparing early. Public markets and potential acquirers like to see an extended history of well-kept financial records and controls to reassure them of the soundness of the business.

I recruit individuals for specific slots or, as is commonly the case in talent-starved organizations, should I create positions for promising candidates? Are the recruits going to manage or replace existing employees? How extensive should the replacements be? Should the replacement process be gradual or quick? Should I, with my personal attachment to the business, make termination decisions myself or should I bring in outsiders?

A young venture needs more than internal resources. Entrepreneurs must also consider their customers and sources of capital. Ventures often start with the customers they can attract the most quickly, which may not be the customers the company eventually needs. Similarly, entrepreneurs who begin by bootstrapping, using money from friends and family or loans from local banks, must often find richer sources of capital to build sustainable businesses.

For a new venture to survive, some resources that initially are external may have to become internal. Many start-ups operate at first as virtual enterprises because the founders cannot afford to produce in-house and hire employees, and because they value flexibility. But the flexibility that comes from owning few resources is a double-edged sword. Just as a young company is free to stop placing orders, suppliers can stop filling them. Furthermore, a company with no assets signals to customers and potential investors that the entrepreneur may not be committed for the long haul. A business with no employees and hard assets may also be difficult to sell, because potential buyers will probably worry that the company will vanish when the founder departs. To build a durable company, an entrepreneur may have to consider integrating vertically or replacing subcontractors with full-time employees.

How strong is the organization? An organization's capacity to execute its strategy depends on its "hard" infrastructure—its organizational structure and systems—and on its "soft" infrastructure—its culture and norms.

The hard infrastructure an entrepreneurial company needs depends on its goals and strategies. (See the sidebar "Investing in Organizational Infrastructure.") Some entrepreneurs want to build geographically dispersed businesses, realize synergies by sharing resources across business units, establish first-mover advantages through rapid growth, and eventually go public. They must invest more in organizational infrastructure than their counterparts who want to build simple, single-location businesses at a cautious pace.

When entrepreneurs don't stop to think about culture, their companies develop one by chance rather than by design.

A venture's growth rate provides an important clue to whether the entrepreneur has invested too much or too little in the company's structure and systems. If performance is sluggish—if, for example, growth lags behind expectations and new products are late—excessive rules and controls may be stifling employees. If, in contrast, the business is growing rapidly and gaining share, inadequate reporting mechanisms and controls are a more likely concern. When a new venture is growing at a fast pace, entrepreneurs must simultaneously give new employees considerable responsibility and monitor their finances very closely. Companies like Blockbuster Video cope by giving frontline employees all the operating autonomy they can handle while maintaining tight, centralized financial controls.

An evolving organization's culture also has a profound influence on how well it can execute its strategy. Culture determines the personalities and temperaments of the workforce; lone wolves are unlikely to want to work in a consensual organization, whereas shy introverts may avoid rowdy outfits. Culture fills in the gaps that an organization's written rules do not anticipate. Culture determines the degree to which individual employees and organizational units compete and cooperate, and how they treat customers. More than any other factor, culture determines whether an organization can cope with the crises and discontinuities of growth.

Unlike organizational structures and systems, which entrepreneurs often copy from other companies, culture must be custom built. As many software makers have found, for instance, a laid-back organization can't compete well against Microsoft. The rambunctiousness of a start-up trading operation may scare away the conservative clients the venture wants to attract. A culture that fits a company's strategy, however, can lead to spectacular performance. Physician Sales & Service (PSS), a medical-products distribution company, has grown from $13 million in sales in 1987 to nearly $500 million in 1995, from 5 branches in Florida to 56 branches covering every state in the continental United States, and from 120 employees to 1,800. Like other rapidly growing companies, PSS has tight financial controls. But, venture capitalist Thomas Dickerson says, "PSS would be just another efficiently managed distribution company if it didn't have a corporate culture that is obsessed with meeting customers' needs and maintaining a meritocracy. PSS employees are motivated by the culture to provide unmatched customer service."

When entrepreneurs neglect to articulate organizational norms and instead hire employees mainly for their technical skills and credentials, their organizations develop a culture by chance rather than by design. The personalities and values of the first wave of employees shape a culture that may not serve the founders' goals and strategies. Once a culture is established, it is difficult to change.

Can I play my role? Entrepreneurs who aspire to operate small enterprises in which they perform all crucial tasks never have to change their roles. In personal service companies, for instance, the founding partners often perform client work from the time they start the company until they retire. Transforming a fledgling enterprise into an entity capable of an independent existence, however, requires founders to undertake new roles.

Founders cannot build self-sustaining organizations simply by "letting go." Before entrepreneurs have the option of doing less, they first must do much more. If the business model is not sustainable, they must create a new one. To secure the resources demanded by an ambitious strategy, they must manage the perceptions of the resource providers: potential customers, employees, and investors. To build an enterprise that will be able to function without them, entrepreneurs must design the organization's structure and systems and mold its culture and character.

While they are sketching out an expansive view of the future, entrepreneurs also have to manage as if the company were on the verge of going under, keeping a firm grip on expenses and monitoring performance. They have to inspire and coach employees while dealing with the unpleasantness of firing those who will not be able to grow with the company. Bill Nussey, cofounder of the software maker Da Vinci Systems Corporation, recalls that firing employees who had "struggled and cried and sacrificed with the company" was the hardest thing he ever had to do.

Few successful entrepreneurs ever come to play a purely visionary role in their organizations. They remain deeply engaged in what Abraham Zaleznik, the Konosuke Matsushita Professor of Leadership Emeritus at the Harvard Business School, calls the "real work" of their enterprises. Marvin Bower, the founding partner of McKinsey & Company, continued to negotiate and direct studies for clients while leading the firm through a considerable expansion of its size and geographic reach. Bill Gates, cofounder and CEO of multibillion-dollar software powerhouse Microsoft, reportedly still reviews the code that programmers write.

But founders' roles must change. Gates no longer *writes* programs. Michael Roberts, an expert on entrepreneurship, suggests that an entrepreneur's role should evolve from doing the work, to teaching others how to do it, to prescribing desired results, and eventually to managing the overall context in which the work is done. One entrepreneur speaks of changing from quarterback to coach. Whatever the metaphor, the idea is that leaders seek ever increasing impact from what they do. They achieve this by, for example, focusing more on formulating marketing strategies than on selling; negotiating and reviewing budgets rather than directly supervising work; designing incentive plans rather than setting the compensation of individual employees; negotiating the acquisitions of companies instead of the cost of office supplies; and developing a common purpose and organizational norms rather than moving a product out the door.

In evaluating their personal roles, therefore, entrepreneurs should ask themselves whether they continually experiment with new jobs and responsibilities. Founders who simply spend more hours performing the same tasks and making the same decisions as the business grows end up hindering growth. They should ask themselves whether they have acquired any new skills recently. An entrepreneur who is an engineer, for example, might master financial analysis. If founders can't point to new skills, they are probably in a rut and their roles aren't evolving.

Entrepreneurs must ask themselves whether they actually want to change and learn. People who enjoy taking on new challenges and acquiring new skills—Bill Gates, again—can lead a venture from the start-up stage to market dominance. But some people, such as H. Wayne Huizenga, the moving spirit behind Waste Management and Blockbuster Video, are much happier moving on to get other ventures off the ground. Entrepreneurs have a responsibility to themselves and to the people who depend on them to understand what fulfills and frustrates them personally.

Many great enterprises spring from modest, improvised beginnings. William Hewlett and David Packard tried to craft a bowling alley foot-fault indicator and a harmonica tuner before developing their first successful product, an audio oscillator. Wal-Mart Stores' founder, Sam Walton, started by buying what he called a "real dog" of a franchised variety store in Newport, Arkansas, because his wife wanted to live in a small town. Speedy response and trial and error were more important to those companies at the start-up stage than foresight and planning. But pure improvisation—or luck—rarely yields long-term success. Hewlett-Packard might still be an obscure outfit if its founders had not eventually made conscious decisions about product lines, technological capabilities, debt policies, and organizational norms.

Entrepreneurs, with their powerful bias for action, often avoid thinking about the big issues of goals, strategies, and capabilities. They must, sooner or later, consciously structure such inquiry into their companies and their lives. Lasting success requires entrepreneurs to keep asking tough questions about where they want to go and whether the track they are on will take them there. ⛉

FURTHER READING

ARTICLE

The Founder's Dilemma
by Noam Wasserman
HBR, February 2008
Product no. R0802G
Although people start businesses to make money and to control their own companies, Wasserman's research shows that those goals are largely incompatible. He explores the fundamental tension between them.

BOOK

Heart, Smarts, Guts, and Luck
by Anthony K. Tjan, Richard J. Harrington, and Tsun-Yan Hsieh
Harvard Business Review Press, 2012
Product no. 10253E
Successful business builders possess a combination of the four traits described in this best seller. Learn which one in particular drives you, which ones to dial up or down to realize your full potential, and at what critical points these qualities are most or least helpful.

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Amar Bhidé is the Thomas Schmidheiny Professor at the Fletcher School of Law and Diplomacy at Tufts. He has published two other HBR articles on entrepreneurship: "Bootstrap Finance: The Art of Start-Ups" (November–December 1992) and "How Entrepreneurs Craft Strategies That Work" (March–April 1994) as well as "The Judgment Deficit," (September 2010).

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ENTREPRENEURSHIP

Natural-Born Entrepreneur

His most famous invention, the computer spreadsheet, changed the course of business. But to this entrepreneur, it was no big deal. He was just doing what came naturally.

by Dan Bricklin

I WAS LUCKY. No doubt about it. In 1979, when my partner, Bob Frankston, and I created VisiCalc, the first electronic spreadsheet, we didn't realize it would jump-start the personal computer industry—let alone revolutionize the way businesses kept records and tested financial scenarios. In the midst of my studies at Harvard Business School, I had grown more than a little frustrated by having to manually calculate and recalculate every single change on a spreadsheet as I worked through a case study. There had to be a better way, I figured, so I started designing a computer program to address those inefficiencies. I described my idea to Bob Frankston, whom I'd met as an undergraduate at MIT, and he agreed to try to turn my primitive prototype into a working program. After toiling for several months in the attic of Bob's home, we had a hunch that we might have something big on our hands. The rest of the VisiCalc story is replete with the usual twists and turns—not to mention some very difficult downturns. But that cool little software program is still regarded as the first killer app of the PC in-

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John Craig

dustry, and, much to my surprise, I have had to get comfortable with being famous as "the father of the electronic spreadsheet."

Some 20 years and four start-ups later, I still get my jollies the same way: by creating tools that solve people's everyday problems. I like to think these are tools that speak to people's needs, whether for expressing a personal passion, such as publishing digital photo albums, or for solving a practical problem, such as automating the small-business budget or prototyping a piece of software. Times haven't always been easy. I've lived through a lawsuit, layoffs, two acquisitions, and a failed start-up. (Let's just say that I won't be endowing any university buildings or faculty chairs anytime soon.) But life as an entrepreneur, professional tinkerer, and technology and business commentator has brought me many joys.

Aspiring entrepreneurs and business executives frequently ask me what I've learned, especially now that the notion of being an entrepreneur seems both glamorous and, every once in a while, an effective method for getting rich. I've done a lot of thinking about that question recently, and although I don't have a complete answer, I do know that unless you find your true calling and love your craft, the risks may outweigh the rewards. Sure, training, talent, and that most elusive component, good timing, are essential. But they are not enough. You need to have a true passion for what you're doing.

You also need humility. We're coming out of a time—the dot-com era—when many entrepreneurs have lost all sense of humility. They've come to believe that the lessons of the past no longer apply and are, in fact, laughable. They've paid a price for their arrogance. Personally, I'm convinced that much of what I know has come from paying attention to timeless questions and to the work of those who came before me.

What Will People Pay For?

Someday soon, so we've been told, cell phones will become our most ubiquitous and essential financial instrument—to be used for everything from checking stock quotes and making trades to buying all sorts of goods and services. Cell phones, these prognosticators argue, will lead a wave of wireless e-commerce, and people will pay to use cell phones in order to make all sorts of purchases.

I beg to differ.

If you look at why people actually use the Internet, cell phones, and other communications technologies *they pay for,* you quickly discover that they are rarely driven by a desire to buy things or track their money. Unlike the kings in children's rhymes, most people don't sit in their counting houses counting out their money. Most people don't buy and sell stocks so frequently and on such whims that they need to do it on a cell phone. When have you ever heard any normal person say, "Oh, look! That trendy kid over there is wearing penny loafers! Quick, I must buy stock in a penny loafer company before it goes up this afternoon." The reality is, most people don't buy and sell many stocks at all—and certainly not the imagined majority who will supposedly drive the wireless Internet revolution.

So what will people pay for? For that answer, listen to cab drivers on their cell phones. Listen to bus drivers. Listen to mothers and teenagers in the mall. Who among us hasn't witnessed—or participated in—these kinds of conversations? "I finally left the office, but traffic is light," "Yes, I can pick up a pizza on the way home," "I've got a free minute and thought I'd say 'hi.'" Or, watch people when they go to an Internet café in Paris, where fellow travelers stop in to connect to the Internet over a café au lait. You don't find them surfing to buy things. Instead, they pay money to send e-mails to friends and loved ones. A large percentage of AOL usage comes from instant-messaging services.

The fact is, people will pay for the privilege of saying "hi," flirting, chitchatting about their days, and coordinating activities with their buddies and families. People engage in all sorts of seemingly mundane and trivial activities: forwarding jokes to people, recommending URLs, arranging dinner plans, and, yes, gossiping. People will also pay money to give little gifts to show that they remember a special event, that they care about or are thinking of someone. They send postcards (mainly the paper kind but increasingly the electronic kind), they spend an inordinate amount of their valuable vacation time buying souvenirs, and they love spending money on friends and loved ones at special times like Christmas. Indeed, for many of us, it is absolutely more fun to give than to receive.

No matter how banal some of these uses sound, they are exactly the kinds of activities people will pay for and have always paid for. (Think of that now archaic communications tool, the telegram, which people continued to use for years in celebration of major life events in spite of its high cost.) Instead of dreaming up far-fetched uses for the technology, we ought to spend some time considering what it is people actually want to do and what the natural uses of these devices might be.

Composing a Life

My formal training with computers began in high school in 1967 when I participated in a National Science Foundation summer program that enhanced my basic programming skills. My education continued at MIT, where I worked at Project MAC, which later became the famous Laboratory for Computer Science. MIT helped me strengthen my skills in programming, systems design, and algorithm analysis and gave me an appreciation for the knowledge and abilities of the great technologists who came before me. My generation was wrestling with the same general problems that the greats, all the way back through Galileo, were trying to solve. Like a lot of my peers at MIT, I revered those who came before me, and I was honored to work with a current generation of stars.

After graduating from MIT, I took a job designing computerized typesetting and early word processing at Digital Equipment Corporation. Four years later, I went to business school, where I learned to understand the relationship between things—for instance, how decisions about allocating costs affect other parts of the business. Business school taught me that all aspects of business, even the seemingly mundane activities, can be fascinating and challenging. Try your hand at enough case studies, and you realize that nothing is as simple as it first appears. These were key moments in my development, but in terms of what made me an entrepreneur, other factors were surely at work.

My entrepreneurial backbone was formed much earlier, as a kid in Philadelphia. My father headed up the family printing business, Bricklin Press, which had been founded by his father in the 1930s. Afternoons spent at

the printing plant and dinners devoted to the day's business problems prepared me (though I didn't realize it at the time) for the trials I would face in my own business ventures. My family's unspoken dedication to the business gave me respect for the paradox of running your own business—the contradictory feelings of freedom and responsibility that define the experience of setting out on your own. Growing up, I never expected that some big company would eventually take care of me; instead, I was always looking for opportunities to turn some nifty idea into a business. Some ideas would work out, I hoped, but I knew others wouldn't, and that risk didn't stop me from wanting to try. I suppose you could say the entrepreneurial instinct was in my genes. But much like a lot of people, I also became an entrepreneur because I felt I couldn't achieve my goals through any other means.

Another important part of my early entrepreneurial training came from a source many people might regard as unusual—the religious instruction I received in Jewish day school, which I attended from kindergarten through high school. Many of my values, my ways of approaching problems, and my first skills as a leader were formed there. One concept of Judaism that greatly impressed me was *tikkun olam*. According to one story, when God made the world, he left it a little bit incomplete. Instead of making bread—so the story goes—God gave us wheat; instead of bricks, we have clay, and we have to bake the bricks ourselves. Why? So that we are partners in completing the act of creation. The point of *tikkun olam* is that our time on earth is important; we are not passive observers but active participants in making the world a better place. That sense of individual responsibility—the need to ask, How will I participate?—stuck with me.

My religious studies also taught me how to analyze complex problems. When you study Torah, you learn how to peel an onion. You learn to look at a situation, a single word or phrase, and to appreciate that even one word can have multiple interpretations. The process of discovering each meaning is gratifying, and it teaches you different styles of logic, which in turn deepen your understanding. The discipline of studying the Bible certainly played a role in my technical work because it reinforced the importance of examining a problem from all angles, sorting through the possibilities, testing different models, learning from them in the process, and recognizing the contributions of great philosophers. As a kid, I had already acquired a passion for tinkering. In the third grade, I built an electromagnetic crane from scratch for a school science fair, and a few years later I had advanced to Heathkit voltmeters, shortwave radios, and a stereo system for my parents.

In yet another way, my religious studies gave me what you might call "just-in-time" leadership training. As one of the more advanced students of Hebrew in my synagogue, I was often called on to lead services, which meant that I had to be able to get up in front of my peers and adults to chant from the Torah. I don't have a particularly melodic voice—I'm no Pavarotti—but that experience helped me to become comfortable performing under pressure and speaking in front of groups. Equally important, it taught me to accept that I would make mistakes and that the crowd wouldn't rip me to shreds. I also came to understand that one of the jobs of the leader was to teach other students how to chant from the Torah themselves. Because of my notoriety and my years as an entrepreneur, these days I am often asked to speak before large audiences, to pitch my ideas to investors, or to give talks to journalists and conference audiences about trends in technology or products. Performing these activities has been made easier by those formative experiences in temple.

So, are entrepreneurs born or made? For me, the answer has been both: through a combination of following my instincts and being in an environment that cultivated and directed my talents. And I suspect this is the case for most entrepreneurs.

THE IDEA IN BRIEF

In 2001, 20 years and four start-ups after Dan Bricklin created the first electronic spreadsheet, VisiCalc, aspiring entrepreneurs often asked him what he'd learned along the way. Besides the need for training, talent, and good timing, he suggests these lessons for surviving the ups and downs of entrepreneurship:

- Understand your true talent and value, appreciate the contributions of others, and know when to ask for help.
- Don't wait to get started, or if you do wait, know that eventually you may be less willing to sacrifice your standard of living for the sake of the business.
- Most important, realize that you are not your business. Your company's success or failure does not reflect on your worth as a person.

Bricklin says his work has been shaped by the idea of being an active participant in making the world a better place. Ultimately, do what you love and don't do it for the dream of money alone.

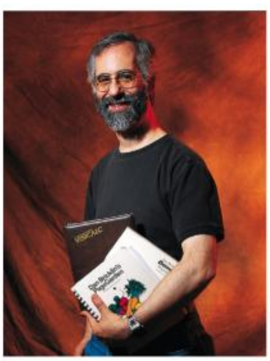
Learning on the Fly

Even with good training and strong motivation, being a successful entrepreneur is tricky. You have to live with having control and *not* having control at the same time. It's like this: In big businesses, when you need to cross a river, you simply design a bridge, build it, and march right across. But in a small venture, you must climb on the rocks. You don't know exactly where each step will take you, but you do know the general direction you're moving in. If you make a mistake, you get wet. If your calculations are wrong, you have to inch your way back to safety and find a different route. And, as you jump from rock to slippery rock, you have to *like* the feeling.

Of course, you can save yourself some grief by taking to heart some conventional wisdom: Hire the right people. Choose people who are flexible—who don't mind doing the dirty work—especially in the early days, when there's more than enough work to go around. And, yes, do what you love, and don't, whatever else, do it for the dream of money alone. Too many people joined dot-coms for the lure of money and glory, only to be left with neither in the end. But those of us who love our craft find that approach foreign. We like to work in areas that interest us, and we hope money will be a by-product. To be sure, certain business truisms still apply: People matter, and focus is important. And yet, I'd like to suggest a few other lessons that have made all the difference to me.

On those darkest days when things aren't going so well, try to remember that your company's failures don't make you an awful person. Likewise, your company's successes don't make you a genius or superhuman.

First, understand your true talent and what value you bring to an endeavor. Too often, entrepreneurs don't value the work others do, and they tend to overestimate their own contributions. Of course, in the early days, when you're simply trying to give birth to an idea, you may not need help from outsiders. But when—make that *if*—you are able to take the business to the next stage of growth, a different and deeper set of talents may be required. If these aren't your talents, you may need others to step in—for instance, to swim in the details of running the operation, to build strategic partnerships, to set financial priorities, or to make the trains run on time. When you have had to do everything as I have—right down to packing the product, licking the stamps, and hiking to the mailbox—you develop a greater appreciation for the contributions of others, from the office manager to the production manager to the customer service people.



Dan Bricklin, who changed the face of the computer industry with his invention of VisiCalc, says he became an entrepreneur because he couldn't achieve his goals through any other means.

Even today at Trellix, the company I founded to build Internet publishing tools, my title isn't president or chief executive officer. It's chief technology officer, a role I planned to hold from the very beginning. I'm not the most senior person in the company, but I can influence the company's direction in ways that matter to me and make the company better. I'm also the public face of the company, which happens to be a role I enjoy. I appreciate the work others do, how their talents contribute to the business, and what I can learn from them. Still, founders always play a special role. Take Paul Allen, for example. In most people's minds, he's still associated with Microsoft, even though he hasn't worked at the company in years. But sometimes founders have to forgo the CEO title for the sake of the business. Accepting that hard truth is often best for the founders, too.

Second, don't wait to get started. Or at least understand that if you wait, you may have less flexibility in making trade-offs between the business and your standard of living. MBA students often ask me whether they should start a business right after graduation or wait until they have more experience. The answer depends on a number of factors, naturally, but I do warn them about the personal sacrifices they will undoubtedly face. All entrepreneurs must ask themselves whether they will be able to tolerate these sacrifices—and whether their families will be able to tolerate them, too. Granted, if you wait until you've been in the workforce for a few years, you'll have more business experience and, let's hope, money in the bank. But you will also have grown accustomed to spending more money; you may be faced with the terror of not being able to make a decision about the business because you can't afford it. If you start early, on the other hand, both your appetite for creature comforts and your family responsibilities are not likely to be as great, and you will be able to make different choices. That's one of the reasons it's important to evaluate the risks and rewards of a venture in such a way that even if you don't succeed, you'll still be happy.

No matter what, however, you must always be a careful spender. In every business I've started—whether backed by venture capital funds, family investors, or my own bank account—I've arranged my affairs so that on short notice I can afford to live without a salary for a year. This approach has allowed me to keep the business going longer with fewer resources or to start another venture if the first one dies. And I've had to do that. For instance, when Bob and I were developing VisiCalc, we raised a little more than $25,000 from family members as a down payment for the computer we used to write the program. Then we obtained royalty advances from the publisher who agreed to distribute the software, which we used to pay other expenses. We didn't draw a salary for about a year, and we were able to live like a couple of students. We were willing to stay in the cheapest hotels or with family members when we traveled to trade shows or made sales calls, and on a few occasions, we even shared a bed if it meant we could save a few dollars. Neither of us had a lot of other responsibilities at the time, so when we sacrificed a little personal comfort on behalf of the business, we didn't have to worry that our families would suffer, too.

The final and most important lesson every entrepreneur must learn is this: You are not your business. On those darkest days when things aren't going so well—and trust me, you will have them—try to remember that your company's failures don't make you an awful person. Likewise, your company's successes don't make you a genius or superhuman. To avoid this ego trap, first you should consider the difference between pushing a tidal wave and riding one, and second, you should accept that every business faces challenges beyond its control. Obviously, these are difficult points to remember when you're heading for a rough patch, but I tell you from experience, business failure is not the end of the world.

Fortunately, I learned the meaning of failure early when Software Arts, the company I established to develop VisiCalc, went belly up in a very public fashion. My friends and family were able to follow virtually every step of its demise because the company's difficulties—a horrible lawsuit with a partner that eventually left both parties broke, and the sale of our assets to Lotus to stave off bankruptcy—were regaled in publications such as *USA Today*. I can recall one particularly awful Friday. I was returning from the West Coast on a red-eye flight with the knowledge that I would have to inform half my staff that their jobs were ending that very day. I was heavy with the weight of that responsibility as I walked off the jetway at seven o'clock in the morning at Logan Airport. Half wondering who would possibly show up to greet passengers at this hour, I lifted my bag onto my shoulder and then turned to see my own family waving and smiling. They knew what kind of day I faced, and they had shown up at this painfully early hour to support me. I cannot tell you how important that moment was to me—and still is. It didn't change the fact that my business was in trouble, but it did make it easier to do a hard job. When you're an entrepreneur, you need a family who will support you that way, a family who will separate your success in business from your worth as a person. I was fortunate to have come from a long line of entrepreneurs, which means that my family doesn't think I am crazy for heading down the same path. Not all my family members have chosen to be entrepreneurs themselves, but they certainly have understood and tolerated the choices I have made.

THESE DAYS, I try to share my experiences as an entrepreneur with other people. I've told my story to many different audiences: business school students, grade school kids, and job-retraining students. In these talks, I make use of a collection of artifacts from my various adventures. These include photographs from those early days, a video of old staff meetings and the Apple Mac announcement, the original VisiCalc program (a working version of which can still be downloaded from the World Wide Web), company T-shirts, old newspaper clippings, and old pen computers and typewriters. People seem to love hearing these stories, warts and all, because—let's face it—we all have our ups and downs, and it's some comfort to know that others have faced and survived hardships, too. Stories like mine, I suppose, give people hope. The point I'm trying to make is that even though I am not wildly rich, the experiences and influence I have had are worth more than money can buy.

How lucky and happy I am to be here. Someone else could very well have gotten here first—someone else could have been the pioneer, the so-called father of the electronic spreadsheet. All of the ideas were already floating around. I just happened to be in the right place at the right time with the right skills and experiences to put the pieces together. As you go through life, you never know what little thing will make a big difference. When I turned 50 this summer, I looked back with wonder and relief. My efforts had amounted to something, even more than I had any reason to hope for.

Dan Bricklin founded and served as chief technology officer of Trellix Corporation (now owned by Web.com). He is currently the president of Software Garden, Inc., and the chief technology officer of Alpha Software Corporation in Burlington, Massachusetts.

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FURTHER READING

ARTICLE

Twitter's Cofounder on Creating Opportunities
by Biz Stone
HBR, June 2015
Product no. R1506A
Stone persuaded his high school to start a lacrosse team and surreptitiously submitted a winning book-jacket design while stacking boxes at Little, Brown. He shares the belief that has informed his career: Opportunity is something you manufacture, not something you wait for.

BOOK

Worthless, Impossible, and Stupid
How Contrarian Entrepreneurs Create and Capture Extraordinary Value
by Daniel Isenberg
Harvard Business Review Press, 2013
Product no. 11143E
Isenberg relates a wealth of counterintuitive lessons that depart from the "Silicon Valley" approach to creating a business—stories of real business builders from around the world that illustrate the new rules of entrepreneurship.

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ENTREPRENEURSHIP

A Test for the Fainthearted

Starting a business is rarely a dignified affair. Do you have the guts—and the mindset—to take on the challenge?

by Walter Kuemmerle

THREE YEARS AGO, almost anyone could have been an entrepreneur; all you needed was a hot—or even lukewarm—idea. Billions of dollars went into ventures hatched by fresh-faced youngsters with, at most, a couple of years' experience at pricey consultancies or high-tech companies under their belts. So they had little business experience? No problem; they could always find a grown-up, like eBay CEO Meg Whitman, to handle the operations. Not surprisingly, many young people came to believe that entrepreneurship was a safe career choice. More than a few of their elders, too, underestimated the risks involved in financing start-ups and ended up pouring millions of dollars into doomed ventures.

The economic downturn has shattered those illusions. Now, as we sift through the debris of hundreds of failed Internet companies, it's a good time to ask the hard questions that many would-be entrepreneurs—and those who bankrolled them—overlooked in the heady days of the boom: What really makes an entrepreneur? What characteristics set successful entrepreneurs apart, enabling them to start ventures against all odds and

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Jonathan Carlson

keep them alive even in the worst of times? Do you have those characteristics, and if you don't, can you develop them?

The truth is, real entrepreneurship is a far cry from managing an established business and farther still from the sanitized model that became popular during the late 1990s. Over the past five years, I have studied more than 50 start-ups—some successful, some not—in 20 countries. My research has uncovered intriguing similarities in ways that successful entrepreneurs behave, similarities that hold true no matter the country or industry involved. Winning entrepreneurs feel comfortable skirting the boundaries of propriety. They are passionate enough about their ideas to assume enormous personal risks—powerful enemies, bankruptcy, even jail—to realize their dreams. However grand their visions, they are ready to start small and patiently scrabble in the mud for any deal they can swing. Profoundly opportunistic, they will do whatever it takes to win the confidence of their customers and investors, knowing that simply staying in business is the only thing that matters.

I've distilled my findings into five straightforward, if discomforting, questions that I see as a kind of litmus test for the potential entrepreneur. By posing these questions to yourself—and answering them with complete honesty—you can help yourself begin to understand if you have what it takes to be an entrepreneur.

Are You Comfortable Stretching the Rules?

All businesspeople have to be a little devious at times—it goes with the territory. But entrepreneurs are different. They're not just willing to bend the rules; they revel in it. In fact, most start-up success stories I've heard contain at least one episode of an audacious entrepreneur using some outrageous tactic to swing a crucial deal or find the resources to get an idea off the drawing board.

Consider the case of two young entrepreneurs who were trying to set up a mail-order business in the late 1990s. A venture capital company had given them seed money, and they needed to quickly recruit a team of two dozen seasoned marketers to create the first catalog. But the entrepreneurs hadn't rented an office yet. Equipped with only a cell phone and computer each, they were working out of their bedrooms. Since the labor market was tight, they knew that the best talent would not bother to show up for interviews unless they could present their company as an established concern. So the enterprising duo decided to live two white lies.

First, they published a large ad in their country's leading business newspaper describing themselves as a "fast-growing multinational company." Although this statement wasn't exactly true, it wasn't false either, since, the entrepreneurs reasoned, they *planned* to expand into other countries in the region. And the ad worked: More than 1,000 applicants responded to it. With résumés in hand, the entrepreneurs rented a plush suite for one day at the local Four Seasons and interviewed selected candidates there. Their deceptions, the entrepreneurs believe to this day, heightened the company's appeal and thereby attracted talented people. And that, in turn, increased the chances of the business's success. For the record, by 2001 the company had 600 people on staff and had indeed become a fast-growing multinational concern.

Do you have the stomach for such subterfuge? What if it puts your livelihood at risk or threatens your family's financial well-being? Since start-ups operate on shoestring budgets, entrepreneurs often have to take big chances with their finances. Many have kept their businesses afloat by juggling personal credit cards or borrowing against their homes—without worrying much about the consequences. Fred Smith, the founder of Federal Express, is celebrated for his financial inventiveness. On at least two occasions, he used creative financing to rescue his fledgling parcel delivery company from bankruptcy. In 1973, when FedEx was on the verge of going belly up, Smith's shenanigans landed him in court and almost got him sacked by his board. He was accused of knowingly making a false statement in order to obtain a $2 million loan from the Union National Bank of Little Rock in Arkansas.

Smith was acquitted, but it was a close call, and the experience taught him a salutary lesson all entrepreneurs should remember whenever they find it necessary to embellish the truth: You can bend the rules, but you can't break them.

Are You Prepared to Make Powerful Enemies?

In general, smart entrepreneurs prefer to go after market niches that incumbents have overlooked. But they are not afraid to make powerful enemies. In fact, they often enjoy playing the underdog because, unlike many people, they don't crave approval. The size of their rivals doesn't bother them much either, and I've seen a number of smart entrepreneurs win by finding cunning ways to use their enemies' own strengths against them.

Aleksandar Mandic embodies this pattern of behavior. In 1993, he started Brazil's first Internet access provider, the eponymous Mandic, and quickly built a small but growing subscriber base. The business began to boom as Brazil woke up to the Internet's potential, and by the mid-1990s, several competitors with deep pockets had entered the market. Among the new players was Universo Online (UOL), a joint venture between two of Brazil's largest communication companies, the Abril Group and the Folha Group. The latter owned *Folha de S. Paulo,* Brazil's largest-selling newspaper with a Sunday circulation of 1 million. UOL began with a splash: One Sunday morning in June 1997, every copy of *Folha* came bundled with a free CD. It was affixed to a full-page ad that extolled the virtues of using the CD to dial up and subscribe to UOL's Internet service.

Mandic could not afford to take on UOL by distributing a million free CDs of his own, even if he had the time to do so. He decided to fight back, but in an imaginative—and cost-effective—way. The following Sunday, Mandic published his own full-page ad on the same page of *Folha* that had contained UOL's ad. It didn't include a CD but provided detailed instructions on how to use the UOL CD to connect to the Internet—this time by subscribing to the Mandic service. The dueling ads became a topic of conversation, especially on the Internet, and everyone marveled at the way Mandic's company had upstaged its much larger rival.

UOL was furious, particularly since it shared a parent company with *Folha*. It complained, and the newspaper's executives agreed to never again run Mandic's ads. But this threat didn't faze the company's leader. He seized on the ban to launch a public campaign against *Folha*'s policies and the newspaper's tight links with UOL. For months, *Folha*'s rivals

In general, smart entrepreneurs are not afraid to make powerful enemies.

were only too happy to keep the controversy alive, and Mandic won enormous popular support as the entrepreneurial David who had taken on a media Goliath.

Do You Have the Patience to Start Small?

In 1999, Tom Herman and Kaleil Isaza Tuzman, best friends since childhood, quit their comfortable jobs to start govWorks, with millions of VC dollars to back them up. Their goal was nothing if not grandiose: to use Internet payment systems to transform the way federal, regional, state, and local governments worldwide collected fees and taxes. To use the company's own phrase, govWorks was about "all payments for all governments." (The film *Startup.com* featured the company.)

Soon after Herman and Tuzman set up shop, they approached a venture capitalist for additional funding and for advice. He suggested that the company test and refine its business model by initially focusing on one payment operation, for parking tickets, in one U.S. city. The entrepreneurs almost bit off his head. "The leader in this market space is going to be a multibillion-dollar company," Tuzman declared. He believed that by winning the support of umbrella organizations that represent many municipalities, such as the U.S. Conference of Mayors, govWorks could quickly go nationwide. But it didn't work out that way. Tuzman and his partner underestimated how little the cities actually trusted the endorsements of the umbrella organizations. The big contracts did not come as quickly as the founders had expected, and in early 2001, the company was no longer in business.

GovWorks's failure is a textbook example of the perils of grandiosity. Smart entrepreneurs recognize that start-ups cannot afford to pass on any opportunity, no matter how small. They see business much like a game of PacMan—you can bag big fish only by learning to swallow small ones. The best entrepreneurs also recognize that trying out a business model on a small scale helps them find out what their industry is about and lets them make mistakes at those times when they can still afford it. Growth, when it comes, is all the more sustainable as a result.

Back in 1987, Leopoldo Fernandez Pujals, a corporate veteran with 20 years of experience at the likes of Procter & Gamble and Johnson & Johnson, decided to set himself up as Spain's first pizza magnate and founded TelePizza. He believed that customers in Spain—and, indeed, throughout Europe—would respond enthusiastically to a branded chain that offered home delivery, as Domino's does in the United States. Pujals recognized, however, that he knew little about making pizza or delivering fast food, let alone how such a business might function in the Spanish market. So he decided to start small, with a single shop in Madrid. In this way, he reasoned, he would be able to experiment with the economics and logistics of a pizza business and gain firsthand experience of his customers as well.

The outlet was an instant hit, but Pujals resisted the temptation to immediately replicate it. He waited a year before opening a second shop, and the delay paid off, because he had a much clearer idea about what would and would not work after his initial experience. During that first year, for instance, he found that Spanish customers felt more comfortable ordering takeout pizza once they had consumed one on the premises. So, in contrast to the setup at Domino's, Pujals included an eating space in his store and experimented with the dining area's size and décor. Ultimately, he discovered that a small, spartan dining room was good enough. Pujals also found it was usually the children's idea to order pizza from home. As a result, TelePizza has consistently marketed its products as family food, targeting its messages to children as well as adults.

Expanding slowly also gave Pujals the chance to work out and test his business model. He was able to determine exactly what sort of investments he could expect future franchisees to make and how large an area of geographic exclusivity he needed to offer them. On the cost front, he found that to tap cheap student labor, franchisees would have to supply delivery personnel with mopeds, because most Spanish students, unlike their American counterparts, did not own motorcycles or cars.

As a result of Pujals's initial caution, growth when it came was both fast and steady. When he sold the company in 1999 to the Spanish food conglomerate Campofrio, TelePizza spanned six countries with more than 600 outlets selling some $250 million worth of pizza a year. He had turned an equity investment

THE IDEA IN BRIEF

Starting your own business is not for the meek, and it's far different from managing an established one. So, what really makes an entrepreneur?

After identifying key behaviors of successful entrepreneurs, the author has distilled five questions that offer a litmus test for those who aspire to do the same:

- Are you comfortable stretching the rules?
- Are you passionate enough to take enormous risks, and even make powerful enemies?
- Do you have the patience to start small and hustle for any deal?
- Are you willing to shift strategies quickly, doing whatever it takes to win the confidence of your customers and investors?
- Do you know how to close a deal?

Answering these questions honestly will help you decide whether you have what it takes to become an entrepreneur. If you don't have all these characteristics yet and still yearn to start your own venture, find ways to put yourself in a position to develop them.

of $100,000 into a fortune of more than $300 million in just 12 years.

Although many aspects of entrepreneurship favor the young, patience does not. Here, more seasoned businesspeople have the edge. The impatience and idealism of the young often lead them astray, pushing them to blindly adopt a get-big-fast philosophy—"going for scale," as the dot-commers put it. This approach makes sense in certain contexts, especially for businesses like on-line recruitment sites, because their competitive advantage lies in the size of their networks. But it does not work for most start-ups. Among the unsuccessful ventures I've studied, many simply burned up their capital by trying to expand too soon. Entrepreneurs should be greedy, but they need to be patient as well.

Are You Willing to Shift Strategies Quickly?

Many would-be entrepreneurs place their strategies on a pedestal. Once they have the plan on paper, they try not to stray from it. Sticking to their guns, they believe, sends out a positive signal to customers, investors, and employees. Changing the plan, on the other hand, undermines credibility. Sometimes this conviction runs so deep that entrepreneurs appear more interested in pursuing the original strategy than in keeping their business afloat.

The harder it has been for a company to work out its strategy, the more trouble it has abandoning it. I studied one group of entrepreneurs who had developed a touch-free, sensor-based technology that enabled the precise locating of objects in a three-dimensional space. After much debate, the group decided to customize the technology for two markets: electric motors and handheld devices. Because the founders decided to focus exclusively on those two applications—and were unwilling to abandon that strategy—they missed out on a $100 million market opportunity to bundle their technology with other companies' products. As a result of that strategic blunder, investors lost confidence in the entrepreneurs, who were forced to sell the business to a hardware manufacturer.

By contrast, smart entrepreneurs—and savvy investors—recognize that a new venture gains credibility more by simply surviving than by doggedly following its original strategy. They are quick to recognize when they have to change course, and they seldom hesitate to do so. Indeed, they often take pride in their ability to turn on a dime, painting their twists and turns in the rosiest of colors. That's not to say that a good strategy is unimportant; it's just that, in the course of day-to-day business, you don't have the luxury of standing pat. You often have to shift from one strategy to another very quickly.

Consider the story of Andy Freire and Santiago Bilinkis. In January 1997, they set up Officenet, Argentina's first catalog-based supplier of office products. By 1999, the company had grown into a profitable $20 million business. Their early success sparked big dreams, and Freire and Bilinkis began talking about turning Officenet into a multinational company—the Staples of South America. The original investors, however, were less than impressed by such bravado, believing that the proposed expansion would require more capital than the company could raise, and certainly more than they could provide.

Then, Submarino, a leading South American retailer of books, CDs, and consumer electronics—a south-of-the-border Amazon.com—proposed a merger with Officenet. Since that arrangement would provide Officenet with the level of investment it needed in order to grow, Freire and Bilinkis were happy to abandon their strategy of independence. Better yet, as they pointed out to their backers and employees, the combination could provide a gateway to markets outside Argentina. Officenet might not become the Staples of South America, conceded Freire and Bilinkis, but being a division of a Southern Hemisphere Amazon.com would do very nicely.

Ten months after the merger, however, circumstances had changed again. Submarino had become a victim of the Internet bust, forced to withdraw its application for a Nasdaq IPO. Freire and Bilinkis recognized at once that the writing was on the wall for Submarino—and for the entrepreneurs' strategy. Freire and Bilinkis pulled out of the merger and reverted to their go-it-alone approach, knocking once again on doors that had shut them out the year before. To their surprise, the experience was different this time, even though market conditions had worsened. Investors, it turned out, were unfazed by Officenet's twists and turns; they now saw Freire and Bilinkis as born survivors. Within three months, the two had raised more than $30 million in one of Latin America's largest postcrash financing rounds. Today, despite Argentina's economic woes, Officenet is a thriving independent concern.

Are You a Closer?

Successful entrepreneurs know how to seal deals. They possess an almost uncanny ability to come in, often at the last moment, and elbow their rivals aside. However tough the market or small the transaction, they know exactly what they must give up—and what they can get away with—while finalizing deals under pressure.

N.R. Narayana Murthy, the man who cofounded the Indian software company Infosys Technologies in 1981, was nothing if not a closer. His company had to break into international software markets because the local one was virtually nonexistent. To succeed, Infosys needed to build a track record, which meant closing deals quickly.

Murthy took charge of sales, landing Infosys's first contract with a U.S. company—a six-year deal to upgrade the computer system at a large, New York-based textile distribution company. The upgrade—from a 16-bit processor to a 32-bit one—was quite involved, requiring that much software be rewritten. Over the next 20 years, Murthy spent little time at home. In 1990, he lived in France for three months, closing just one deal.

His efforts paid off. Today Infosys is a serious contender in the customized software market in the United States and Europe, with $400 million in revenues and a market capitalization of around $8 billion.

Being a closer involves more than a willingness to go the distance in negotiating deals. You also have to be comfortable repeatedly making life-or-death decisions in the dark. Most executives-turned-entrepreneurs don't realize how big the gap is between making decisions in established corporations and making them in start-ups. And that's one of the main reasons many first-rate executives find it hard to adjust to the entrepreneur's world. Not only are decisions in a start-up more important—even small errors can kill the business—but they are of an entirely different nature.

In a corporation, managers are usually making the same sorts of decisions every day and are surrounded by other people making similar choices. While corporate managers obviously have to operate with a degree of uncertainty—they may not have all the information required—the environment is familiar, and that fosters self-confidence. In a start-up, however, managers don't have those comfort layers. If they can't trust their gut, they'll freeze.

In one case I studied, a senior investment banker had left a prestigious Wall Street company to join a start-up established by a former colleague. Wall Street traders are not known for their indecision, and this one had been a star, staking millions of dollars on his trading instincts and closing dozens of securities deals daily. But his killer instincts deserted him once he left the familiar environment of the trading floor. He even had trouble choosing which office supply vendor to go with. As he put it: "I felt I needed more and more information every time I tried to make a decision."

Real entrepreneurs know that using their time to gather extensive information is a luxury they sometimes cannot afford. They are more concerned that a decision be made than that it be the best possible choice. One entrepreneur I studied estimated that he had had to make around 150 key decisions before he was ready to do business—from naming his company to hiring his first employee. If he hadn't been able to trust himself to make those decisions quickly, he might have never launched the company.

Learning the Ropes

What happens if you answered "no" to any of my questions? Does that mean you can never start a business? Not necessarily. It certainly helps to have an entrepreneurial personality from the get-go, but you can learn some of the traits I've described. And even if you can't master them all, you can sometimes make allowances for your deficiencies.

If you're not a natural-born entrepreneur, the worst thing you can do is to simply dive into your first venture. Rather, you should work a few years for a fast-growing company, ideally in the same industry in which you want to start your business. It's a fairly risk-free way to get exposure to entrepreneurial life, and with some close encounters already behind you, you'll feel more comfortable with the risks, twists, and turns of managing your own business.

You might also look for a mentor—perhaps someone from the fast-growing company where you learned the ropes—who can help you identify which entrepreneurial traits you most need to develop. I've found that successful entrepreneurs are usually happy to act as mentors; they see it as a way of giving back. But don't take all your mentor's advice at face value. As you become more successful as an entrepreneur, your mentor may begin to feel threatened and may even seek to undermine your confidence. As we've seen, entrepreneurs have sizable egos.

You should also look for a partner. Few people are all-round entrepreneurs, gifted with every necessary trait. Your partner should be an equal—a cofounder; an early-stage venture capitalist; or an older, experienced corporate executive hired to fill a senior position such as CFO. Sometimes the partner will act as a brake by bringing your grand visions down to earth or by reminding you of the limits of the law. At other times, though, it can be the partner who pushes you to close the deal or to challenge your assumptions.

BEING AN ENTREPRENEUR isn't for everyone, and even those who have the right stuff find the path to success much rougher and, usually, much longer than they had anticipated. But if you start your journey with a clear sense of your own capabilities and the gaps in them, you'll be much more likely to succeed in your venture.

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FURTHER READING

ARTICLE

The CEO of Athenahealth on the Role of Anger in Starting New Businesses
by Jonathan Bush
HBR, December 2015
Product no. R1512A

Disappointed by the lack of humanity in how health care is delivered, Jonathan Bush looked for an entrepreneurial way to improve the system. Athenahealth has freed doctors from the drudgery of paperwork to spend more time with patients.

HBR CASE STUDY

Is a Start-Up's Strength Becoming Its Weakness?
by Ramana Nanda and Liz Kind
HBR, November 2015
Product no. R1511K

A central tenet of a popular start-up website is that it's free—a huge advantage over similar sites. But therein lies the conflict: Can the site's creators now form a long-range plan to monetize its services?

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ENTREPRENEURSHIP

What Entrepreneurs **Get Wrong**

A global survey shows that most company founders regret waiting too long to start selling. An entrepreneur-friendly sales model can help.

by Vincent Onyemah, Martha Rivera Pesquera, and Abdul Ali

FOR MANY ENTREPRENEURS, the process of launching a company begins with the lightbulb moment when they conceive of a breakthrough idea for a new product or service. Very often, they are so passionate about the idea that they believe its merits will be self-evident to prospective customers—that the innovation is so obviously superior it will sell itself. Entrepreneurs who avoid that delusion may think of their initial sales as a chicken-and-egg problem: They realize that getting buy-in from potential customers is a top priority, but until they design and build the product (which often requires securing funding, assembling a team, and many other tasks), how could they possibly make a sales call?

Both attitudes fail to recognize a simple fact: Salesmanship is central to the success of any young company, and entrepreneurs ignore this at their peril. Yet many do ignore it, in large part because they have little sales experience and have probably not taken classes in how to sell, even if they have formal business education (as Suzanne Fogel and colleagues explained in "Teaching Sales," HBR, July–August 2012). For those in search of guidance,

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the research and advice on salesmanship may not offer much help: The vast majority of techniques, models, and strategies are aimed at large, established companies, not start-ups, which tend to face a unique set of objections from prospects. And when entrepreneurs get around to making those crucial first sales, they often make common mistakes, such as not considering the strategic advantages of a particular customer or extending a deep discount just to make the sale.

In our study of entrepreneurs in Hong Kong, Kenya, Mexico, Nigeria, the United Kingdom, and the United States, we shed light on how they approached the task of making their first sales and what they wished they'd done differently. In all, we spoke with 120 founders, more than half of whom had previous start-up experience. In this article, we examine the mistakes they cited most frequently, explore the objections they faced when they began making sales calls, and present an alternative sales model uniquely suited to a start-up's circumstances.

Regrets, We've Had a Few

The founders we interviewed cited the following five missteps most frequently:

Starting late. More than half our interviewees fully developed their products before getting feedback from potential buyers. In hindsight, most viewed this as a mistake, echoing one of the mantras of Eric Ries's "lean start-up" philosophy: Get in front of prospects from day one. As one CEO told us, "You'll learn more from talking to five customers than you will from hours of market research [at a computer]." The goal should be to gauge customer reaction to the general concept you plan to build. "Don't make anything until you sell it," advised one entrepreneur. "Get people really interested in buying it before you invest too much time and effort."

Failing to listen. Even founders who started selling early said they were too focused on convincing prospects of the new product's merits and not concerned enough with finding out what prospects thought of the idea. Some realized that their passion and ego made them respond negatively to criticism and discount ideas for changes that they later saw would have increased the marketability of their offerings. "Listen to the feedback from the customers and reshape your idea and your product to fit what they actually want," one interviewee advised. Another described the process this way: "It's really all about understanding what the pain point is in the marketplace, and the best way to do that is to talk to prospects and validate, validate, validate your idea." As one U.S. entrepreneur who had approached the task correctly said, "The goal of our demo was not only to explain what we do but also to give the illusion of explaining what we do, while we really tried to extract information about their business and how we could help them."

Offering discounts. Faced with pressure (from themselves or their VCs) to make early sales, many founders offered price discounts in order to close initial deals—often establishing unsustainable pricing precedents with those customers. Worse yet, news of the discounts spread around small industries, crippling the ventures' long-term pricing power. In retrospect, the entrepreneurs wished they had found alternative sweeteners to close early deals—free shipping, say, or a discount on orders placed before a certain date. And if you're going to offer temporary discounts, they told us, it's smart to put the terms in writing.

Selling to family and friends. Making early sales to family members was especially common among entrepreneurs outside the U.S. and for those in the restaurant, clothing, and wealth management industries. But you never know why relatives are buying from you—often their motivation is love, pity, or a sense of obligation, not compelling product quality. In retrospect, founders believed those sales created a false sense of validation and that they would have been better off pursuing arm's-length transactions with customers who would have given them candid feedback.

Failing to seek strategic buyers. For cash-strapped entrepreneurs with no sales record, the thrill of getting the first "yes" can blind them to other considerations. Can this customer open new doors or provide referrals? Can the customer supply usage data that could make my value proposition more compelling? Some of the founders we interviewed wished they had conducted a strategic assessment of their first buyers. Others chose their first clients deliberately in order to get feedback, perform beta testing, get referrals, or guarantee repeat business. These strategic first sales often led to long-term success.

Some founders realized that their passion and ego made them respond negatively to criticism and discount ideas for improving their products.

Sorry, You're Too Small

As they looked back on their nascent sales efforts, the entrepreneurs we spoke with described a long series of hurdles. Many had problems developing lists of prospects. Once they had identified likely targets, they faced obstacles in getting past gatekeepers or securing appointments. (This is especially problematic in Latin America and Africa, where most people won't pick up the telephone if they don't recognize the number displayed. In those situations, founders needed to find acquaintances who could make referrals simply to secure an appointment.) Some entrepreneurs described difficulty articulating precisely what made their product or service different from the alternatives. When they did make a sale, several suffered because no one in their venture was responsible for accounts receivable. "I realized I had to collect when I ran out of cash," reported one Mexican founder. "At times, three or four months would pass without invoices being sent to customers, because I was not well organized."

The biggest problem with the actual mechanics of selling, however, was handling the objections of potential customers. Our interviews revealed five categories of objections, most of which are different from those faced by salespeople in established firms.

Efficacy. Potential customers were consistently skeptical about the ability of new products to deliver on their value propositions. Some entrepreneurs could show results from beta tests or independent lab results, but that wasn't possible for all products and services. In those cases, offering samples or free trials often proved effective. One of our subjects, the founder of a furniture reupholstering business in Mexico, made an early sale by eating lunch in one of his market's largest hotels. At the end of the meal, he asked the restaurant manager to introduce him to the facilities director, who came to the table. The entrepreneur showed him the worn fabric on the chairs and offered to refurbish two of them for a small fraction of the replacement price. Once the facilities director saw the finished chairs, he talked the business up at meetings of his professional association, leading other big hotels to place orders.

Credibility. Prospects also expressed doubt about a new company on the basis of the founder's age, gender, personal background, or experience level. Founders with relevant experience highlighted that; those who lacked it touted partners or board members with solid industry reputations. The founder of a Nigerian outsourcing company described the process: "The first resistance had to do with the company being very new, but I conquered that by showing that I'd been in this kind of business for years before venturing out solely. Then they looked at my board composition and felt the directors were credible enough—and *they* had confidence in this young company. That gave them the needed boost to say, 'OK, let's just have a go.'"

Size. One founder we spoke with summed up this pervasive concern: "How do you make the prospect comfortable with the fact that your company is small?" There is no easy answer. Many founders highlighted a key benefit of their company's size: the fact that customers were dealing with the CEO instead of a sales rep. For companies selling physical products, quality and value helped dispel concerns. Ultimately, though, overcoming objections about size required founders to develop trust with prospects and to take steps to reduce the risk of dealing with a start-up. For instance, some founders did not ask for a deposit from their earliest customers but instead used a pay-on-delivery model until they achieved a track record.

Price. Salespeople from established businesses often field complaints about price, of course, but start-ups reported that their prospects were especially likely to push back on pricing because they knew the entrepreneurs were eager to make early sales. In fact, several prospects stated directly that they expected significant price cuts for becoming early users. Some entrepreneurs walked away from those deals, some gave discounts, and others pushed back.

Price objections often stemmed from prospects' incomplete, biased, or subjective cost/benefit analyses, so savvy founders developed tactics to counter these. For instance, a Mexican start-up pitching digital recordkeeping to large organizations consistently met with executives who failed to account for the real estate and labor costs of storing a large amount of poorly organized records in a back office. Over time, this company's founders became adept at calculating those costs to illustrate the value of their service. For entrepreneurs who believed their prices were fair, a price objection could indicate that they were failing to adequately describe the offering. "Usually when prospects said they couldn't afford our service, I interpreted it as they didn't want it or didn't understand it," a founder told us. "That meant we had to go back and do a better job explaining our service and how we could add value."

Switching costs. To adopt a new product or service, prospects might need to modify their routines, procedures, systems, or internal or external relationships. Making such modifications to switch to a new, untested offering can seem especially costly, but buyers do not always verbalize these concerns. To address tacit objections about switching costs, the entrepreneurs we interviewed took it upon themselves to ask questions that would lead prospects to talk freely. One U.S.–based start-up that produced a mobile app to help people make restaurant reservations recalled a key problem at the time: "Most restaurants don't have a computer at the front desk, and so we had to address that. The managers said, 'Well, we're not really looking to change the way we do things.' Restaurants are pretty slow to change." The founders won managers over by showing them projections (based on beta tests) of how revenue would increase as customers became able to manage their own wait times.

THE IDEA IN BRIEF

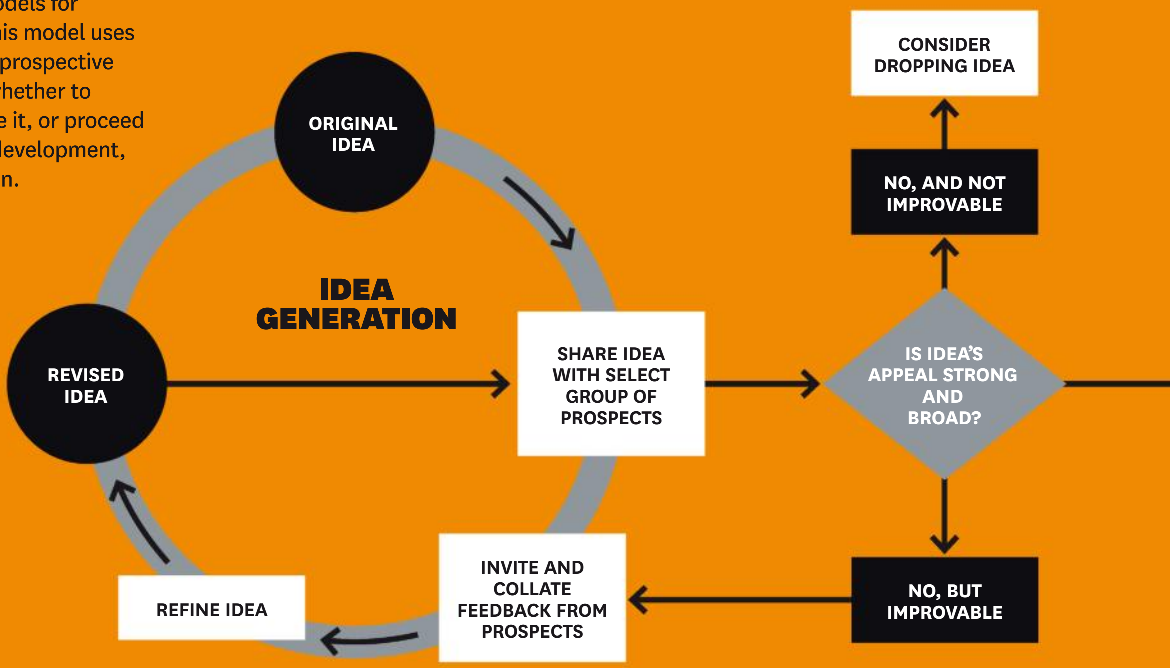
In interviews with 120 company founders from six countries, the authors learned that most founders thought they had waited too long to start selling their products.

More than half didn't begin contacting customers until they had a fully developed offering. This traditional approach misses the opportunity to obtain valuable early feedback from prospective customers during the product design phase—a key tenet of the lean start-up methodology.

This article describes other common mistakes in entrepreneurial selling, reports on the unique objections company founders hear from potential customers (and suggests ways to counter them), and outlines an entrepreneurial sales model that utilizes early customer feedback to improve product design.

An Entrepreneur-Friendly Sales Model

Unlike traditional sales models for established companies, this model uses information gleaned from prospective customers to determine whether to abandon the idea, improve it, or proceed with prototyping, product development, and further lead generation.



FURTHER READING

ARTICLES

Why Entrepreneurs Don't Scale
by John Hamm
HBR, December 2002
Product no. R0212J
Hamm, a leadership coach, identifies four management tendencies that work for small-company or business-unit leaders but become limitations when those individuals try to run larger organizations: loyalty to comrades, attention to detail, single-mindedness, and working in isolation.

Cisco's CEO on Staying Ahead of Technology Shifts
by John Chambers
HBR, May 2015
Product no. R1505A
In the past two decades, the kinds of technology companies use—and the ways they're used—have changed numerous times. Chambers shares how anticipating those transitions and getting ahead of them has driven Cisco's evolution.

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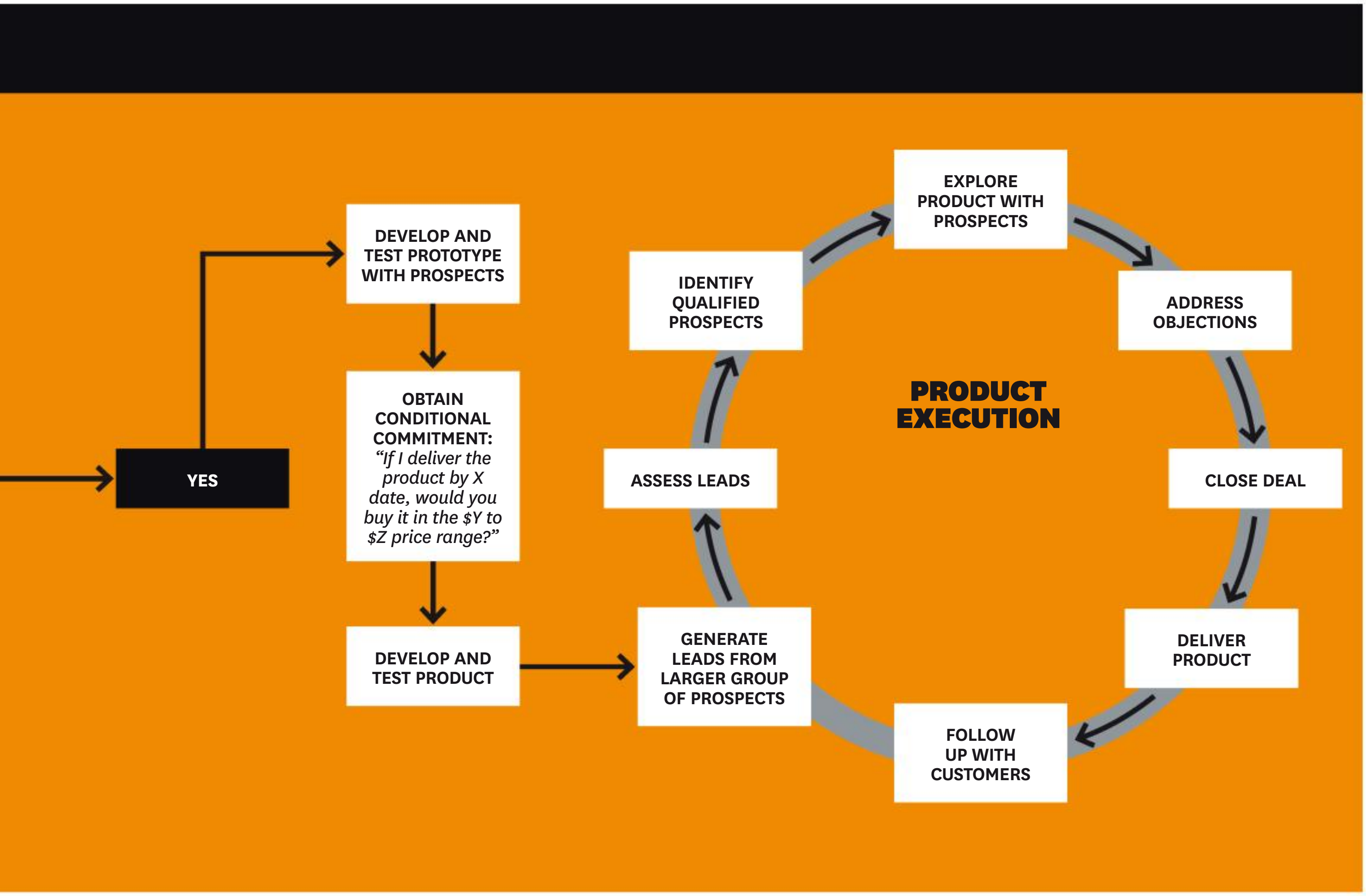
A Sales Framework for Start-Ups

Existing frameworks for selling are focused on established companies. They almost always assume that the salesperson has a fully developed product, and they have a simple goal: to make a sale. While these models advise reps to listen to prospects in order to anticipate objections or gain insight into the organizational dynamics that drive decision making, they generally do not account for the fact that information gleaned during the sales process can be crucial in designing (or redesigning) the product itself.

On the basis of our interviews with company founders, we have constructed an alternative model that's far more suitable for start-ups (see the exhibit "An Entrepreneur-Friendly Sales Model"). It calls for engagement with prospects as soon as an idea is conceived—and long before the product is actually created. The goal of these meetings is to obtain market intelligence not only about product design but also about promotion, distribution, and pricing strategies. After a round



of these meetings, an entrepreneur should ask if the idea really has strong and broad appeal. The answer to that question should determine whether the entrepreneur jettisons the idea, returns to the drawing board, or proceeds to develop a prototype, obtain conditional commitments from prospects, generate more leads, and engage in other traditional sales activities.

Research has shown that it's easier to get people to commit to an idea if they are involved in its creation. By engaging with prospects early, founders can not only gather feedback to improve product design but also increase prospects' involvement in the process, thus raising the odds that they'll purchase the offering.

This model may also ease the challenges entrepreneurs face in getting appointments with prospects. If founders present the appointments as occasions to discuss products that don't yet exist—not as sales calls—prospects may be more open to them. In general, people are more willing to give advice than to listen to a sales pitch. Entrepreneurs can use that dynamic to their advantage.

START-UPS FACE MANY challenges, and entrepreneurs must wear many hats during the process of launching a company. It's no surprise that they often postpone selling (or otherwise engaging with customers) until they've already created and begun producing their offerings. Our research demonstrates, however, that early customer feedback is essential and that founders who fail to consult with customers soon after the lightbulb moment will ultimately come to regret it.

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ENTREPRENEURSHIP

The Global Entrepreneur

A new breed of entrepreneur is thinking across borders—from day one.

by Daniel J. Isenberg

FOR A CENTURY and more, companies have ventured abroad only after establishing themselves at home. Moreover, when they have looked overseas, they haven't ventured too far afield, initially. Consumer health care company Johnson & Johnson set up its first foreign subsidiary in Montreal in 1919—33 years after its founding in 1886. Sony, established in 1946, took 11 years to export its first product to the United States, the TR-63 transistor radio. The Gap, founded in 1969—the year Neil Armstrong walked on the moon—opened its first overseas store in London in 1987, a year after the *Challenger* space shuttle disaster.

Companies are being born global today, by contrast. Entrepreneurs don't automatically buy raw materials from nearby suppliers or set up factories close to their headquarters. They hunt for the planet's best manufacturing locations because political and economic barriers have fallen and vast quantities of information are at their fingertips. They also scout for talent across the globe, tap investors wherever they may be located, and learn to manage operations from a distance—the moment they go into business.

Originally published in December 2008

Take Bento Koike, who set up Tecsis to manufacture wind turbine blades in 1995. The company imports raw materials from North America and Europe, and its customers are located on those two continents. Yet Koike created his globe-girding start-up near São Paulo in his native Brazil because a sophisticated aerospace industry had emerged there, which enabled him to develop innovative blade designs and manufacturing know-how. Tecsis has become one of the world's market leaders, having installed 12,000 blades in 10 countries in the past decade and racked up revenues of $350 million in 2007.

Standing conventional theory on its head, start-ups now do business in many countries before dominating their home markets. In late 2001, Ron Zwanziger, David Scott, and Jerry McAleer teamed up to launch their third medical diagnostics business, even though Zwanziger lives in the United States and Scott and McAleer live in England. They started Inverness Medical Innovations by retaining the pieces of their company that Johnson & Johnson didn't acquire and immediately gained a presence in Belgium, Germany, Ireland, Israel, the United Kingdom, and the United States. The troika didn't skip a beat. In seven years, they wanted to grow the new venture into an enterprise valued at $7 billion and believed that being born global was the way to do it. They're getting there: Inverness Medical's assets were valued at $5 billion as of August 2008.

Today's entrepreneurs cross borders for two reasons. One is defensive: To be competitive, many ventures, like Tecsis and Inverness Medical, have to globalize some aspects of their business—manufacturing, service delivery, capital sourcing, or talent acquisition, for instance—the moment they start up. That may sound obvious today, but until a few years ago, it was standard practice for U.S. venture capitalists, in particular, to require that the companies they invested in focus on domestic markets.

How Diaspora Networks Help Start-Ups Go Global

Many entrepreneurs have taken advantage of ethnic networks to formulate and execute a global strategy. The culture, values, and social norms members hold in common forge understanding and trust, making it easier to establish and enforce contracts.

Through diaspora networks, global entrepreneurs can quickly gain access to information, funding, talent, technology—and, of course, contacts. In the late 1990s, for instance, Boston-based Desh Deshpande, who had set up several high-tech ventures in the United States, was keen to start something in his native India. In April 2000, he met an optical communications expert, Kumar Sivarajan, who had worked at IBM's Watson Research Center before returning to India to take up a teaching position at the Indian Institute of Science in Bangalore. Deshpande introduced Sivarajan to two other Indians, Sanjay Nayak and Arnob Roy, who had both worked in the Indian subsidiaries of American high-tech companies. The trust among the four enabled the creation of the start-up Tejas Networks in two months' time. Deshpande and Sycamore Networks, the major investors, wired the initial capital of $5 million, attaching few of the usual conditions to the investment. Tejas Networks has become a leading telecommunications equipment manufacturer, generating revenues of around $100 million over the past year.

The research that my Harvard Business School colleague William Kerr and I have done suggests that entrepreneurs who most successfully exploit diaspora networks take these four steps:

Map networks. The members of a diaspora often cluster in residential areas, public organizations, or industries. For instance, in Tokyo, Americans tend to work for professional service firms such as Morgan Stanley and McKinsey, live in Azabu, shop in Omotesandō, and hang out at the American Club.

Identify organizations that can help. Many countries have offices overseas that facilitate trade and investment, and they open their doors to people visiting from home. These organizations can provide the names of influential individuals, companies, and informal organizations, clubs, or groups.

Tap informal groups. Informal organizations of ethnic entrepreneurs and executives are usually located in communities where immigrant professionals are concentrated. In the United States, for instance, they thrive in high-tech industry neighborhoods such as Silicon Valley or universities like MIT.

Identify the influentials. It can be tough to identify people who have standing with local businesses and also within the diaspora network. A board member or coach that both respect is an invaluable resource for a would-be entrepreneur.

The other reason is to take the offense. Many new ventures are discovering that a new business opportunity spans more than one country or that they can use distance to create new products or services. Take RacingThePlanet, which Mary Gadams founded in 2002 to stage marathons, each 250 kilometers long and lasting seven days, in the world's most hostile environments. Her team works out of a small Hong Kong office, but the company operates in the Gobi Desert in Mongolia, the Atacama Desert in Chile, the Sahara Desert in Egypt, and Antarctica. Distance has generated the opportunity: If the deserts were accessible, participants and audiences would find the races less attractive, and the brand would be diluted. RacingThePlanet isn't just about running; it's also about creating a global lifestyle brand, which Gadams uses to sell backpacks, emergency supplies, clothing, and other merchandise, as well as to generate content for the multimedia division, which sells video for websites and GPS mapping systems. The company may be just six years old, but brand awareness is high, and RacingThePlanet is already profitable.

In this article, I'll describe the challenges start-ups face when they are born global and the skills entrepreneurs need to tackle them.

Key Challenges

Global entrepreneurs, my research shows, face three distinct challenges.

Distance. New ventures usually lack the infrastructure to cope with dispersed operations and faraway markets. Moreover, physical distances create time differences, which can be remarkably tough to navigate. Even dealing with various countries' workweeks takes a toll on a start-up's limited staff: In North America, Europe, China, and India, corporate offices generally operate Monday through Friday. In Israel, they're open Sunday through Thursday. In Saudi Arabia and the UAE, the workweek runs Saturday through Wednesday, but in other predominantly Muslim countries like Lebanon, Morocco, and Turkey, people work from Monday through Friday or Saturday.

A greater challenge for global entrepreneurs is bridging what the British economist Wilfred Beckerman called in 1956 "psychic distance." This arises from such factors as culture, language, education systems, political systems, religion, and economic development levels. It can heighten—or reduce—psychological barriers between regions and often prompt entrepreneurs to make counterintuitive choices. Take the case of Encantos de Puerto Rico, set up in 1998 to manufacture and market premium Puerto Rican coffee. When founder-CEO Angel Santiago sought new markets in 2002, he didn't enter the nearby U.S. market but chose Spain instead. That's because, he felt, Puerto Ricans and Spaniards have similar tastes in coffee and because of the ease of doing business in Spanish, which reduced the psychic distance between the two countries. When two years later, Encantos de Puerto Rico did enter the United States, it focused initially on Miami, which has a large Hispanic population.

Context. Nations' political, regulatory, judicial, tax, environmental, and labor systems vary. The choices entrepreneurs make about, say, where to locate their companies' headquarters will affect shareholder returns and also their ability to raise capital. When the husband-and-wife team of Andrew Prihodko, a Ukrainian studying at MIT, and Sharon Peyer, a Swiss-American citizen studying at Harvard, set up an online photo management company, they thought hard about where to domicile Pixamo. Should they incorporate it in Ukraine, which has a simple and low tax structure but a problematic legal history? Or Switzerland, where taxes are higher but the legal system is well established? Or Delaware, where taxes are higher still but most U.S. start-ups are domiciled? Prihodko and Peyer eventually chose to base the company in the relatively tax-friendly Swiss canton of Zug, a decision that helped shareholders when they sold Pixamo to NameMedia in 2007.

Some global entrepreneurs must deal with several countries simultaneously, which is complex. In 1994, Gary Mueller launched Internet Securities to provide investors with data on emerging markets. Three years later, the start-up had offices in 18 countries and had to cope with the jurisdictions of Brazil, China, and Russia on any given day. By learning to do so, Internet Securities became a market leader, and in 1999, Euromoney acquired 80% of the company's equity for the tidy sum of $43 million.

Customers expect start-ups to possess the skills and deliver the levels of quality that larger companies do.

Resources. Customers expect start-ups to possess the skills and deliver the levels of quality that larger companies do. That's a tall order for resource-stretched new ventures. Still, they have no option but to do whatever it takes to retain customers. In 1987, Jim Sharpe acquired a small business, XTech, now a manufacturer of faceplates for telecommunications equipment. Initially, the company made its products in the United States and sold them overseas through sales representatives and distributors. However, by 2006, Cisco, Lucent, Intel, IBM, and other XTech customers had shifted most of their manufacturing to China. They became reluctant to do business with suppliers that didn't make products or have customer service operations in China. So Sharpe had no choice but to set up a subsidiary in China at that stage.

ARTICLE
AT A GLANCE

THE IDEA IN BRIEF

- More and more start-ups are being born global.
- By tapping resources or serving customers across nations, entrepreneurs can take on larger rivals, chase global opportunities, and use distance to create new products or services.
- Distances, differences in cultural contexts, and paucity of resources are the main challenges new ventures face.
- Successful entrepreneurs are clear in their purpose, strike alliances from positions of weakness, are able to manage global supply chains, and can establish multinational organizations from the outset.

Competencies Global Entrepreneurs Need

All entrepreneurs must be able to identify opportunities, gather resources, and strike deals. They all must also possess soft skills like vision, leadership, and passion. To win globally, though, they must hone four additional competencies.

Articulating a global purpose. Developing a crystal clear rationale for being global is critical. In 1999, for example, Robert Wessman took control of a small pharmaceuticals maker in his native Iceland. Within weeks, he concluded that the generics player had to globalize its core functions—manufacturing, R&D, and marketing—to gain economies of scale, develop a large product portfolio, and be first to market with drugs as they came off patent. Since then, Actavis has entered 40 countries, often by taking over local companies. Wessman faced numerous hurdles, but he stuck to the strategy. Actavis now makes 650 products and has 350 more in the pipeline. In 2007, it generated revenues of $2 billion and had become one of the world's top five generics manufacturers.

Alliance building. Start-ups can quickly attain global reach by striking partnerships with large companies headquartered in other countries. However, most entrepreneurs have to enter into such deals from positions of weakness. An established company has managers who can conduct due diligence, the money to fly teams over for meetings, and the power to extract favorable terms from would-be partners. It has a reasonable period within which to negotiate a deal, and it has options in case talks with one company fail. A start-up has few of those resources or bargaining chips.

Start-ups also have problems communicating with global partners because their alliances have to span geographic and psychic distances. Take the case of Trolltech, an open-source software company founded in 1994 in Oslo by Eirik Chambe-Eng and Haavard Nord. In 2001, the start-up landed a contract to supply a Japanese manufacturer with a Linux-based software platform for personal digital assistants (PDAs). The dream order quickly turned into a nightmare. There were differences between what the Japanese company thought it would get and what the Norwegian supplier felt it should provide, and the start-up struggled to deliver the modifications its partner began to demand. Suspecting that Trolltech wouldn't deliver the software on time, the Japanese company offered to send over a team of software engineers. However, when it suggested that both companies work through the Christmas break to meet a deadline—a common practice in Japan—Trolltech refused, citing the importance of the Christmas vacation in Norway. The relationship almost collapsed, but Chambe-Eng and Nord managed to negotiate a new deadline that they could meet without having to work during the holiday season.

Supply-chain creation. Entrepreneurs must often choose suppliers on the other side of the world and monitor them without having managers nearby. Besides, the best manufacturing locations change as labor and fuel costs rise and as quality problems show up, as they did in China.

Even start-ups can thrive by using distance to gain competitive advantage.

Start-ups find it daunting to manage complex supply networks, but they gain competitive advantage by doing so. Sometimes the global supply chain lies at the heart of the business opportunity. Take the case of Winery Exchange, cofounded by Peter Byck in 1999. The California-based venture manages a 22-country network of wineries and breweries. Winery Exchange works closely with retail chains, such as Kroger, Tesco, and Costco, to develop premium private-label products, and it gets its suppliers to produce and package the wines as inexpensively as possible. The venture has succeeded because it links relatively small market-needy suppliers with mammoth product-hungry retailers and provides both with its product development expertise. In 2006, Winery Exchange sold 2 million cases of 330 different brands of wine, beer, and spirits to retailers on four continents.

In addition to raw materials and components, start-ups are increasingly buying intellectual property from across the world. Hands-On Mobile, started by David Kranzler, is a Silicon Valley–based developer of the mobile versions of Guitar Hero III, Iron Man, and other games. When the company started in 2001, the

How Social Entrepreneurs Think Global

Atsumasa Tochisako is an unlikely entrepreneur. When he was in his mid-fifties, he left a senior position at the Bank of Tokyo-Mitsubishi to set up Microfinance International, a global for-profit social enterprise (FOPSE, for short), based in Washington, D.C. Having also been stationed in Latin America for many years, Tochisako had observed the large cash remittances coming from immigrants in the United States, as well as the exorbitant charges they paid commercial banks and the poor service they received. Sensing a business opportunity and the chance to do some good, he decided to provide immigrant workers with inexpensive remittance, check-cashing, insurance, and microlending services.

MFI was international from its birth in June 2003, with operations in the United States and El Salvador. Since then, it has expanded into a dozen Latin American countries and further extended its reach by allowing multinational financial institutions, such as the UAE Exchange, to use its proprietary Internet-based settlement platform.

Like Tochisako, many entrepreneurs today combine social values, profit motive, and a global focus. Social entrepreneurs are global from birth for three reasons. First, disease, malnutrition, poverty, illiteracy, and other social problems exist on a large scale in many developing countries. Second, the resources—funds, institutions, and governance systems—to tackle those issues are mainly in the developed world. Third, FOPSEs that tackle specific conditions can often be adapted to other countries. For instance, in 2002, Shane Immelman founded The Lapdesk Company to provide portable desks to South African schoolchildren, a third of whom are taught in schoolrooms that don't have adequate surfaces on which to write. The company asks large corporations in South Africa to donate desks—with some advertising on them—for entire school districts. By doing so, these companies are able to meet the South African government's requirement that they invest part of their profits in black empowerment programs. Since then, Immelman has adapted the business model to Kenya, Nigeria, and the Democratic Republic of Congo and has launched programs in India and Latin America.

There are no easy answers to the challenges of managing a start-up in the topsy-turvy world of global entrepreneurship. In some cases, there are contingencies that no textbook provides answers for.

markets for mobile multimedia content were developing faster in Asia and Europe than in the United States, and gamers were creating attractive products in China, South Korea, and Japan. Kranzler realized that his company had to acquire intellectual property and design capacity overseas in order to offer customers a comprehensive catalog of games and the latest delivery technologies. Hands-On Mobile therefore picked up MobileGame Korea, as well as two Chinese content development companies, which has helped it become a market leader.

Multinational organization. In 2006, I conducted a simulation exercise called the Virtual Entrepreneurial Team Exercise (VETE) for 450 MBA students in 10 business schools in Argentina, Austria, Brazil, England, Hong Kong, Liechtenstein, the Netherlands, Japan, and the United States. The teams, each composed of students from different schools and different countries, developed hypothetical pitches for Asia Renal Care, a Hong Kong–based medical services start-up, that had raised its first round of capital in 1999. They experienced a slice of global entrepreneurial life in real time, using technologies like Skype, wikis, virtual chat rooms, and, of course, e-mail to communicate with one another. The students learned how to build trust, compensate for the lack of visual cues, respect cultural differences, and deal with different institutional frameworks and incentives—the competencies entrepreneurs need for coordination, control, and communication in global enterprises. The would-be entrepreneurs' emotions ranged from elation to frustration, and their output varied from good to excellent.

Start-ups cope with the challenges of managing a global organization in different ways. Internet Securities used a knowledge database to share information among its offices around the world, increasing managers' ability to recognize and solve problems. RacingThePlanet used intensive training to ensure that volunteers perform at a consistently high level during the events it holds. Trolltech worked round the clock to meet deadlines, passing off development tasks from teams in Norway to those in Australia as the day ends in one place and begins in the other. Inverness Medical hired key executives wherever it could and organized the company around them rather than move people all over the world.

Still, there are no easy answers to the challenges of managing a start-up in the topsy-turvy world of global entrepreneurship. Take the case of Mei Zhang, who founded WildChina, a high-end adventure-tourism company in China, in 2000. Three years later, Zhang hired an American expatriate, Jim Stent, who had a deep interest in Chinese history and culture, as her COO. Zhang moved to Los Angeles in 2004, anointing Stent as CEO in Beijing and appointing herself chairperson. Thus, a Chinese expatriate living in the United States had to supervise an American expatriate living in Beijing. And when the two amicably parted ways in 2006, Zhang started managing the Chinese company from Los Angeles. These are contingencies no textbook provides for.

ENTREPRENEURS SHOULDN'T FEAR the fact that the world isn't flat. Being global may not be a pursuit for the fainthearted, but even start-ups can thrive by using distance to gain competitive advantage.

Daniel J. Isenberg is a professor of entrepreneurship practice at Babson Executive Education in Boston, an adjunct professor at Columbia Business School, and an associate of the Harvard Kennedy School Growth Lab. He is the author of *Worthless, Impossible, and Stupid: How Contrarian Entrepreneurs Create and Capture Extraordinary Value* (Harvard Business Review Press, 2013).

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ENTREPRENEURSHIP

Blitzscaling

The Chaotic, Sometimes Grueling Path To High-Growth, High-Impact Entrepreneurship

Interview by Tim Sullivan

REID HOFFMAN is one of Silicon Valley's grown-ups. After helping to found PayPal, he moved on to found LinkedIn, in 2002, which has turned him into a billionaire. He was an early investor in Facebook and now serves as a partner at the venture capital firm Greylock. He's written two books, *The Start-Up of You* (with Ben Casnocha) and *The Alliance: Managing Talent in the Networked Age* (with Casnocha and Chris Yeh).

In the fall of 2015, Hoffman began teaching a computer science class called Technology-Enabled Blitzscaling at Stanford University, his alma mater, with John Lilly (a partner at Greylock and formerly the CEO of Mozilla), Allen Blue (cofounder of LinkedIn), and Chris Yeh (cofounder of Allied Talent). In this edited interview with Tim Sullivan, the editorial director of HBR Press, Hoffman talks about the challenges, risks, and payoffs of blitzscaling.

Originally published in April 2016

Marc Olivier LeBlanc

HBR: Let's start with the basics. What is blitzscaling?
Hoffman: Blitzscaling is what you do when you need to grow really, really quickly. It's the science and art of rapidly building out a company to serve a large and usually global market, with the goal of becoming the first mover at scale.

This is high-impact entrepreneurship. These kinds of companies always create a lot of the jobs and industries of the future. For example, Amazon essentially invented e-commerce. Today, it has over 150,000 employees and has created countless jobs at Amazon sellers and partners. Google revolutionized how we find information—it has over 60,000 employees and has created many more jobs at its AdWords and AdSense partners.

Why this focus on fast growth? We're in a networked age. And I don't mean only the internet. Globalization is a form of network. It adds networks of transport, commerce, payment, and information flows around the world. In such an environment, you have to move faster, because competition from anywhere on the globe may beat you to scale.

Software has a natural affinity with blitzscaling, because the marginal costs of serving any size market are virtually zero. The more that software becomes integral to all industries, the faster things will move. Throw in AI machine learning, and the loops get even faster. So we're going to see more blitzscaling. Not just a little more, but a lot more.

How did you settle on the term "blitzscaling"? It has some interesting associations. I have obvious hesitations about the World War II association with the term "blitzkrieg." However, the intellectual parallels are so close that it is very informative. Before blitzkrieg emerged as a military tactic, armies didn't advance beyond their supply lines, which limited their speed. The theory of the blitzkrieg was that if you carried only what you absolutely needed, you could move very, very fast, surprise your enemies, and win. Once you got halfway to your destination, you had to decide whether to turn back or to abandon the lines and go on. Once you made the decision to move forward, you were all in. You won big or lost big.

Blitzscaling adopts a similar perspective. If a start-up determines that it needs to move very fast, it will take on far more risk than a company going through the normal, rational process of scaling up.

This kind of speed is necessary for offensive and defensive reasons. Offensively, your business may require a certain scale to be valuable. LinkedIn wasn't valuable until millions of people joined our network. Marketplaces like eBay must have both buyers and sellers at scale. Payment businesses like PayPal and e-commerce businesses like Amazon have low margins, so they require very high volumes. Defensively, you want to scale faster than your competitors because the first to reach customers may own them, and the advantages of scale may lead you to a winner-takes-most position. And in a global environment, you may not necessarily be aware of who your competition really is.

Are there several dimensions to the idea of scale? There are three kinds of scale. People naturally focus on two of them: growing your revenues and growing your customer base. And of course, if you don't get those right, then nothing else matters. But very few businesses can succeed on those fronts without also scaling the organization. An organization's size and its ability to execute determine whether it can capture customers and revenue.

We see scale as a series of stages, based on orders of magnitude: A family-scale business can measure its employees in single digits; a tribe in tens; a village in hundreds; a city in thousands. A nation has more than 10,000 employees. These are estimates, not precise guides; a company often remains a family until around 15 employees, a tribe until around 150, and so on.

At each level, the way you run various functions—financing the company, hiring and onboarding employees, marketing the product, and so on—changes significantly. There aren't rules governing this when you're blitzscaling; you use heuristics instead—and by that I mean guidelines that help you make decisions and learn on the fly.

Blitzscaling is what you do when you need to grow really, really quickly.

Organizational scale is more about the character of the company than it is an exact employee head count—things don't change drastically at exactly 150 employees. And you're not necessarily scaling each element of the firm at the same time or rate. You're more likely to focus first on customer service and sales than other functions. But even then, you'll have to blitzscale the other parts of the organization. So all along you really do need to be thinking about the company as a whole: How will you allocate your talent, and then how will you grow it? How will you hold on to your culture? How will you communicate? How will your competitive landscape shift?

When does a start-up begin to blitzscale? At the family scale, you're usually raising money and figuring out exactly what your product or service is. You most likely have not launched a product yet.

At the tribe scale, you're just starting to have a real company. It's fairly rare—not unheard of, but rare—for blitzscaling to start at this phase unless you have a runaway hit of a product: PayPal or Instagram, for example. More typically, you've launched some version of the product or service, and you've homed in on your target market. But you're still not certain that the start-up can really scale massively. There's always some level of risk. You may decide not to scale at this stage, because you're not sure you have a product-market fit yet. Or you may decide to move ahead anyway, because you know you absolutely need to, for the offensive and defensive reasons we just talked about.

So the blitzscale process usually starts between the tribe and village scale. By then you've ironed out the product-market fit, you have some data, and you know what the competitive landscape looks like.

This is when the logic of blitzscaling becomes very clear. Once you begin to prove—to yourself and others—that there's an interesting category and a big market opportunity, you attract all kinds of competition. At the low end, other start-ups may be launching their own version of your product or service and trying to achieve scale in the market before you. At the high end, established brands are figuring out how to leverage their own assets to own part or all of your space.

A start-up has two advantages as a first mover going through blitzscale: focus and speed. Established brands tend not to be as fast or as focused. And competing start-ups probably don't have momentum yet (although they may be just as fast and focused).

The canonical example is Groupon, which made it to this middle stage and got hit by massive competition on both the high and the low ends. It wasn't able to both scale fast and build a durable product and thus failed to fully realize a potentially industry-transforming opportunity.

What organizational issues do you run into when blitzscaling? Blitzscaling is always managerially inefficient—and it burns through a lot of capital quickly. But you have to be willing to take on these inefficiencies in order to scale up. That's the opposite of what large organizations optimize for.

In hiring, for instance, you may need to get as many warm bodies through the door as possible, as quickly as you can—while hiring quality employees and maintaining the company culture. How do you do that? Different companies use different hacks. As part of blitzscaling at Uber, managers would ask a newly hired engineer, "Who are the three best engineers you've worked with in your previous job?" And then they'd send those engineers offer letters. No interview. No reference checking. Just an offer letter. They've had to scale their engineering fast, and that's a key technique that they've deployed.

We faced this issue at PayPal. In early 2000, payment transaction volume was growing at a compounding rate of 2% to 5% per day. That kind of growth put PayPal in a deep hole as far as customer service was concerned. Even though the only place we listed our contact information was in the Palo Alto phone directory, angry customers were tracking down our main number and dialing extensions at random. Twenty-four hours a day, you could pick up literally any phone and talk to an angry customer. So we turned off all our ringers and used our cell phones. But that wasn't a solution. We knew we needed to build a customer service capacity—fast.

But that's very difficult to do in Silicon Valley. So we decided to scale up in Omaha. This was during the first dot-com boom, so we convinced the governor of Nebraska that he wanted a piece of the internet revolution. He and the mayor held press conferences about how PayPal was going to open a customer service office, prompting a flood of job applicants. For four weekends straight, we flew out about 20% of the company to interview them. People showed up with their résumés, and we'd put them in a room and do group interviews. Within six weeks, we had 100 active customer-service people fielding e-mails.

It's now a classic technique for internet companies to offer e-mail and web-based customer service only. But we had to figure out how to hack our customer service challenge at a very fast pace. There was no playbook to tell us what to do. There still isn't.

If there are no rules, how do you come up with your approach? Sometimes freedom from normal rules is what gives you competitive advantage. For example, if we had understood how pernicious credit card fraud and chargebacks were in the early days at PayPal, I'm not sure we

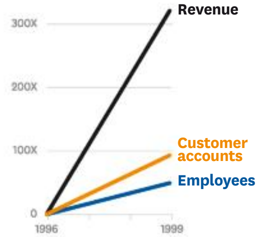
BY THE NUMBERS

AMAZON

EMPLOYEES
1996: **151**
1999: **7,600**

REVENUE
1996: **$5.1 MILLION**
1999: $**1.64 BILLION**

CUSTOMER ACCOUNTS
1996: **180,000**
1999: **16.9 MILLION**



CHANGE OVER TIME

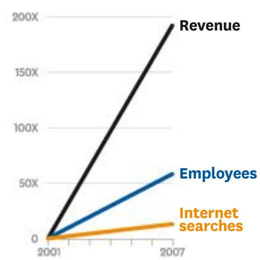
BY THE NUMBERS

GOOGLE

EMPLOYEES
2001: **284**
2007: **16,805**

REVENUE
2001: **$86 MILLION**
2007: **$16.6 BILLION**

SEARCHES PER YEAR
2001: **27 BILLION**
2007: **372 BILLION**



CHANGE OVER TIME

would have believed that such a service could be successful. We didn't realize how staggering the losses could be.

All the banking people knew the rules—you had to protect against fraud first. That prevented them from trying anything that looked remotely like PayPal. Our ignorance allowed us to build something fast, but then of course we had to fix it on the run, because we were already in the minefield.

Most critics thought we were losing so much money in 2000 because of our customer acquisition bonuses. But that wasn't the case. The industry's average customer-acquisition cost through advertising was around $40. So when we gave customers who recommended a friend 10 bucks and gave the new customer 10 bucks, we were cutting costs in half.

Why depend on heuristics rather than rules? Because you're looking for an edge that distinguishes you from other competitors, who are following conventional wisdom. That's not to say that there aren't rules. Don't allow anyone to embezzle your money. That's a rule. But it doesn't give anyone a competitive edge.

It sounds as if your choice of heuristics can lead to radically different organizational outcomes. Yes. One of the differentiators between Google and Microsoft, two blitzscaling companies, was that Google wanted to stay very flat, whereas Microsoft built up a lot of hierarchy.

You had to have eight direct reports at Google to be a manager, but there was no upper limit. People had 10, 15, 20, even 100 direct reports to minimize middle management. It would likely have been more managerially efficient to give someone no more than eight people. However, Google chose a flat organization that sacrificed that kind of efficiency to achieve an extreme focus on technology development. Microsoft, on the other hand, followed a more classical and hierarchical approach.

All the banking people knew the rules. That prevented them from trying anything that looked remotely like PayPal.

That reminds me of Google's decision to hire only people with very high GPAs from elite universities. As a heuristic, there's obviously collateral damage—there are many smart people you're not allowed to hire—but it makes sense if your goal is to hire a large number of smart generalists quickly. That created a lot of frustration. "I can't hire my friend who doesn't have that qualification, but I know that he's really good."

And the company says, "Yeah, sorry. That's the way we execute as we blitzscale. We need a simple heuristic so that we can focus on what really matters." Another benefit of Google's decision to hire only from elite universities is that it helped create and maintain a coherent culture as the company scaled.

Why is culture so important to blitzscaling? Because you're growing an organization very fast, you have to make people accountable to each other on a horizontal or peer-to-peer basis, and not just vertically and top-down through the hierarchy.

What other heuristics are important as you go from, say, village to city? Specialization at all levels becomes more important. You need to understand how to run a large-scale engineering department, for example, and how to deploy a significant amount of capital in marketing. You need dashboards and analytics and metrics for those functions as much as you need them to help you understand customers and the marketplace.

You also need to have much higher reliability; sometimes the inefficiency that you accepted as you blitzscaled through the village stage is no longer tenable at a larger scale. You have to hire people who know how to make sure that your site is never down. And you have to be more careful in your release of engineering product. As a result, you have less adaptability. For example, Facebook famously shifted from a mantra of "Move fast and break things" to "Move fast with stable infrastructure."

You also move from a single-threaded organization to a multi-threaded one, allowing the company to focus on more than one thing at a time. When you're in a tribe, everybody is attuned to one priority. In a village, you're likely to start focusing on the thing that you're going to scale. You're also beginning to think about side experiments—for example, building developer tools, or experimenting with marketing or other paid acquisition. And you're likely adding new functions, like corporate development to consider acquisitions.

All of this rolls up to your macro goal of succeeding as a company, but as you move from village to city, functions are beginning to be differentiated; you're really multi-threading.

Companies at the city scale usually have more than one main product. They may have one central revenue stream, such as Google's AdWords or Microsoft Office, but several different products. They've built an architecture that determines how the products relate to each other. And each product can be multi-threaded as well.

Most Silicon Valley firms go global as they move from village to city, but some are global from Day One. At LinkedIn, we launched with 15 countries on our drop-down list. By the second day, we were getting e-mails from people whose countries were not on the list. It was an interesting geographic lesson for me, because I wasn't aware that the Faroe Islands was a country until we got a complaint. So I went and read a little history and said, OK, add it to the list. It's real.

Do different pockets of the company use different playbooks? Yes. For example, Google developed two device operating systems simultaneously: Android and Chrome. When Google acquired Andy Rubin and his start-up, Android Inc., Andy was set up as an entrepreneur within Google, focused on this experiment, and accountable to Larry Page. From Google's corporate resources perspective, it was a matter of asking Andy what he needed to make the project work.

Andy wanted Android to stay cohesive and focused. So for example, only Android employees' badges would grant access to the Android office; general Google employees couldn't get in. The Android team didn't run its software through Google's standard code review process. Andy also wanted to be able to cut different deals with mobile operators—whatever it took to get his project off the ground—without a cross-check.

In a completely different initiative, Chrome was developed in C++ (Android was developed in Java) and focused on laptops and browsers, rather than phones. Google could have handled that differently, by bundling Android and Chrome into one project, coherently attacking the device OS opportunity. But it chose instead to multi-thread, hiring the best person for the project, giving him the tools to get the job done, and letting him run a completely separate project and develop his own playbook.

One of the questions I've heard you ask is, What can you ignore? And maybe the flip side of that is, At each stage, what first-order problems are you solving? One of the metaphors that I use for

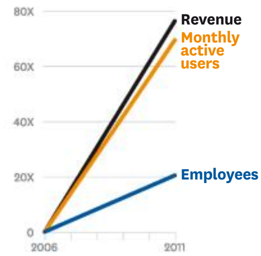
BY THE NUMBERS

FACEBOOK

EMPLOYEES
2006: **150**
2011: **3,200**

REVENUE
2006: **$48 MILLION**
2011: **$3.7 BILLION**

ACTIVE USERS
(MONTHLY)
2006: **12 MILLION**
2011: **845 MILLION**



CHANGE OVER TIME

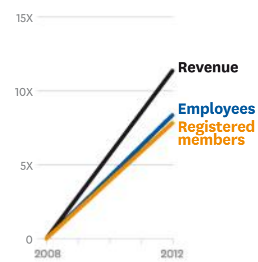
BY THE NUMBERS

LINKEDIN

EMPLOYEES
2008: **370**
2012: **3,458**

REVENUE
2008: **$79 MILLION**
2012: **$972 MILLION**

REGISTERED MEMBERS
2008: **17 MILLION**
2012: **150 MILLION**



CHANGE OVER TIME

LEVELS OF ORGANIZATIONAL SCALE
A GLOSSARY

	Number of Employees	User Scale	Revenue
FAMILY	<10	<100K	<$10M
TRIBE	10–100	100K–1M	$10M+
VILLAGE	100–1,000	1M–10M	$100M+
CITY	1,000–10,000	10M–100M	$1B+
NATION	>10,000	>100M	$5B+

start-ups is, You throw yourself off a cliff and assemble your airplane on the way down. If you don't solve the right problem at the right time, that's the end. Mortality puts priorities into sharp focus.

When you're blitzscaling, a whole bunch of things are inevitably broken, and you can't work on them all at once. You have to triage. You fix the things that will get investors to give you more cash. The lift that capital provides means you have a longer time in the air to get things right. You're unlikely to get your plane to fly on your first capital lift or even your second.

A general principle of management is that if you have team dynamics problems, you fix them right away. But in blitzscaling, you're adding those challenges all the time. And you're moving so fast that today's problems aren't going to be the same as tomorrow's. The operation is always patched together and kind of ugly and held together with duct tape. So maybe you ignore the team's dysfunction for a while.

For example, your engineers might be unhappy. You think, Should we build development tools to help them be more productive? Should we allocate a bunch of our engineers to make that happen? But you know that the size of the team will continue to change radically; any tools you create today are going to be obsolete. So you don't try to solve that problem yet, even though you know that ignoring it will breed organizational unhappiness and that people will be frustrated. In nonblitzscaling circumstances those kinds of issues might be a top priority, but when you're blitzscaling, sometimes you have to just let them burn.

Remember, even if you do solve the problem, it will most likely stay solved only for a short time.

Can you alleviate unhappiness by telling people why you're making certain decisions? Yes, but only to a limited extent. What really keeps it all together is the perception that you're moving at high speed because you're growing something big, and that you're going to be part of something successful.

Almost every blitzscaling org that I have seen up close has a lot of internal unhappiness. Fuzziness about roles and responsibilities, unhappiness about the lack of a clearly defined sandbox to operate in. "Oh my God, it's chaos, this place is a mess." The thing that keeps these companies together—whether it's PayPal, Google, eBay, Facebook, LinkedIn, or Twitter—is the sense of excitement about what's happening and the vision of a great future. Because I'm part of a team that's doing something big, I'll work through my local unhappiness. Sure, I'd like a tidier sandbox, I'd like to be more efficient, I'd like the organization to be run more smoothly. But I'm willing to let it go because the pain will be worth it.

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ARTICLES

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HBR, July–August 2013
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According to the authors, CEOs spend too little time on building the kind of learning organization and culture that growth requires. Read about six common mistakes that executives make in this arena.

Chobani's Founder on Growing a Start-Up Without Outside Investors
by Hamdi Ulukaya
HBR, October 2013
Product no. R1310A
Ulukaya relates how he went from making yogurt for himself at home to buying a run-down yogurt factory, financed by a loan from the Small Business Administration. Within three years of its creation, Chobani was a top-selling brand.

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MANAGING THE BUSINESS

Start-Ups That Last

How to scale your business

by Ranjay Gulati and Alicia DeSantola

W

WHY DO so many start-ups that seem to have it all—customers, cash, a promising outlook—run off the rails? Ask a venture capitalist, and you'll probably hear that they have trouble "scaling."

What does that mean, though? VCs typically describe it as a need to "professionalize the organization" and "bring in grown-ups." But those are simplistic fixes—poor substitutes for the substantive changes that need to occur. Start-ups these days grow so rapidly that it's difficult for them to correct course once they recognize missteps. They can improve their prospects by understanding the mechanics of effective scaling before they reach that moment of truth.

Venture capitalist Ben Horowitz compares scaling to a "black art." He and others have proposed useful ideas for demystifying it, but start-ups still lack a cogent framework for transitioning to mature firms. That's what this article provides. Drawing on our extensive case studies of fast-growing companies and on 75 years of organizational research, we have identified four critical activities for successfully scaling a venture. Firms must *hire functional experts* to take the enterprise to the next level, *add management structures* to accommodate increased head count while maintaining

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Margaret Neill

informal ties across the organization, *build planning and forecasting capabilities,* and *spell out and reinforce the cultural values* that will sustain the business.

It's easy to misconstrue these activities as replication—as merely increasing the capacity and efficiency of what you're already doing. But they're also about handling greater market and organizational complexity as you seek *different* avenues for growth. That can mean developing new products or services, entering new markets, or engaging in other forms of innovation.

Many entrepreneurs will resist these activities. They often develop strategies opportunistically, lacking a frame of reference because they are starting from scratch, and they take a similar ad hoc approach to building their organizations. Founders tend to view formal structures and processes—elements common to all four activities—as bureaucratic threats to their entrepreneurial souls. They also worry about losing speed, control, and team intimacy. When they eschew order and discipline, however, they pay a steep price: chaotic operations and unpredictable performance.

Scaling doesn't mean that ventures should disavow their start-up identities and embrace large-company dogma once they're poised for growth. But those prepared to manage that growth—and to learn new ways of operating and behaving—stand a much better chance of making it in the long term.

Defining Specialized Roles

Founders typically do a bit of everything—basically, whatever it takes to get the business off the ground. Through informal channels they hire fellow generalists, who cobble together *their* roles and responsibilities partly by pursuing their own passions and partly by looking around and seeing what needs to be done. This idiosyncratic "all hands on deck" approach can work fine in the beginning, when adrenaline is high and the company is small. But as organizations expand, they face new levels of complexity that require them to define and assign tasks more formally.

To accomplish this, they typically seek specialization in select functions, such as sales, human resources, marketing, R&D,

and manufacturing. This benefits them in two ways. First, the specialists use their knowledge to tackle their functions' work more efficiently. Second, as they introduce and implement best practices within their domains, they catalyze future growth by creating slack in the rest of the firm. People who no longer have to worry about marketing, for example, are free to explore other activities.

Of course, all this can create tension between the "old guard" generalists and the domain experts. Demands for functional expertise often outstrip early employees' abilities to keep up through organic learning. As a consequence, functional leadership titles increasingly go to outsiders, and the legacy folks may grow resentful. Early employees may also chafe against the narrowing confines of their changing roles. Not every generalist can or even wants to become a specialist. Often people get frustrated and leave, taking their valuable relationships and their tacit understanding of the firm's mission and culture with them.

To keep people working together constructively, it's important to anticipate and manage these growing pains. Let's look at how one start-up, Birchbox, did so.

Birchbox experienced explosive growth within just a few years of its founding, thanks to a business model crafted around consumers' discoveries of new beauty products. Each month subscribers received a box of samples customized according to their personal profiles. They could simply pay their fees and enjoy the samples; they could also go to the Birchbox website and buy larger quantities of the products they liked most. A dedicated team generated a steady stream of digital articles and video tutorials about beauty trends to further engage customers. This model attracted a million subscribers in the first four years, inspiring dozens of copycat start-ups to pitch their businesses as "the Birchbox for X."

To keep up with demand, Birchbox grew from eight employees in 2010 to more than 300 in April 2014, when it secured $60 million in series B funding. In the process, employees' roles and responsibilities shifted. Nicole Fealey, the director of people operations and performance, recalls the excitement of being a jack-of-all-trades during the first 18 months. "That's what I love about start-ups," she says. "You never get bored." But she realizes that she and other early employees lacked the knowledge and experience to handle everything on their own as the company grew—and that they would have burned out if they'd tried.

Consider the logistics of shipping a million boxes of unique samples each month—or the job of building sales relationships with enough partner organizations to continually fill those boxes with fresh, interesting products. To manage such complex work, Birchbox divided it into specialized functions and sought out domain experts to improve the effectiveness of each one. The new hires included a CTO with a computer science PhD from Carnegie Mellon and a vice president of brand campaigns who had been a principal at Booz & Company.

"When I walked in and looked objectively at certain monthly processes, I saw that they had been established in a hacked-together way," says Kate Price, who served as VP of brand campaigns for about three years before becoming VP of Canada. "My consultant mind immediately went to thinking that we should fix all those things, but I learned pretty quickly to respect the people who at the age of 24 had built a process that was part of the engine keeping the company running." Cofounder Katia Beauchamp agrees

> "We worked really hard to get people to believe that you can hire people better than you."
>
> —**KATIA BEAUCHAMP,** COFOUNDER, BIRCHBOX

about the importance of appreciating the old guard—a group the cofounders see as essential to Birchbox's "special sauce." She says, "I think we do a really good job of showing people how valuable their skill sets are and celebrating the fact that we wouldn't be here without their collective capabilities." That attitude has kept early employees feeling valued and engaged.

Even so, they have sometimes struggled to find their place in the growing organization. "It's scary for sure," Beauchamp acknowledges. "I don't think it's easy for me to this day; I don't think it's easy for anybody." Some people had to hire their own bosses to supervise activities they themselves had nurtured since the beginning, rewriting their own job descriptions accordingly. Matt Field, a former early employee who headed international operations during the big growth phase, saw that as an opportunity for personal development. "I knew I did not have the background or knowledge to take Birchbox to the level of aspiration we had," he says. "I hired someone who could teach me and empower me to get better at my job."

Cultivating a learning mindset among employees was key, as was reminding them of the challenges ahead and the ways in which experienced talent could help. Those things got Field and others focused on the greater good of the firm instead of worrying about their relevance and status in the new order. Beauchamp says that she and cofounder Hayley Barna "worked really hard to get people to believe that you can hire people better than you." Involving members of the old guard in the hiring process assured them they would still have a voice. The founders also talked with them about how the domain experts could mentor them and help them develop their niches in the growing firm.

As more outsiders have joined and settled into functional divisions, early employees have provided cohesion through their broad understanding of how the components of the business model fit together. They also serve as a cultural channel back to the time when Birchbox had no brand cachet—a time when it took great resourcefulness to grab the attention of prospective partners and customers.

"People joke that they could never have gotten their jobs now," Beauchamp remarks. "The old guard didn't come in with as much industry experience, but they are superskilled at 'Birchbox'—at our vision and practices."

Does specialization bring risks? Absolutely. Once functions have independent leaders, employees might hunker down in their silos and stop identifying with the organization as a whole. Tribal instincts can prevent cross-functional idea sharing and innovation, so firms must ensure that informal interactions continue across teams and divisions. When companies are in a high-growth phase, they often forgo relationship-building activities in favor of more-immediate work demands. But over time that can lead to stasis and unoriginality. Firms are better served in the long run by fostering cross-pollination while they organize to support the work that needs to be done. The answer is not to avoid building silos but to find ways of bridging them.

ARTICLE AT A GLANCE

THE IDEA IN BRIEF

THE DILEMMA
Founders often resist bringing discipline to their growing start-ups, for fear of losing agility and control. But then, ironically, operations become chaotic and performance suffers.

THE TACTICS
Manage growth for the long term by hiring functional experts, adding management structure, beefing up planning and forecasting, and continually reinforcing your organization's cultural values.

THE REWARDS
This approach to scaling won't just make your firm more efficient—though it will certainly do that. It will also help you find and exploit new opportunities.

Adding Management Structure

When launching their start-ups, many founders eschew hierarchy because of their egalitarian ideals. But as their firms scale, a growing number of people report to a handful of leaders. Founders may think this allows them to remain in command, because all decisions pass through them. But ironically, their organizations spin out of control as centralized authority becomes a bottleneck that hinders information flow, decision making, and execution. A couple of people at the top can't effectively supervise everyone's increasingly specialized day-to-day work; in such a system, accountability for organizational goals gets lost. And employees find it hard to remain focused and engaged when they don't have managerial guidance and processes. They may become frustrated as they struggle for access to decision makers who are juggling many other projects and people.

That happened early on at CloudFlare, a San Francisco–based start-up that was founded in 2009 and quickly became an important player in content delivery and security for small to medium-size websites. By July 2012 it was serving nearly 500,000 websites, with more than 2 billion daily page views (then about 1% of total internet page views). At that time it recounted some of its growing pains to Harvard Business School's

Tom Eisenmann and Alex Godden, who published a teaching case about it.

In the beginning CloudFlare's founders proudly—and vocally—proclaimed that they would build a completely flat organization, with no hierarchical titles or HR function. Like many start-up leaders, CEO Matthew Prince wanted to promote flexibility and individual achievement and believed they would be stifled by bureaucratic control. In creating a title-free organization, he also hoped to avoid future organizational chart conflicts, since the people initially heading up the small venture probably wouldn't be suited to lead a team of 250, and senior roles would inevitably change. "Either the original person gets demoted, in which case he or she will likely leave, or the new person doesn't get brought in," Prince said. "Neither is a great outcome."

Nevertheless, problems cropped up. In the three months ending in July 2012, five of the firm's 35 employees quit, some citing the lack of a clear midlevel reporting structure and the nonexistent HR practices. They described situations in which they had no one to turn to (short of pestering the founders) if they thought certain practices, such as activities related to software or coding standards, needed to change. Without official policies, they found it difficult to navigate conversations about taking vacation and sick days, balancing work and family expectations, and expensing items. The employee backlash was similar to what Zappos experienced in 2015, when it announced that it was eliminating all titles and managers, and 14% of its workforce—210 people—consequently took buyouts and quit.

Even though CloudFlare lost fewer people than Zappos, the percentage was about the same. Soon after the departures, Prince acknowledged that the firm needed more structure. "We are under no illusion that these management practices will work forever," he told Eisenmann and Godden. "You can already see some gaps. People want feedback; they want direction. When we double our current staff, we will need more hierarchy and managers and processes." A product manager had recently joined the organization, but Prince, who still disliked the word "manager," called him a "product engineer." He preferred to think of his employees as being "assisted."

By 2015 the firm had hired additional managers, along with an HR administrator and a talent recruiter. Prince wanted the organizational chart to remain flexible enough to attract senior hires without discouraging solo contributors, but he recognized that adding management structure was helping CloudFlare grow. When building up some areas, such as enterprise sales, he added hierarchical layers. He recently commented, "It's been fascinating to watch people from the engineering team look at the sales team and say, 'Hey, they actually look happy and productive. Maybe managers aren't such a bad thing.'"

"It's been fascinating to watch people from the engineering team look at the sales team and say, 'Hey, they actually look happy and productive. Maybe managers aren't such a bad thing.'"

—MATTHEW PRINCE, CEO, CLOUDFLARE

Of course, organizations can take structure too far. Having excess layers in the decision-making chain can slow things down by restricting the flow of information (top-down or bottom-up). It can also demotivate employees by signaling that they're not trusted to handle their own work. But as we saw at CloudFlare, people find *too little* guidance demotivating as well.

Firms that complement formal structures with informal mentoring and feedback can keep motivation intact. That's because those things foster a learning mindset, helping employees grow right along with the organization. Clearly delineated roles and areas of authority also enable people to make faster, smarter decisions locally. They streamline the process, rather than gum it up, and promote individuals' development. The more decisions people are empowered to make on the ground, the more they learn and the more accountable they become.

Planning and Forecasting with Discipline

Improvisation is integral to young ventures; it's how they make discoveries. However, as firms grow they need a framework of plans and goals to guide them. That way they can keep trying new things and reacting to dynamic markets, but with an eye toward larger objectives and sustaining the business. Otherwise improvisation essentially amounts to aimless riffing.

Many start-ups, including India's Micromax Informatics, have learned that the hard way. In 2010 Micromax seemed unstoppable. Having stormed the mobile handset market just a couple of years before, it was selling more than a million units a month. Its four cofounders had ambitions to make the company a global leader, and the numbers seemed to put it on that path: That year revenue more than quadrupled, and net profits more than quintupled. In September Micromax raised $45 million in private equity from Sequoia Capital and other investors, and in October it announced plans to go public.

But in July 2011 the company withdrew its IPO. Its relentless pursuit of growth had come at the expense of business hygiene, and it had lost momentum as a result. Mohit Bhatnagar, a managing director in Sequoia's New Delhi office, says, "From the outside it looked like a company that had grown exponentially, with great customer adoption of its products. However, on the inside it was chaotic."

At a board meeting later that year, Micromax committed to major organizational changes. To their credit, the founders agreed to bring in an outside CEO, along with senior leaders from blue-chip firms such as Airtel and HTC. When those leaders arrived, they were struck by the utter lack of planning. For instance, Micromax had done little to standardize market and employee information, let alone use it to inform sales, operations, or talent management decisions.

As the new CEO at the time (he has since left the firm), Deepak Mehrotra led the charge to implement strategic planning. With the founders' support, he stressed the importance of regular goal-setting and pacing exercises companywide to build a long-term vision. He says, "At my first meeting with my direct reports, in January 2012, I made them write their epitaphs: 'Imagine that two years hence, all 16 of you are returning from celebrating a great year, and your plane crashes. What would you want as your obituary?'" That was his way of getting managers to think more concretely about the company's future and set clearer performance targets—things the founders had avoided in their excitement to pursue new opportunities and their reluctance to admit when things weren't panning out. For example, the founders had initiated aggressive expansions to Brazil and Dubai, undeterred by their limited knowledge of customer preferences in those markets. Once systematic planning got under way, the company shut down those operations.

Micromax also began to bridge planning gaps at the operational and tactical levels. In many functions, managers lacked real-time data. Sales was a prime example: Once handsets shipped to distribution channel partners, the firm had long waits before finding out which models had sold, so placing advance orders with suppliers

> **"I now know at exactly what stage in the supply chain a device is. I know, in the top 20 cities in the country and street by street, the models I have sold."**
>
> —**SUMEET KUMAR**, COFOUNDER, MICROMAX

> **"Most of the personalities here talk a little faster. I tend to hire people who inherently have a bit of discontent."**
>
> —**RYAN HOWARD**, COFOUNDER, PRACTICE FUSION

involved a lot of guesswork. That led to underavailability of fast-moving products and excessive returns of others. It also made it hard to know how much inventory to retain. As a result, the company experienced cash flow challenges and had a limited ability to launch new products until it reached credit and inventory settlements with suppliers.

Cofounder Sumeet Kumar designed a solution: a tool that tracked each phone from shipment by the manufacturer to activation by the user. "I now know at exactly what stage in the supply chain a device is," he explains. "I know, in the top 20 cities in the country and street by street, the models I have sold." Micromax completed the tool's rollout in November 2012. Sales and inventory planning have since become much more precise, enabling the firm to learn within 30 days whether a product "is going to be a rock star or a failure." This has reduced problems with stock-outs, returns, and cash flow.

Before Micromax applied this sort of discipline, it had an ad hoc style of pouncing on opportunities as they arose, using a combination of tacit knowledge and off-the-cuff fixes. Leaders rationalized this approach on the grounds that decisions had to be made quickly because rivals were close on the company's heels, looking to copy existing products. In the frenzy to tackle pressing challenges, the tasks of documenting solutions and analyzing how they might have been reached more efficiently often fell by the wayside. People had little interest in establishing routines to deal with repeat issues. When they came up with effective solutions, they rarely shared them companywide; each unit had to discover its own best way of doing things. And when key people left, their knowledge walked out the door with them.

As Micromax's leaders discovered, even in a fast-paced, high-growth environment, it's important to set aside time to plan and to identify and share best practices. It's easy to assume that such activities are incompatible with agility and managerial discretion. To be sure, overly rigid planning processes can provoke battles over limited resources, which may hamstring innovation. But it's possible to have freedom within a framework. Setting clear goals and guidelines, systematically gathering and sharing information to shed light on performance and enable better forecasting, and creating processes instead of relying on key individuals to craft one-off solutions—all these promote efficient, smart decisions, especially when the world around you is in flux.

With these interventions, Micromax regained its footing in the mobile market. Its 2015 fiscal year revenue was almost $2 billion.

Sustaining the Culture

Culture is typically a big part of what draws people to join start-ups—and what keeps them going. As employees battle the odds to turn a fledging business into a viable company, working late nights and weekends to make it happen, they're motivated by camaraderie and a sense of belonging to something important.

Founders recognize how powerful this is and rely on nostalgic, almost mythic, stories about the organization's first days to get everyone to embrace the culture. That can work while a venture is small and all the employees can personally relate to those stories—but as more people come aboard, leaders may struggle to maintain a strong organizational culture. That's a problem, because culture may be most important during periods of growth. As a venture starts to formalize its functions and reporting chains, identifying with the larger organization helps employees work across boundaries and engage in the spontaneous collaboration and exchange of ideas the company needs to innovate.

Although founders of fast-growing firms say they worry about losing their organizational culture, few take steps to codify and reinforce it. Their attention quickly shifts to things that feel more urgent, such as operations and marketing. As a result, employees' motivation and engagement slip and people leave, hoping to recapture the magic somewhere else.

How can entrepreneurs prevent these consequences? They can start by clearly articulating their cultural values in their mission and vision statements and in job descriptions. That makes it easier to recognize cultural drift before it goes too far. It also helps the organization keep its values alive by hiring for cultural fit and rewarding desired behaviors through recognition and compensation.

Let's look at how this played out at Practice Fusion, a San Francisco firm that makes a cloud-based platform for electronic health care records. By late 2013 it had hired nearly 200 employees within 12 months, more than doubling in size. Throughout that period, cofounder Ryan Howard made it a priority to preserve the organizational culture.

One of the firm's tenets, "Be scrappy," harked back to the days when the cofounders, spurned by VC investors, worked out of coffee shops and used insurance money from a motorcycle accident to cover payroll. So it's not surprising that early on, the leaders relied heavily on folklore—tales about their marathon workweeks and bootstrap solutions—to convey this core value. But as the business became larger and more complex, that created distance between leaders and employees. The founders' charisma and stories were no longer enough to bind everyone together.

Anticipating this problem, Howard articulated the firm's values more formally, posting them online and in the building. You'll now find them painted on the office walls—not just scrappiness (his personal favorite) but also integrity, customer focus, teamwork, fun, community giving, and "doing extraordinary things." These values have become criteria for hiring and performance evaluation. For example, leaders expect employees to be resourceful, self-motivated problem solvers. "Most of the personalities here talk a little faster," Howard says. "I tend to hire people who inherently have a bit of discontent."

The firm also instituted weekly town-hall-style meetings, where the founders encourage employees to ask tough questions about what matters most at Practice Fusion, the problems it faces, how key decisions were made, and so on. This not only ensures a regular line of communication with employees but also makes everyone insiders, privy to the leaders' thinking about critical issues.

The staff also comes together once a month for "phenomenal Friday," where divisions take turns sharing updates and challenges. Sitting together and swapping stories helps weave the different groups into a unified community—an effort that requires regular care and feeding, especially in a company that extols scrappy self-starters.

AS JUST ABOUT ANY rapidly growing start-up will attest, scaling up is challenging. Market crashes, unreliable supply and distribution partners, fierce rivals, and plenty of other external forces can buffet firms. But that doesn't mean companies need to be chaotic on the inside. Effective internal organization frees them up to keep pursuing new opportunities and brings long-term survival within reach.

Entrepreneurs may worry that the changes we propose will be the death of spontaneity, adaptability, and speed—everything that got them up and running in the first place. Indeed, these are valuable qualities. Many large companies realize that too; that's why they often try to behave more like new ventures. We're not suggesting that start-ups abandon what made them special and innovative. But it's a lot easier to launch your rocket ship in search of new horizons when you don't have to worry that someone forgot to fill the tank.

Between the extremes of ad hoc and prescriptive organizing, there's a useful middle ground. Leaders who can find it will have an edge on their rivals—and that really matters, given how few new ventures become established players.

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FURTHER READING

ARTICLES

The Core Competence of the Corporation
by C.K. Prahalad and Gary Hamel
HBR, May–June 1990
Product no. 90311
A company's competitiveness derives from its collective learning, or core competencies, and core products (the tangible results of that learning). Explore how a corporation can identify and organize around its core competencies for sustained success.

Leadership Lessons from Great Family Businesses
by Claudio Fernández-Aráoz, Sonny Iqbal, and Jörg Ritter
HBR, April 2015
Product no. R1504G
Only 30% of family businesses last into the second generation, and the rate declines even further after that. Through interviews with family and nonfamily executives, the authors define the four things that the most successful family businesses do well.

More Reading @ HBR.org

Beating the Odds When You Launch a New Venture

Smart entrepreneurs aren't cowboys—they're methodical managers of risk.

by Clark G. Gilbert and Matthew J. Eyring

FOR NEARLY 20 YEARS the case study used to introduce Harvard Business School's Entrepreneurial Management course has been Howard Stevenson's "R&R." It looks at Bob Reiss, an entrepreneur who launches a venture in the board game industry. Students are encouraged to explore all the production, development, distribution, and marketing costs associated with the new venture.

A cursory reading of the case suggests that it's a lesson in the rewards that come to an entrepreneur who is willing to take on an enormous amount of risk. Reiss capitalizes on what he correctly foresees is an ephemeral opportunity to ride the coattails of the Trivial Pursuit craze before me-too products flood the market. But a more careful analysis reveals something else entirely. At every turn, Reiss seeks to reduce his risks before making any significant financial investments or operational commitments. For example, he presells a sizable number of units to ensure cash flow. As students come to understand, Reiss actually limits his at-risk capital to the cost of the game design and the prototype. Rather than the high-risk, high-reward seeker he initially seems, Reiss proves to be a manager who constantly identifies risks and finds creative ways to remove them.

Originally published in May 2010

Tackling the Right Risks First

Risk and value are inversely proportional: When you remove risk, you increase value. But it matters in what sequence you tackle risks, because not all of them are created equal.

Suppose a manager is launching a new e-commerce business. He must remove a number of risks before the venture reaches its peak value. He could simply remove them as they occur to him.

But unless he confirms demand, it doesn't matter how provocative his website is; customers won't buy. And if he doesn't answer the product-mix question, he will fill his warehouse with products he can't sell.

Addressing these two risks early creates disproportionate value quickly, not only saving critical resources but also moving the venture in the right direction sooner.

Over the past decade we have participated in the development of a dozen or so corporate ventures and served on new-venture boards at a host of companies, including Johnson & Johnson, the Scripps Media Center, and Landmark Media Enterprises. Although many of the ideas in this article come from our direct work with new ventures, they also reflect more than 10 years of collaborative thinking by the Entrepreneurial Management teaching group at HBS.

What has become clear to us is that the most effective corporate innovators are the ones who follow the same discipline Bob Reiss did. Success comes to those who quickly identify and systematically eliminate risks in the right order, using the right level of resources and the right methods.

Recognize That Not All Risks Are Created Equal

New ventures fairly bristle with risks. If managers attempted to eliminate all of them, the products or services would never get to market. The key question is "What's the most important uncertainty?" and the answer should be targeted early. In considering how to answer that question, we have found it useful to think in three broad, sometimes overlapping categories: deal-killer risks, path-dependent risks, and easy-win, high-ROI risks.

Deal-killer risks. As the name implies, these are uncertainties that, if left unresolved, could undermine the entire venture. Such risks may be less obvious in the moment than they appear in hindsight, after catastrophe has struck. That's because they often take the form of unwarranted or unexamined assumptions about the premises underpinning the venture. For example, a colleague of ours was an early employee at a start-up satellite radio company aimed at consumers in the developing world. The premise of the venture was that satellite broadcasting technology would be a relatively cost-effective way to bring mass media to markets that lacked infrastructure. Market research suggested that a huge latent need would turn into a booming business. The company deftly negotiated broadcasting licenses in several developing countries and solved a number of complex technological challenges. Nevertheless, the business imploded. What was the problem?

As it turned out, the demand identified by market research depended on customers' being able to access the broadcasts through low-cost

AT A GLANCE

THE IDEA IN BRIEF

Despite stereotypes to the contrary, the best entrepreneurs are relentless about managing risks—indeed, that's their core competency. As the risk level of a new venture goes down, the value goes up.

Risks should be uncovered and hedged in order of their importance and affordability: deal-killers first; then the risk of settling too early on a strategic direction; and finally, operational risks that can be disposed of quickly and cheaply.

All new ventures are partly wrong and partly right. Run small, cheap, fast experiments to determine which bits are which and what course corrections you need to make.

radio receivers—which turned out to be impossible. The radio receiver required complex features such as multimode playback, a keypad for ordering subscription services, and—worst of all—professional installation, which made the device unaffordable in most of the developing world. Having failed to identify this fatal vulnerability, the company invested hundreds of millions of dollars to reach consumers who couldn't pay for its service. The business limped along before ultimately going bankrupt. The company should not have left this key deal-killer assumption so utterly untested until late in the life of the venture. Quick-hit market research and rapid prototyping could have provided early warning signals.

Path-dependent risks. Rare is the new venture that never has to confront strategic forks in the road to success. Path-dependent risks arise when pursuing the wrong path would involve wasting large sums of money or time or both. For example, consider the question confronting E Ink, a supplier of electronic paper display technologies in Cambridge, Massachusetts. In the company's early days there was great debate over whether its electronic "ink" would best be used for large-area display signage, flat-panel screens for e-books, or the more ambitious radio-paper products, which could be programmed and updated remotely. Each option had different technical, marketing, and distribution requirements; if the company chose wrong, it risked misallocating millions of dollars.

Rather than choosing one path and hoping for the best, E Ink reduced the cost of pursuing all three by outsourcing its marketing and production capabilities and then focused on resolving the risks associated with the core technology for all three applications. Thus, when display signage proved less successful, the company was not locked into a single market, and the technical knowledge it had developed allowed the fledgling venture to successfully license its technology for more viable products—most notably Amazon's Kindle.

Risks that can be resolved without spending a lot of time and money. Even after entrepreneurs have considered both deal-killer and path-dependent risks, many uncertainties will remain on the table. If every one were addressed, they'd never get their products to market. But the more risks that can be eliminated, and the faster they can be removed, the greater the odds of success. Accordingly, successful entrepreneurs also look for risks that are quick and cheap to resolve, applying a cost-benefit approach that we think of as the "experimental ROI"—the amount of risk that can be reduced for each dollar invested in an experiment designed to resolve it. For example, one of the earliest experiments that Reed Hastings, the founder of Netflix, conducted in developing his movie-rental-by-mail business was to mail himself a CD in an envelope. By the time it arrived undamaged, he had spent 24 hours and the cost of postage to test one of the venture's key operational risks.

Fail to spot a deal-killer risk, and your venture is doomed. Fail to hedge a path-dependent risk, and you dramatically raise the odds that you'll run out of funds before you ever come to market—or will get there far too late. Fail to address a high-ROI risk in an orderly way, and you may transform a temporary setback into an insurmountable obstacle.

Such was the fate of a start-up we worked with that targeted the nascent medical tourism market. The venture's value proposition was to fly patients overseas for high-quality, inexpensive medical care, which it expected to deliver at half the cost of the same care in the United States. Several deal-killer risks faced the venture. Unfortunately, rather than tackling them early, by beginning with those that could be tested most quickly and at the least cost, team members plunged into a time-consuming and expensive effort. To gauge demand, they conducted a series of long interviews with *Fortune* 500 corporate benefits managers and insurers around the country. Things looked very promising. However, not until they'd put in nearly six months of work and spent considerable money on travel did they decide to do something they should have done early on: run two simple, high-ROI experiments to test key risks. The first involved a seminar to introduce the concept to prospective patients. The second involved several phone calls to U.S. hospitals to discover their unpublished discount prices for certain procedures. In only two weeks (and at virtually no expense), the team learned that patient demand was actually quite tepid and limited to a very narrow band of procedures, and that U.S. hospitals were willing to lower their prices—to near

Test Early, Test Cheaply

Perhaps the most dangerous result of injecting too much money too soon into a venture is that it creates a confirmation bias in the minds of venture managers. Instead of testing their assumptions, they become more and more invested in confirming them. But successful entrepreneurs do the opposite: They devise low-cost experiments to disprove a concept before it's too late.

We've found two types of experiments helpful in our work.

TARGETED EXPERIMENTS

These are designed to pinpoint a deal-killer or path-dependent risk. Examples might include running tests on battery life before launching a new portable device, checking for toxicity in a drug before running full-scale efficacy tests, and testing bandwidth and connectivity concerns before launching an online learning program at various locations across the country.

WHEN RISKS ARE OVERLOOKED...

15%

Fewer than 15% of firms are still in operation three years after initial funding, according to one study of venture-backed start-ups.

international levels in some cases—if patients paid cash up front. By failing to address their greatest risk—that no market existed for their services—in the cheapest and fastest way, the team members wasted significant resources and missed a critical opportunity to redirect their strategy to something more promising, such as a venture restricted to regional medical travel within the U.S or travel to a close international destination like Mexico.

A common mistake is to focus on one key risk to the exclusion of others. Sometimes you must be satisfied with partial risk resolution in one area, even as you start to consider and work on risk in another. As a general rule, we have found it's best to select a "stake in the ground" customer early in the life of the venture. You can then confirm a rough price point at which customers can be served, even as you continue to reduce related technical risk.

Be Judicious with Capital

All other things being equal, a large corporation's deep pockets should give it an advantage over bootstrap entrepreneurs when it comes to financing a new venture. But in practice, a parent company's funding procedures are often a major liability—something one of our colleagues, Brad Gambill, has referred to as "the curse of too much capital." Corporations typically allocate money for a new venture all at once, hoping for a large payoff fairly soon. The more money that is sunk into a project at the outset, the less patience the company tends to have and the more people believe in the validity of their original approach, even in the face of evidence to the contrary.

The way venture capitalists invest in start-ups—by providing capital in multiple rounds as the value of the venture increases—is far more effective. As one of our colleagues puts it, "With each risk you pull off the table, value goes up proportionally." The lower the risk, the greater the value, so this approach favors entrepreneurs who use early funding to reduce the greatest risks—allocating sufficient funds to test the deal-killer risks first and the path-dependent risks as quickly as possible, and then squeezing the most value out of their scarce resources by systematically working through the remaining risks according to the principle of "spend a little to learn a lot."

At many big companies, a project's status correlates almost perfectly with the amount of

INTEGRATED EXPERIMENTS

These are designed to test how various elements—the actual business model and operations—work together. In essence, they involve launching the business, or some part of it, in miniature. Although pilot programs are nothing new, our experience suggests that entrepreneurs rarely give them sufficient time to play out. An exception is Aaron Kennedy, who founded Noodles & Company, a chain of quick-casual restaurants. From the beginning Kennedy intended to take his concept nationwide, but he started with just three restaurants. He revised the menu, varied the décor, and tested several pricing structures. For almost an entire year he focused on sharpening the concept and making it work on a small scale. Today the chain has more than 218 locations in 18 states.

An integrated experiment may be a pilot, a test-site location, a prototype, or any other trial operation. It might include tests to "launch" the business in a way that allows customers to purchase the product in a real transactional environment. Targeted experiments such as surveys and focus groups can provide insights, but those that come from placing the product in a sales channel where customers make actual purchase decisions are often much deeper.

Experiments should help redirect a venture, not confirm that your initial ideas were correct.

money invested in it. The competitive advantage of autonomous start-ups is that they have too little money to go far in the wrong direction.

We can demonstrate the power of this dynamic with two very different examples. Vermeer Technologies, a start-up based in Cambridge, Massachusetts, had only one product: a website development tool called FrontPage. The company was eventually sold to Microsoft, and Microsoft FrontPage became the most widely used web-design software package in the world. But that's not where Vermeer's strategy began. In the early 1990s its founders had hoped to create an interface that would allow users to access content through a common reader across a wide network of computers all over the world. There was only one problem: A nascent service—the World Wide Web—was free to anyone who wanted to access it. After Vermeer's founders learned more about the Web, they decided to take another path altogether, devising a software tool that let nontechnical programmers create their own websites. Reflecting on their original strategy, the founders laugh in relief that they didn't make any significant investment at the outset, because they might have poured their capital into building an ultimately worthless company.

An equally instructive example with a less fortunate outcome is that of Joint Juice, a Bay Area company founded by an orthopedic surgeon who came up with the breakthrough idea of converting glucosamine, effective in reducing joint pain, from a large pill into a more convenient liquid. A strong conviction that his target market was young to middle-aged athletes led to a series of expensive choices relating to the product's caloric load, packaging, distribution channel, and marketing approach. Lavish advertising campaigns were built around professional and Olympic athletes. These early, high-cost investments became self-reinforcing.

Just as data were beginning to reveal that the real demand lay with an older demographic—people who wanted lower-calorie, less-expensive products—an opportunity arose to go national with two large grocery chains. Sunk costs made the opportunity more tempting than it should have been, and Joint Juice signed an expansion contract replete with the high slotting fees associated with grocery retail. When it became clear that the channel and market were wrong, the enterprise was already locked in to a product incorrectly formulated, positioned, and distributed. Today Joint Juice has been adapted

Case Study

Robin Wolaner, who launched *Parenting* magazine, began with an insight: Large numbers of highly educated women were having children much later in their professional careers than had been true in the past. She raised a small amount of seed capital to push her idea for a magazine forward and chose to spend it on answering the one question that, if unresolved, would render all other risks moot: Is there a differentiated need and a real demand for this product? Wolaner sent out direct-response cards describing a magazine that would focus on both parents and would have a uniquely sophisticated editorial orientation. Early market tests typically get a response rate of 3% to 4%. Her cards came back at greater than 7%. Because this deal-killer risk was pulled off the table at the outset, valuation jumped from less than $500,000 to more than $5 million.

$5 million

to the right market, but only after millions of dollars more were invested—and significant changes were made to the management team.

We cannot make this point too strongly: At the start of a new venture, the only thing you can know about your initial strategy is that it's probably part right and part wrong. One of our colleagues conducted a study of the *Inc.* 500 entrepreneurs and found that most successful ventures had redirected their strategy at least five times before they hit a solid growth trajectory. If you go full speed in your first direction, you'll compromise your ability to figure out which part is wrong—and pay a high price when you eventually do figure it out. But if you invest in stages, spending small sums on the assumption that your strategy will need adjustment, you'll find it much easier to adapt quickly and reach a winning outcome.

Manage Experiments Efficiently

Identifying and prioritizing risks correctly and then conceiving and funding experiments to resolve them systematically will make the unpredictable process of launching a new venture as efficient as it can be. You can take several steps to make your experiments more effective.

Limit the duration. According to Meg Whitman, the former president and CEO of eBay, the company succeeded in its earliest days by recognizing that perfection is sometimes the enemy of the good. It's often better to get something into the market quickly, learn from it, and move on to the next phase of development than to analyze an idea to death and try to perfect it before launch. Even deal-killer risks can sometimes be tested quickly and simply. For example, Innosight Ventures saw an opportunity to serve consumers in India who couldn't afford washing machines but wanted an alternative to the traditional *dhobi* services, which are slow, use dirty water and inferior detergents, and beat clothes on rocks to remove the water from them. The venture managers needed only 60 days to move from completion of the business plan to an initial market test. The test was simple but powerful: They invested a few thousand dollars to build a kiosk that contained a washing machine and a dryer and put it on a busy street corner to see if people were willing to pay 40 rupees (about $1) per kilogram to wash their clothes. It was essentially a mini-launch designed to answer the key question in their business plan: Is there unmet demand for an inexpensive laundry service? Several weeks of growing customer demand at the site indicated a high likelihood that the concept and pricing were essentially sound and with further refinement could exceed estimated break-even levels. Today more than two dozen kiosks have been set up in several Indian cities, and there are plans to expand the business to more than a thousand over the next few years.

Test one thing at a time. Poorly designed experiments vary too many factors at once, increasing the expense and making it difficult to determine what causes what. Experiments should be simple and focused on resolving uncertainties one by one. At a large media company we worked with, the venture managers ran experiments to test a new website registration system that would allow them to target various demographic segments with ads. They didn't know whether registration should be required or optional. Accordingly, their experiment was designed to answer the questions, Will people be discouraged from visiting the sites if they are forced to register? and, Will people register at all if they aren't required to? Instead of running tests over an entire network of websites, they picked two comparable sites and for a month ran one with an opt-in registration and the other with a forced registration. Everything else was held constant—promotion, launch, investment, and so forth. When the forced registration didn't reduce site visits significantly, they had their answer.

Apply the lessons learned. Too often managers miss the whole point of these experiments. They are meant to help redirect a venture, not to confirm that your initial ideas were correct. Some of our colleagues call this discovery-driven learning. Recall the data on the *Inc.* 500 ventures—five major course corrections for every successful venture. Sometimes those corrections come painfully, but it's better to choose to adjust early than be forced to adjust later.

Be willing to turn off experiments. This idea is closely related to the previous point, but requires far more discipline. Some ventures are simply not going to work. A deal-killer risk may in fact kill the deal. The sooner you cut your losses in such cases, the sooner you can go on to the next venture. More often, though, the principle applies to some specific component of the venture. We've watched executives in the newspaper industry struggle with this as they've tried to migrate from print media to digital content. One senior manager confessed to us, "We had a thousand experiments running; some of them were working and some of them were not. Sometimes the challenge isn't turning them on—it's turning them off." When an entrepreneur learns that a product or an approach won't work, it is critical to end the experiment and move in a new direction.

A study of the *Inc.* 500 entrepreneurs found that most successful ventures had redirected their strategy at least five times before they hit a solid growth trajectory.

NEW VENTURE FORMATION will always be fraught with risks. We don't want to imply that a systematic approach to identifying and mitigating them will eliminate them. But we do take issue with the notion that it's the risks that produce the rewards. As Bob Reiss's story has illustrated for decades—and our experience continues to confirm—great entrepreneurs don't take risks; they manage them. Quickly determining what's right and what's wrong with key assumptions and then making speedy adjustments often means the difference between failure and success. As entrepreneurial managers learn to do this, they bend the risk-reward curve in their favor and beat the odds.

Clark G. Gilbert is the president of Brigham Young University–Idaho and formerly the CEO and president of Deseret News Publishing and Deseret Digital Media. **Matthew J. Eyring** is the chief strategy and innovation officer at Vivint, a provider of smart home technology.

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ARTICLES

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by Martin Reeves, Ming Zeng, and Amin Venjara
HBR, June 2015
Product no. R1506E
The authors examine how China's Alibaba grew from an 18-person start-up to an $8 billion empire by regularly resetting its vision, testing out new models, shaping opportunities, and building adaptive structures—continually retuning the strategy and the organization using the principles behind algorithms.

Two Keys to Sustainable Social Enterprise
by Roger L. Martin and Sally R. Osberg
HBR, May 2015
Product no. R1505G
To be financially sustainable, successful ventures in the realm of social entrepreneurship focus on changing two features of an existing system: the economic actors involved and the enabling technology applied.

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MANAGING THE BUSINESS

Lean Strategy

Start-ups need both agility and direction.

by David Collis

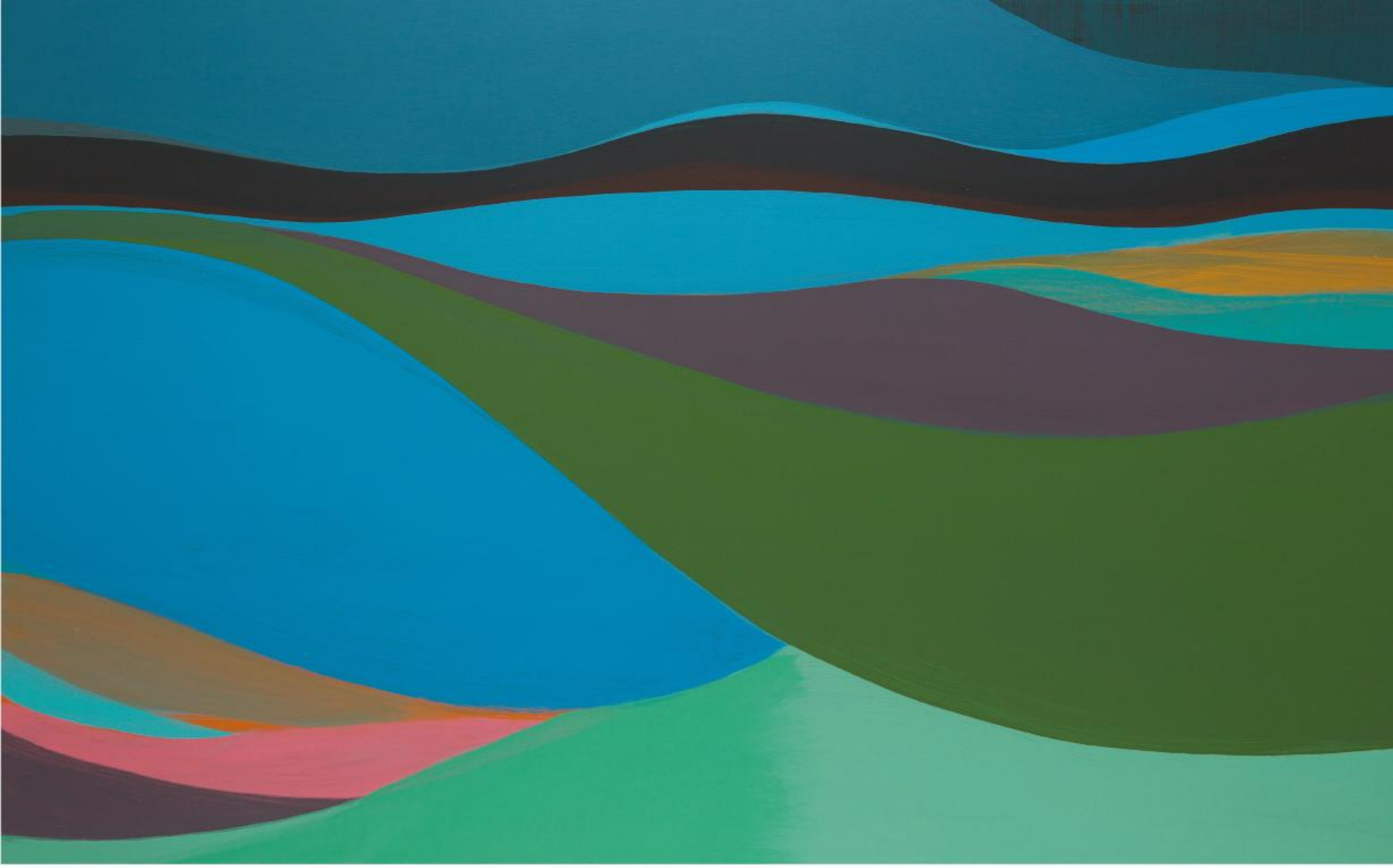
STRATEGY AND ENTREPRENEURSHIP are often viewed as polar opposites. Strategy is seen as the pursuit of a clearly defined path—one systematically identified in advance—through a carefully chosen set of activities. Entrepreneurship is seen as the epitome of opportunism—requiring ventures to pivot in new directions continually, as information comes in and markets shift rapidly. Yet the two desperately need each other. Strategy without entrepreneurship is central planning. Entrepreneurship without strategy leads to chaos.

What many entrepreneurs fail to grasp is that rather than suppressing entrepreneurial behavior, effective strategy encourages it—by identifying the bounds within which innovation and experimentation should take place. But executives who want their established firms to be more entrepreneurial often don't fully appreciate how stage-gate processes, multiple-horizon planning, and other corporate tools for managing strategic growth initiatives can undermine innovation.

The reality is, integrating the bottom-up approach of lean start-ups with the top-down orientation of strategic management remains devilishly hard. Is there a way to get the best of both worlds?

Originally published in March 2016

Margaret Neill



Yes. The solution is something I call a *lean strategy process,* which guards against the extremes of both rigid planning and unrestrained experimentation. It emerged from the more than 20 years I've spent studying and working with entrepreneurial ventures and large companies. In this framework, strategy provides overall direction and alignment. It serves as both a screen that novel ideas must pass and a yardstick for evaluating the success of experiments with them. Strategy allows—indeed, encourages—frontline employees to be creative, while ensuring that they remain on the same page with the rest of the organization and pursue only worthwhile opportunities.

The Entrepreneur's Challenge

Howard H. Stevenson of Harvard Business School defines entrepreneurship as "the pursuit of opportunity without regard to resources currently controlled." This highlights the fundamental challenge confronting entrepreneurs: They all suffer from a shortage of money, talent, intellectual property, access to distribution, and so on. While acquiring additional external resources is partly the answer, the internal challenge is to wisely shepherd, conserve, and deploy the resources the venture does possess. That is exactly what strategy is all about. Indeed, the single best piece of advice for any company builder is this: Know what *not* to do. Strategy helps you figure that out.

Much more so than leaders of established firms, entrepreneurs need to recognize these fundamental principles:

The opportunity cost of doing A is that you cannot also do B. In a resource-constrained venture, choices are mutually exclusive. If you allocate two software engineers to customize a product for a new customer, you will delay the release of version 2.0 of the product by three months. No amount of experimentation will get around this problem.

Every choice creates a unique path with a different outcome and unforeseen implications. This is why you cannot simply do A now and B later—because circumstances will almost certainly have changed. Competitors will have launched their own version 2.0. Key suppliers will have signed contracts that commit all their capacity to others. Potential customers' judgments

about the service will already be clouded by their experience with a competitor's version. The employee who would have been instrumental in pursuing B will have left the company. Every choice is an irrevocable rejection of something else.

Decisions are interdependent. If John in marketing does A, it has ramifications for Peter in product development, and vice versa. Any venture needs to ensure that the scarcest resource—people's time—is spent on the tasks that are critical to the organization as a whole, not just to one department. In an established firm, operating units are subject to many organizational constraints: the brand's positioning, a shared sales force, and so on. Those constraints help ensure consistency among initiatives and innovations. A new venture, however, lacks organizational parameters; the world is its oyster. This makes it even more important for entrepreneurs to set boundaries.

Simple market tests aren't always useful. The lean start-up camp celebrates agility and adaptation through rapid testing. That may be an effective way to innovate incrementally and fine-tune an offering's fit with the market, but some ideas simply cannot be evaluated in a series of quick, cheap experiments. Though few concepts require all-or-nothing investments, as the launch of Federal Express did, many do entail substantial up-front expenditures. Innovations that bring to market truly novel products and services, like steel minimills and electric cars, often involve building complete ecosystems and require long-term investments.

While adoption rates are accelerating (Facebook achieved 100 million users in just over four years, WhatsApp in two years), some businesses will mature more slowly. Customers may need time to appreciate the value of a new product, or suppliers may need to work down a cost or experience curve to deliver at a reasonable price. Businesses such as accountable care organizations in health care and Tesla's lithium ion batteries would never have gotten off the ground had they been expected to demonstrate immediate success.

What's more, quick A/B tests that capture customer preferences may fail to account for various alternatives' longer-run impact on brand reputation and purchasing behavior. Such tests also focus too heavily on initial usage. Sometimes immediate traction with target customers is ephemeral: Users tire of the novelty or—like Groupon's customers—find that repeated use is uneconomical. This is one reason that consumer-packaged-goods firms are careful to distinguish trial from repeated use.

The single best piece of advice for any entrepreneur is this: Know what *not* to do.

How Strategy Can Help

In a world governed by the principles discussed here, a strategy that articulates the firm's overall direction is indispensable. It helps entrepreneurs do four things:

Choose a viable opportunity. Rigorous strategic analysis can distinguish markets that promise enduring success from those that offer only the illusion of substantial, if immediate, returns. Many a new firm has failed because it pursued the latter. The archetypal example is a business with low barriers to entry. Consider Groupon again. Its innovative model of online coupons for local retailers and service providers quickly generated sales. Unfortunately, anyone and her mother could also launch such a site—and did. Demand for the service proved transitory, and no one has made any money in the business.

Yes, an entrepreneur can make a quick killing by starting such a business and then selling it to a strategic (or foolish) buyer. A classic example is Minnetonka. It brought to market a series of innovations—from Softsoap to the pump dispenser for toothpaste—that had no protection from copycats. Yet as the first mover, the company could grow rapidly before selling out to established firms: Colgate-Palmolive bought its soft-soap business, and Unilever bought the other product lines. However, this business model still reflects a strategic choice: Knowing that the business cannot be sustainable, the entrepreneur does everything possible to minimize long-term commitments and maximize the gross margin and sales while looking for the exit.

Another misstep is entering a large and growing market without analyzing whether the firm will be able to build a sustainable competitive advantage in it. Best Buy, Mattel's line of Barbie dolls, eBay, and a slew of others entered China thinking that anyone could make money there—only to fail. It may be much wiser to pursue several smaller, less risky opportunities that together could create a successful long-term business.

An initial strategic screen can save a venture from going down the wrong path: one that might be readily validated by a market test of a minimum viable product but is unlikely to support a long-term business. At Eleet, a start-up based in Providence, Rhode Island, the founders (one of whom is my son) initially developed eight possible B2B and B2C use cases for their concept, providing chauffeurs to drive you in your own car. For a few hundred thousand dollars, the team could have rapidly tested some of those use cases. But before trying out even one, the founders analyzed the target markets and recognized that a B2B version would be the most sustainable. As a result, they set aside the B2C use cases and instead ran tests that demonstrated the existence of high-volume B2B users, firms that would provide the service to their employees in lieu of limousine service. They're now in the early stages of trying to build that business. (Full disclosure: I've advised, invested in, or served as a board director for Eleet and several other companies mentioned in this article.)

Stay focused on the prize. Ventures that lack strategic bounds try to do too much and spread themselves too thin.

Because they fail to concentrate their available resources, they can't win in any key market.

Sophia Amoruso, founder of Nasty Gal, initially succeeded in building a business that resold vintage clothing on eBay. Then she diversified into a variety of new activities: selling brand-name designer clothing; a magazine; an autobiography (*#GirlBoss*) and promotional book tour; retail stores; international websites; and branded products such as shoes, swimwear, lingerie, and home goods. Seduced by an overabundance of opportunities, she threw a lot of ideas against the wall to see what would stick. But with no clear focus, employees stumbled over one another, competing for resources—including Amoruso's attention—and growth stalled. She stepped down as CEO in January 2015.

In a similar manner, new ventures—driven by the need to generate cash to meet payroll—often respond to every sales inquiry, even when the customer is not in the target set. In its start-up phase, Picis, a health-care information-systems company, was pursuing two markets, operating rooms and intensive care units, winning orders in both. But in both markets the firm was struggling to get traction. After it decided to concentrate on operating rooms (and made a related acquisition), it was able to gain share and build a viable position.

Align the entire organization. In tiny start-ups, it may be possible to coordinate activities through daily personal interaction. In larger ventures, project management or a bureaucracy can help somewhat with this, but only a strategy allows a leader to empower all employees while avoiding duplicative efforts and the pursuit of conflicting agendas. A clearly articulated strategy can ensure that every aspect of an organization—the type of personnel hired, the compensation system and reward metrics employed, the IT system installed, and so on—is designed to support its distinctive value proposition.

A clarified strategy prevented staff members at Muzzy Lane Software, an educational gaming company, from continuing to pursue work-for-hire that produced one-off games. This had been an important source of funding: A single contract could cover the company's cash burn for several months. But the firm realized that its real focus should be on educational publishers, and having built a core software platform on which such firms could develop their own content, it needed to improve the suite of authoring tools. Diverting developers to customize a game would slow down that critical activity. The staff was actively discouraged from seeking such projects.

Make the necessary commitments. After deciding which opportunities to pursue, firms must make the investments needed for success. Obviously, testing should be done to minimize risk and maximize the value of each one. But, as discussed earlier, every so often an investment, like building a hospital in a new district, has to be made without a guarantee of return or the ability to be tested in phases. In those cases, it's critical to conduct a careful analysis before proceeding. And, of course, the investment must be a strategic fit.

ARTICLE AT A GLANCE

THE IDEA IN BRIEF

THE ISSUE
Leaders of start-ups often see strategy, the pursuit of a clearly defined path that is systematically identified in advance, as the enemy of entrepreneurship, which requires ventures to be opportunistic and quickly shift course as they learn what customers want.

THE REALITY
Entrepreneurs badly need strategies that articulate what their ventures will and will not do. Such boundaries are crucial for making the most of scarce resources, deciding which ideas to pursue, and evaluating experiments. But a rigid, fixed strategy is dangerous.

THE SOLUTION
The lean strategy process integrates the bottom-up approach of the lean start-up with the top-down orientation of strategic management. In an iterative fashion, the venture builds new capabilities and revises the original strategy in response to what it learns.

Combining Deliberate and Emergent Strategy

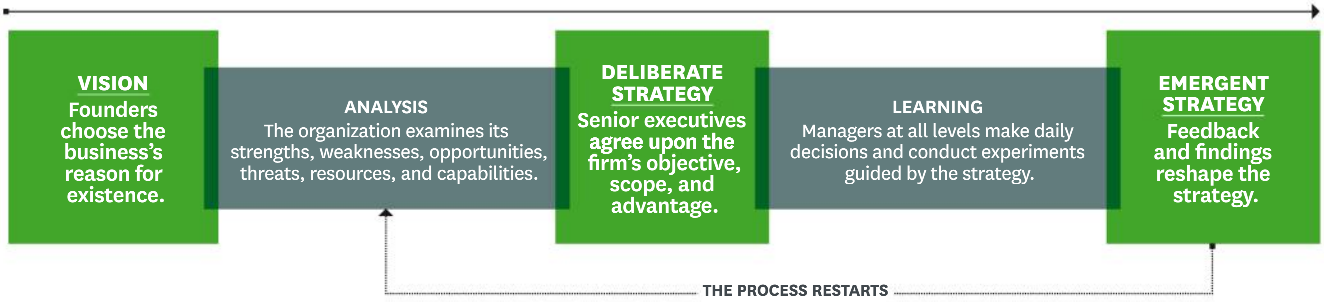
If strategy is to address the entrepreneur's challenge, it must also embrace entrepreneurial techniques. Entrepreneurship—empowered local experimentation—allows a firm to explore the right innovations and continually refine them to better fit the market. It's necessary no matter what a firm's size or industry is. Here's how to incorporate it effectively into strategic approaches:

Vision. The lean strategy process begins with perhaps the only aspect of the strategy that should in any sense be permanent: the organization's vision or ultimate purpose—the reason for its existence. A vision should be compelling and motivational. It may also be aspirational and possibly even unachievable. Microsoft's original vision, for example, was to place "a personal computer on every desk." Under its founders, Ben & Jerry's strove to "make the world's best ice cream, to pursue progressive social change, and to provide fair compensation to employees and shareholders alike."

Deliberate strategy. To deliver on the entrepreneurial vision, a deliberate strategy should be agreed upon by senior executives. It should be crafted with involvement throughout the organization, from a rigorous evaluation of the firm's current strengths and weaknesses, internal resources and capabilities, and external opportunities and threats. The deliberate strategy will identify the broad market position where the

The Lean Strategy Process

By combining traditional strategy with lean start-up practices, ventures can align employees around a common purpose, make the most of limited resources, learn from the market, and then adjust the strategy.



firm can use its unique capabilities to satisfy customer needs in a way that no competitor can.

In my view, the three underlying elements of a strategy are objective, scope, and competitive advantage. (Though I won't go into the details here, you can find them in my April 2008 HBR article with Michael Rukstad, "Can You Say What Your Strategy Is?") Let's look briefly at how those three concepts apply to new ventures.

Objective. This is an articulation of the near-term goal that defines success in the eye of the venture's leader. If her objective is to go public within three years, that will have implications very different from those of building a sustainable business she'll still control five years out, or of selling to a strategic buyer once the business is established. For each objective, the strategy must also establish the metrics that will maximize the firm's market value when achieved. With an IPO, for instance, the metrics might include X million new customers, a Y% share of online retail, version 3.0 installed at Z key customers, and so on.

Scope. Probably the most critical strategic guide rail, scope identifies "what business we are in" and draws boundaries around what the venture will and will not do. Southwest, for instance, developed its original low-cost-airline strategy within a clearly defined domain. It decided not to compete head-to-head with the majors in big airports or on routes with flight times over a couple of hours. Instead, Southwest concentrated on building a dominant network of short-haul flights between second-tier airports. And since another premise of the strategy was that low prices had to be simple and transparent, the airline devoted no efforts to complex yield-management initiatives that would have allowed Southwest to wring the maximum fares from passengers.

Competitive advantage. Any venture needs clarity about how it will win—why customers will buy its products rather than those of competitors. That advantage should help the company satisfy an underlying customer need and, ideally, address an immediate customer pain point. It can be captured in a summary of features that are superior to those of competitors, which may also acknowledge, if not even celebrate, those aspects of the product or service that will underperform. This distinctive value proposition should align the firm's activities and shape future experiments.

One of Southwest's key advantages, for example, was rapid turnaround time, which helped it maximize its use of assets and keep prices low. The airline chose not to provide meals, because doing so would have increased costs and turnaround times. When passengers complained, customer service personnel merely responded with polite letters explaining that adding meal service would raise fares.

Emergent strategy. In implementing the strategy, managers at all levels in the organization make myriad decisions every day. The sum of all these independent choices gradually alters the company's position and determines the exact form the strategy takes over time. This is the emergent dimension of strategy.

Many frontline decisions, like daily flight departure times at Southwest, are routinized and require little or no thought. Some, like whether to hold a plane at the gate to accommodate delayed connecting passengers, require judgment and should be informed by the company's strategy. And some are conscious variations that seek to improve an existing product or practice. One incremental innovation suggested by Southwest employees, Business Select, gave passengers a free drink and early boarding for a small premium. Because it would not interfere with fast gate turns, the airline introduced it.

It is here that the notion of strategy as a filter looms large. In considering what experiments to undertake, people throughout an organization develop and test hypotheses about how to improve the strategic positioning by identifying current mismatches, gaps, or opportunities in the offering's fit with the market. Thus entrepreneurial activity in the lower levels of the organization is not random. For instance, rather than developing complex yield-management software algorithms, as other airlines did, Southwest's IT group focused on innovations in customer self-service that could be delivered on low-cost, personal-computer-based systems. Similarly, frontline personnel came up with Southwest's boarding procedures (the unique numbered stands for boarding at a Southwest gate), which contributed to the carrier's rapid turnaround time.

Once an innovation is introduced, the strategic screen again comes into play. The venture now has to evaluate the outcome of the experiment and decide whether to end, continue, or amend it (a decision that will have lasting repercussions). Without a broader orientation, wrong conclusions can be drawn from results. During the Battle of Britain, for instance, after-action reports built a picture of where damage had been inflicted by the Nazis on Spitfires returning to base. This was used to identify the areas on the planes that needed to be reinforced—that is, until a bright spark pointed out that they were not the areas that were most vulnerable. In all likelihood, the areas where there was no damage on returning planes were most problematic, since hits there meant planes never came back.

Strategy provides a framework for interpreting market feedback. It is only with a clear strategic perspective that organizations effectively learn from experiments. If the outcome of the innovation is simply a no-go decision, all the information and skills that were developed through it will be lost. But if the firm carefully digs down into where things went right or wrong—which hypotheses were validated or disproved—it can amend the strategy wisely. Instagram's original strategy was to develop a private mobile phone app, Burbn, that "enabled friends to check in to locations, make plans (future check-ins), earn points for hanging out with friends, post pictures, and much more." When users reacted negatively to an app that could do all those things, the baby was not thrown out with the bathwater. Instead, the founders decided to focus on being really good at one thing. Noticing that users posted a lot of pictures, they spent eight weeks developing a better photo-sharing app and doing a beta test. The rest, as they say, is history.

In response to environmental changes and the findings of experiments, the venture builds new internal capabilities and, if necessary, revises the original deliberate strategy. Then the process begins all over again. It is therefore true that the firm evolves as a result of the incremental choices made every day. However, this does not imply that the strategy emerges only after the fact. Rather, at every point in time there has to be clear agreement on the constraints imposed by the current strategy, even if that strategy does shift.

Nuventive, an ed-tech company, had a suite of products for assessing and improving institutional and student performance. But with limited revenue, it had to choose to invest in a focused way. As it turned out, the company's focus would change over the years as market opportunities waxed and waned, and the relative attractiveness of product lines shifted. Nevertheless, at each point in time, the strategy made clear to everyone in the firm which products had priority and which innovative ideas would have first dibs on scarce resources (the software developers). The other products were just provided enough support to keep them viable. Nuventive was, therefore, flexible enough to adjust to the changing marketplace but strategic enough to deliver against the best opportunity.

STRATEGY MATTERS EVEN more to entrepreneurs than to established businesses. Yet lean methods for innovation also have a lot of value. The two are not in conflict; rather their reconciliation in the lean strategy process holds out hope for entrepreneurs in organizations of all sizes to become agile, effective innovators.

Any resource-constrained organization needs a strategy that defines boundaries. Clarifying what is in and what is out of bounds ensures that experimentation is not rampant and is encouraged within those parameters. It helps firms identify the long-term attractiveness of possible business models or market spaces before testing their feasibility. By combining strategy and experimentation in such a fashion, all firms can greatly increase the odds of achieving lasting success.

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FURTHER READING

ARTICLES

Blue Ocean Strategy
by W. Chan Kim and Renée Mauborgne
HBR, October 2004
Product no. R0410D
A "blue ocean" is a previously unknown market space where demand is created rather than fought over, with ample opportunity for rapid and profitable growth. The authors share their observations from studying more than 150 blue-ocean creations and the strategic moves that helped those businesses build powerful brand equity.

Transient Advantage
by Rita Gunther McGrath
HBR, June 2013
Product no. R1306C
In today's turbulent environment, companies seeking sustainable competitive advantage can't afford to spend months crafting a single long-term strategy. They need a portfolio of transient advantages that can be built quickly and abandoned just as rapidly—which calls for a whole new playbook.

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Why the Lean Start-Up Changes Everything

by Steve Blank

LAUNCHING A NEW ENTERPRISE—whether it's a tech start-up, a small business, or an initiative within a large corporation—has always been a hit-or-miss proposition. According to the decades-old formula, you write a business plan, pitch it to investors, assemble a team, introduce a product, and start selling as hard as you can. And somewhere in this sequence of events, you'll probably suffer a fatal setback. The odds are not with you: As new research by Harvard Business School's Shikhar Ghosh shows, 75% of all start-ups fail.

But recently an important countervailing force has emerged, one that can make the process of starting a company less risky. It's a methodology called the "lean start-up," and it favors experimentation over elaborate planning, customer feedback over intuition, and iterative design over traditional "big design up front" development. Although the methodology is just a few years old, its concepts—such as "minimum viable product" and "pivoting"—have quickly taken root in the start-up world, and business schools have already begun adapting their curricula to teach them.

The lean start-up movement hasn't gone totally mainstream, however, and we have yet to feel its full impact. In many ways it is roughly

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where the big data movement was five years ago—consisting mainly of a buzzword that's not yet widely understood, whose implications companies are just beginning to grasp. But as its practices spread, they're turning the conventional wisdom about entrepreneurship on its head. New ventures of all kinds are attempting to improve their chances of success by following its principles of failing fast and continually learning. And despite the methodology's name, in the long term some of its biggest payoffs may be gained by the *large* companies that embrace it.

In this article I'll offer a brief overview of lean start-up techniques and how they've evolved. Most important, I'll explain how, in combination with other business trends, they could ignite a new entrepreneurial economy.

The Fallacy of the Perfect Business Plan

According to conventional wisdom, the first thing every founder must do is create a business plan—a static document that describes the size of an opportunity, the problem to be solved, and the solution that the new venture will provide. Typically it includes a five-year forecast for income, profits, and cash flow. A business plan is essentially a research exercise written in isolation at a desk before an entrepreneur has even begun to build a product. The assumption is that it's possible to figure out most of the unknowns of a business in advance, before you raise money and actually execute the idea.

Once an entrepreneur with a convincing business plan obtains money from investors, he or she begins developing the product in a similarly insular fashion. Developers invest thousands of man-hours to get it ready for launch, with little if any customer input. Only after building and launching the product does the venture get substantial feedback from customers—when the sales force attempts to sell it. And too often, after months or even years of development, entrepreneurs learn the hard way that customers do not need or want most of the product's features.

After decades of watching thousands of start-ups follow this standard regimen, we've now learned at least three things:

1. Business plans rarely survive first contact with customers. As the boxer Mike Tyson once said about his opponents' prefight strategies: "Everybody has a plan until they get punched in the mouth."

2. No one besides venture capitalists and the late Soviet Union requires five-year plans to forecast complete unknowns. These plans are generally fiction, and dreaming them up is almost always a waste of time.

3. Start-ups are not smaller versions of large companies. They do not unfold in accordance with master plans. The ones that ultimately succeed go quickly from failure to failure, all the while adapting, iterating on, and improving their initial ideas as they continually learn from customers.

One of the critical differences is that while existing companies *execute* a business model, start-ups *look* for one. This distinction is at the heart of the lean start-up approach. It shapes the lean definition of a start-up: a temporary organization designed to search for a repeatable and scalable business model.

The lean method has three key principles:

First, rather than engaging in months of planning and research, entrepreneurs accept that all they have on day one is a series of untested hypotheses—basically, good guesses. So instead of writing an intricate business plan, founders summarize their hypotheses in a framework called a *business model canvas*. Essentially, this is a diagram of how a company creates value for itself and its customers. (See the exhibit "Sketch Out Your Hypotheses.")

Second, lean start-ups use a "get out of the building" approach called *customer development* to test their hypotheses. They go out and ask potential users, purchasers, and partners for feedback on all elements of the business model, including product features, pricing, distribution channels, and affordable customer acquisition strategies. The emphasis is on nimbleness and speed: New ventures rapidly assemble minimum viable products and immediately elicit customer feedback. Then, using customers' input to revise their assumptions, they start the cycle over again, testing redesigned offerings and making further small adjustments (iterations) or more substantive ones (pivots) to ideas that aren't working. (See the exhibit "Listen to Customers.")

Third, lean start-ups practice something called *agile development,* which originated in the software industry. Agile development works hand-in-hand with customer development. Unlike typical yearlong product development cycles that presuppose knowledge of customers' problems and product needs, agile development eliminates wasted time

Sketch Out Your Hypotheses

The business model canvas lets you look at all nine building blocks of your business on one page. Each component of the business model contains a series of hypotheses that you need to test.

KEY PARTNERS

Who are our key partners?
Who are our key suppliers?
Which key resources are we acquiring from our partners?
Which key activities do partners perform?

KEY ACTIVITIES

What key activities do our value propositions require?
Our distribution channels?
Customer relationships?
Revenue streams?

KEY RESOURCES

What key resources do our value propositions require?
Our distribution channels?
Customer relationships?
Revenue streams?

VALUE PROPOSITIONS

What value do we deliver to the customer?
Which one of our customers' problems are we helping to solve?
What bundles of products and services are we offering to each segment?
Which customer needs are we satisfying?
What is the minimum viable product?

CUSTOMER RELATIONSHIPS

How do we get, keep, and grow customers?
Which customer relationships have we established?
How are they integrated with the rest of our business model?
How costly are they?

CHANNELS

Through which channels do our customer segments want to be reached?
How do other companies reach them now?
Which ones work best?
Which ones are most cost-efficient?
How are we integrating them with customer routines?

CUSTOMER SEGMENTS

For whom are we creating value?
Who are our most important customers?
What are the customer archetypes?

COST STRUCTURE

What are the most important costs inherent to our business model?
Which key resources are most expensive?
Which key activities are most expensive?

REVENUE STREAMS

For what value are our customers really willing to pay?
For what do they currently pay?
What is the revenue model?
What are the pricing tactics?

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and resources by developing the product iteratively and incrementally. It's the process by which start-ups create the minimum viable products they test. (See the exhibit "Quick, Responsive Development.")

When Jorge Heraud and Lee Redden started Blue River Technology, they were students in my class at Stanford. They had a vision of building robotic lawn mowers for commercial spaces. After talking to over 100 customers in 10 weeks, they learned their initial customer target—golf courses—didn't value their solution. But then they began to talk to farmers and found a huge demand for an automated way to kill weeds without chemicals. Filling it became their new product focus, and within 10 weeks Blue River had built and tested a prototype. Nine months later the start-up had obtained more than $3 million in venture funding. The team expected to have a commercial product ready just nine months after that.

Stealth Mode's Declining Popularity

Lean methods are changing the language start-ups use to describe their work. During the dot-com boom, start-ups often operated in "stealth mode" (to avoid alerting potential competitors to a market opportunity), exposing prototypes to customers only during highly orchestrated "beta" tests. The lean start-up methodology makes those concepts obsolete because it holds that in most industries customer feedback matters more than secrecy and that constant feedback yields better results than cadenced unveilings.

AT A GLANCE

THE IDEA IN BRIEF

Over the past few years, a new methodology for launching companies, called the "lean start-up," has begun to replace the old regimen.

Instead of executing business plans, operating in stealth mode, and releasing fully functional prototypes, young ventures are testing hypotheses, gathering early and frequent customer feedback, and showing "minimum viable products" to prospects. This new process recognizes that searching for a business model (which is the primary task facing a start-up) is entirely different from executing against that model (which is what established firms do).

Recently, business schools have begun to teach the methodology, which can also be learned at events such as Startup Weekend. Over time, lean start-up techniques could reduce the failure rate of new ventures and, in combination with other trends taking hold in the business world, launch a new, more entrepreneurial economy.

In most industries, customer feedback and constant feedback matter more than secrecy for start-ups.

Those two fundamental precepts crystallized for me during my career as an entrepreneur. (I've been involved with eight high-tech start-ups, as either a founder or an early employee.) When I shifted into teaching, a decade ago, I came up with the formula for customer development described earlier. By 2003 I was outlining this process in a course at the Haas School of Business at the University of California at Berkeley.

In 2004, I invested in a start-up founded by Eric Ries and Will Harvey and, as a condition of my investment, insisted that they take my course. Eric quickly recognized that waterfall development, the tech industry's traditional, linear product development approach, should be replaced by iterative agile techniques. He also saw similarities between this emerging set of start-up disciplines and the Toyota Production System, which had become known as "lean manufacturing." Eric dubbed the combination of customer development and agile practices the "lean start-up."

The tools were popularized by a series of successful books. In 2003, I wrote *The Four Steps to the Epiphany,* articulating for the first time that start-ups were not smaller versions of large companies and laying out the customer development process in detail. In 2010, Alexander Osterwalder and Yves Pigneur gave entrepreneurs the standard framework for business model canvases in *Business Model Generation.* In 2011 Eric published an overview in *The Lean Startup.* And in 2012 Bob Dorf and I summarized what we'd learned about lean techniques in a step-by-step handbook called *The Startup Owner's Manual.*

The lean start-up method is now being taught at more than 25 universities and through a popular online course at Udacity.com. In addition, in almost every city around world, you'll find organizations like Startup Weekend introducing the lean method to hundreds of prospective entrepreneurs at a time. At such gatherings a roomful of start-up teams can cycle through half a dozen potential product ideas in a matter of hours. Although it sounds incredible to people who haven't been to one, at these events some businesses are formed on a Friday evening and are generating actual revenue by Sunday afternoon.

Creating an Entrepreneurial, Innovation-Based Economy

While some adherents claim that the lean process can make individual start-ups more successful, I believe that claim is too grandiose. Success is predicated on too many factors for one methodology to guarantee that any single start-up will be a winner. But on the basis of what I've seen at hundreds of start-ups, at programs that teach lean principles, and at established companies that practice them, I can make a more important claim: Using lean methods across a portfolio of start-ups will result in fewer failures than using traditional methods.

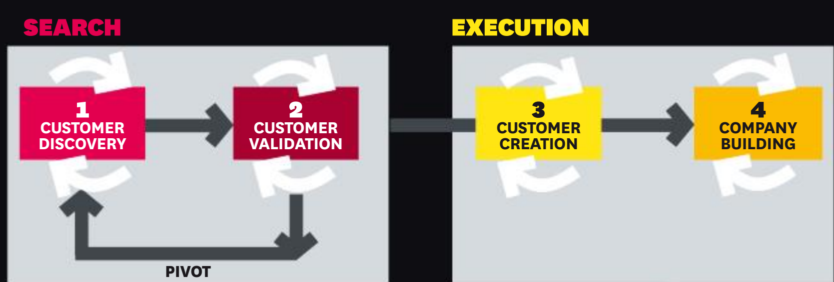
A lower start-up failure rate could have profound economic consequences. Today the forces of disruption, globalization, and regulation are buffeting the economies of every country. Established industries are rapidly shedding jobs, many of which will never return. Employment growth in the 21st century will have to come from new ventures, so we all have a vested interest in fostering an environment that helps them succeed, grow, and hire more workers. The creation of an innovation economy that's driven by the rapid expansion of start-ups has never been more imperative.

In the past, growth in the number of start-ups was constrained by five factors in addition to the failure rate:

1. The high cost of getting the first customer and the even higher cost of getting the product wrong.
2. Long technology development cycles.
3. The limited number of people with an appetite for the risks inherent in founding or working at a start-up.
4. The structure of the venture capital industry, in which a small number of firms each needed to invest big sums in a handful of start-ups to have a chance at significant returns.

Listen to Customers

During customer development, a start-up searches for a business model that works. If customer feedback reveals that its business hypotheses are wrong, it either revises them or "pivots" to new hypotheses. Once a model is proven, the start-up starts executing, building a formal organization. Each stage of customer development is iterative: A start-up will probably fail several times before finding the right approach.



1 Founders translate company ideas into business model hypotheses, test assumptions about customers' needs, and then create a "minimum viable product" to try out their proposed solution on customers.

2 Start-up continues to test all other hypotheses and tries to validate customers' interest through early orders or product usage. If there's no interest, the start-up can "pivot" by changing one or more hypotheses.

3 The product is refined enough to sell. Using its proven hypotheses, the start-up builds demand by rapidly ramping up marketing and sales spending, and scales up the business.

4 Business transitions from start-up mode, with a customer development team searching for answers, to functional departments executing its model.

5. The concentration of real expertise in how to build start-ups, which in the United States was mostly found in pockets on the East and West coasts. (This is less an issue in Europe and other parts of the world, but even overseas there are geographic entrepreneurial hot spots.)

The lean approach reduces the first two constraints by helping new ventures launch products that customers actually want, far more quickly and cheaply than traditional methods, and the third by making start-ups less risky. And it has emerged at a time when other business and technology trends are likewise breaking down the barriers to start-up formation. The combination of all these forces is altering the entrepreneurial landscape.

Today open source software, like GitHub, and cloud services, such as Amazon Web Services, have slashed the cost of software development from millions of dollars to thousands. Hardware start-ups no longer have to build their own factories, since offshore manufacturers are so easily accessible. Indeed, it's become quite common to see young tech companies that practice the lean start-up methodology offer software products that are simply "bits" delivered over the web or hardware that's built in China within weeks of being formed. Consider Roominate, a start-up designed to inspire girls' confidence and interest in science, technology, engineering, and math. Once its founders had finished testing and iterating on the design of their wired dollhouse kit, they sent the specs off to a contract manufacturer in China. Three weeks later the first products arrived.

Another important trend is the decentralization of access to financing. Venture capital used to be a tight club of formal firms clustered near Silicon Valley, Boston, and New York. In today's entrepreneurial ecosystem, new super angel funds, smaller than the traditional hundred-million-dollar-sized VC fund, can make early-stage investments. Worldwide, hundreds of accelerators, like Y Combinator and TechStars, have begun to formalize seed investments. And crowdsourcing sites like Kickstarter provide another, more democratic method of financing start-ups.

The instantaneous availability of information is also a boon to today's new ventures. Before the internet, new company founders got advice only as often as they could have coffee with experienced investors or entrepreneurs. Today the biggest challenge is sorting through the

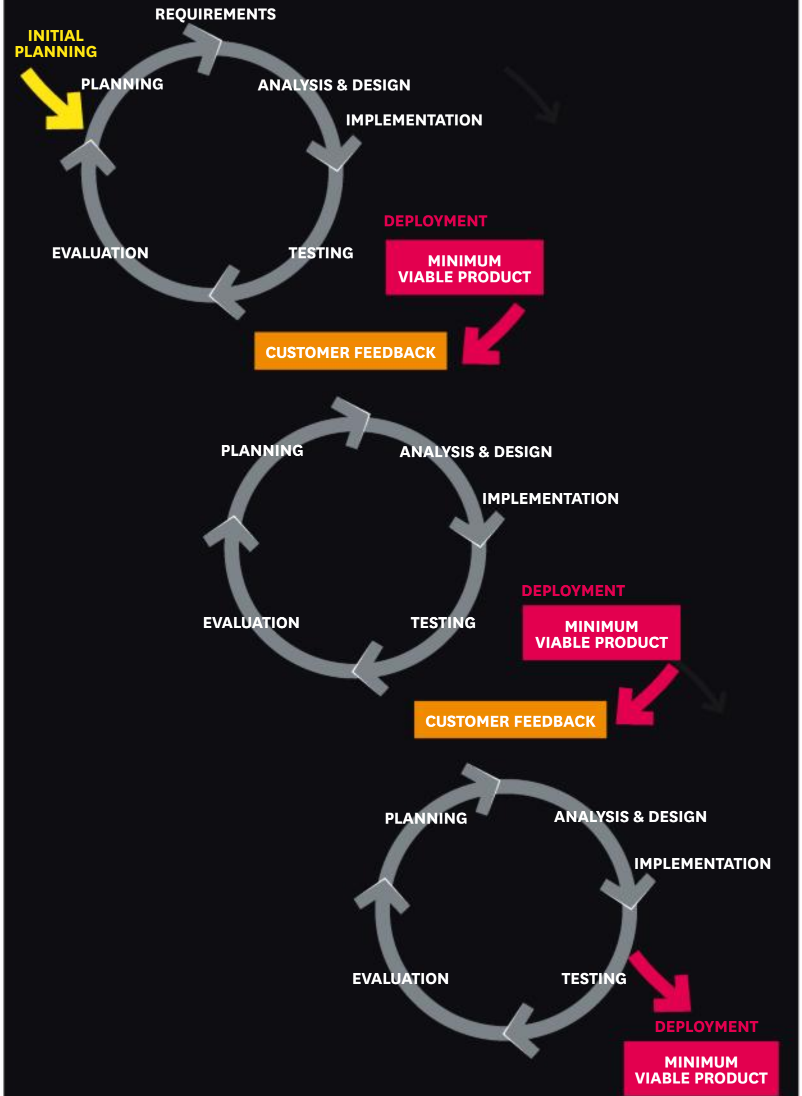
What Lean Start-Ups Do Differently

The founders of lean start-ups don't begin with a business plan; they begin with the search for a business model. Only after quick rounds of experimentation and feedback reveal a model that works do lean founders focus on execution.

	Lean	Traditional
Strategy	Business Model Hypothesis-driven	Business Plan Implementation-driven
New-Product Process	Customer Development Get out of the office and test hypotheses	Product Management Prepare offering for market following a linear, step-by-step plan
Engineering	Agile Development Build the product iteratively and incrementally	Agile or Waterfall Development Build the product iteratively, or fully specify the product before building it
Organization	Customer and Agile Development Teams Hire for learning, nimbleness, and speed	Departments by Function Hire for experience and ability to execute
Financial Reporting	Metrics That Matter Customer acquisition cost, lifetime customer value, churn, viralness	Accounting Income statement, balance sheet, cash flow statement
Failure	Expected Fix by iterating on ideas and pivoting away from ones that don't work	Exception Fix by firing executives
Speed	Rapid Operates on good-enough data	Measured Operates on complete data

Quick, Responsive Development

In contrast to traditional product development, in which each stage occurs in linear order and lasts for months, agile development builds products in short, repeated cycles. A start-up produces a "minimum viable product"—containing only critical features—gathers feedback on it from customers, and then starts over with a revised minimum viable product.



overwhelming amount of start-up advice they get. The lean concepts provide a framework that helps you differentiate the good from the bad.

Lean start-up techniques were initially designed to create fast-growing tech ventures. But I believe the concepts are equally valid for creating the Main Street small businesses that make up the bulk of the economy. If the entire universe of small business embraced them, I strongly suspect it would increase growth and efficiency, and have a direct and immediate impact on GDP and employment.

There are signs that this may in fact happen. In 2011 the U.S. National Science Foundation began using lean methods to commercialize basic science research in a program called the Innovation Corps. Eleven universities now teach the methods to hundreds of teams of senior research scientists across the United States.

MBA programs are adopting these techniques, too. For years they taught students to apply large-company approaches—such as accounting methods for tracking revenue and cash flow, and organizational theories about managing—to start-ups. Yet start-ups face completely different issues. Now business schools are realizing that new ventures need their own management tools.

As business schools embrace the distinction between management execution and searching for a business model, they're abandoning the business plan as the template for entrepreneurial education. And the business plan competitions that have been a celebrated part of the MBA experience for over a decade are being replaced by business model competitions. (Harvard Business School became the latest to make this switch, in 2012.) Stanford, Harvard, Berkeley, and Columbia are leading the charge and embracing the lean start-up curriculum. My Lean LaunchPad course for educators is now training over 250 college and university instructors a year.

A New Strategy for the 21st-Century Corporation

It's already becoming clear that lean start-up practices are not just for young tech ventures.

Corporations have spent the past 20 years increasing their efficiency by driving down costs. But simply focusing on improving existing business models is not enough anymore. Almost every large company understands that it also needs to deal with ever-increasing external threats by continually innovating. To ensure their survival and growth, corporations need to keep inventing new business models. This challenge requires entirely new organizational structures and skills.

Over the years managerial experts such as Clayton Christensen, Rita McGrath, Vijay Govindarajan, Henry Chesbrough, Ian MacMillan, Alexander Osterwalder, and Eric von Hippel have advanced the thinking on how large companies can improve their innovation processes. During the past three years, however, we have seen large companies, including General Electric, Qualcomm, and Intuit, begin to implement the lean start-up methodology.

Lean start-up practices aren't just for young tech ventures. Large companies, such as GE and Intuit, have begun to implement them.

GE's Energy Storage division, for instance, is using the approach to transform the way it innovates. In 2010 Prescott Logan, the general manager of the division, recognized that a new battery developed by the unit had the potential to disrupt the industry. Instead of preparing to build a factory, scale up production, and launch the new offering (ultimately named Durathon) as a traditional product extension, Logan applied lean techniques. He started searching for a business model and engaging in customer discovery. He and his team met face-to-face with dozens of global prospects to explore potential new markets and applications. These weren't sales calls: The team members left their PowerPoint slides behind and listened to customers' issues and frustrations with the battery status quo. They dug deep to learn how customers bought industrial batteries, how often they used them, and the operating conditions. With this feedback, they made a major shift in their customer focus. They eliminated one of their initial target segments, data centers, and discovered a new one—utilities. In addition, they narrowed the broad customer segment of "telecom" to cell phone providers in developing countries with unreliable electric grids. Eventually GE invested $100 million to build a world-class battery manufacturing facility in Schenectady, New York, which it opened in 2012. According to press reports, demand for the new batteries is so high that GE is already running a backlog of orders.

THE FIRST HUNDRED YEARS of management education focused on building strategies and tools that formalized execution and efficiency for existing businesses. Now, we have the first set of tools for searching for new business models as we launch start-up ventures. It also happens to have arrived just in time to help existing companies deal with the forces of continual disruption. In the 21st century those forces will make people in every kind of organization—start-ups, small businesses, corporations, and government—feel the pressure of rapid change. The lean start-up approach will help them meet it head-on, innovate rapidly, and transform business as we know it.

Steve Blank is an adjunct professor at Stanford University, a lecturer at the University of California at Berkeley, and a Senior Fellow at Columbia University. He has participated in eight high-tech start-ups as either a cofounder or an early employee.

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FURTHER READING

ARTICLES

What Is Disruptive Innovation?
by Clayton M. Christensen, Michael Raynor, and Rory McDonald
HBR, December 2015
Product no. R1512B
Over the past 20 years, the theory of disruptive innovation has been enormously influential—and widely misunderstood. Here, Christensen and his coauthors correct some of the misinformation, describe how thinking on the subject has evolved, and discuss the theory's utility.

Reigniting Growth
by Chris Zook and James Allen
HBR, March 2016
Product no. R1603F
Stall-out occurs when the growth engine that powered a company to success stops working. But it can be overcome. The authors share the attitudes and behaviors that companies need to achieve sustainable growth.

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MANAGING THE BUSINESS

Six Myths About **Venture Capitalists**

by Diane Mulcahy

STEVE JOBS, MARK ZUCKERBERG, SERGEY BRIN: We celebrate these entrepreneurs for their successes, and often equally extol the venture capitalists who backed their start-ups and share in their glory. Well-known VC firms such as Kleiner Perkins and Sequoia have cultivated a branded mystique around their ability to find and finance the most successful young companies. Forbes identifies the top individual VCs on its Midas List, implicitly crediting them with a mythical magic touch for investing. The story of venture capital appears to be a compelling narrative of bold investments and excess returns.

The reality looks very different. Behind the anecdotes about Apple, Facebook, and Google are numbers showing that many more venture-backed start-ups fail than succeed. And VCs themselves aren't much better at generating returns. For more than a decade the stock markets have outperformed most of them, and since 1999 VC funds on average have barely broken even.

The VC industry wouldn't exist without entrepreneurs, yet entrepreneurs often feel as if they're in the backseat when it comes to dealing with VCs. For someone who's starting (or thinking of starting) a company, the myths surrounding venture capital can be powerful. In this article

Originally published in May 2013

I will challenge some common ones in order to help company founders develop a more realistic sense of the industry and what it offers.

MYTH 1

Venture Capital Is the Primary Source of Start-Up Funding

Venture capital financing is the exception, not the norm, among start-ups. Historically, only a tiny percentage (fewer than 1%) of U.S. companies have raised capital from VCs. And the industry is contracting: After peaking in the late 1990s, the number of active VC firms fell from 744 to 526 in the decade 2001–2011, and the amount of venture capital raised was just under $19 billion in 2011, down from $39 billion in 2001, according to the National Venture Capital Association (NVCA).

But less venture capital doesn't mean less start-up capital. Non-VC sources of financing are growing rapidly and giving entrepreneurs many more choices than in the past. Angel investors—affluent individuals who invest smaller amounts of capital at an earlier stage than VCs do—fund more than 16 times as many companies as VCs do, and their share is growing. In 2011 angels invested more than $22 billion in approximately 65,000 companies, whereas venture capitalists invested about $28 billion in about 3,700 companies. AngelList, an online platform that connects start-ups with angel capital, is one example of the enormous growth in angel financing. Since it launched, in 2010, more than 2,000 companies have raised capital using the platform, and start-ups now raise more than $10 million a month there. (Disclosure: The Kauffman Foundation is an investor in AngelList.)

Another new source of start-up investment is crowdfunding, whereby entrepreneurs raise small amounts of capital from large numbers of people in exchange for nonequity rewards such as products from the newly funded company. Kickstarter reports that more than 18,000 projects raised nearly $320 million through its platform in 2012—triple the amount raised in 2011. Passage of the JOBS (Jumpstart Our Business Startups) Act last year promises to support even faster growth by allowing crowdfunders to invest in exchange for equity and by expanding the pool of investors who can participate.

MYTH 2
VCs Take a Big Risk When They Invest in Your Start-Up

VCs are often portrayed as risk takers who back bold new ideas. True, they take a lot of risk with their *investors'* capital—but very little with their own. In most VC funds the partners' own money accounts for just 1% of the total. The industry's revenue model, long investment cycle, and lack of visible performance data make VCs less accountable for their performance than most other professional investors. If a VC firm invests in your start-up, it will be rooting for you to succeed. But it will probably do just fine financially even if you fail.

Why? Because the standard VC fund charges an annual fee of 2% on committed capital over the life of the fund—usually 10 years—plus a percentage of the profits when firms successfully exit, usually by being acquired or going public. So a firm that raised a $1 billion fund and charged a 2% fee would receive a fixed-fee stream of $20 million *a year* to cover expenses and compensation. VC firms raise new funds about every three or four years, so let's say that three years into the first fund, the firm raised a second $1 billion fund. That would generate an additional $20 million in fees, for a total of $40 million annually. These cumulative and guaranteed management fees insulate VC partners from poor returns because much of their compensation comes from fees. Many partners take home compensation in the seven figures regardless of the fund's investment performance. Most entrepreneurs have no such safety net.

Other investment professionals often face far greater performance pressure. Consider mutual fund managers, whose fund performance is reported daily, whose investors can withdraw money at any time, and who are often replaced for underperformance. VC performance is ultimately judged at the end of a fund's 10-year life, so venture capitalists are free from the level of accountability that's common in other investment realms. They take on less personal risk than angel investors or crowdfunders, who use their own capital. And all investors take fewer risks than most entrepreneurs, who put much of their net worth and all of their earning capacity into their start-ups.

FURTHER READING

ARTICLE

How to Write a Great Business Plan
by William A. Sahlman
HBR, July–August 1997
Product no. 97409
Rather than focusing on financial projections, a great business plan considers a series of questions relating to the four factors critical to the success of every new venture: the people, the opportunity, the context, and the possibilities for both risk and reward.

BOOK

Get Backed
Craft Your Story, Build the Perfect Pitch Deck, and Launch the Venture of Your Dreams
by Evan Baehr and Evan Loomis
Harvard Business Review Press, November 2015
Product no. 15004E
Here is a handbook for anyone who has an idea and needs to build relationships to get it off the ground. Learn the secrets of the world's best storytellers, fundraisers, and start-up accelerators.

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MYTH 3
Most VCs Offer Great Advice and Mentoring

A common VC pitch to entrepreneurs is that the firm brings much more than money to the table: It offers experience, operational and industry expertise, a broad network of relevant contacts, a range of services for start-ups, and a strong track record of successful investing.

In some cases those nonmonetary resources really are valuable. But VCs vary tremendously—both as firms and as individuals—in how much effort they put into advising and assisting portfolio companies. Among those who do mentor their CEOs, ability and the quality of advice can differ widely. There are no solid data about the industry's delivery on this mentoring promise. But if you asked the CEOs of 100 VC-funded companies how helpful their VCs are, some would say they're fabulous, some would say they're active but not a huge help, and some would say they do little beyond writing checks. This last group isn't necessarily bad, of course: Some CEOs may be happy to skip the mentoring and just take the cash. But for founders who have bought into the idea that VCs provide lots of value-added help, it can be a source of great disappointment.

The best way to determine whether a VC firm or partner brings resources other than capital to the table is to conduct your own due diligence, just as you'd do a thorough reference check on a key hire. Talk with the CEOs of the firm's other portfolio companies and ask if the partner is accessible, how much he or she adds to boardroom discussion, and whether the CEO has received constructive help in dealing with company problems. Ask about resources the firm offers—PR, recruiting, and so forth—and whether those have been useful.

Some questions you should ask the VC firm directly, such as: Whom does it intend to put on your board? Is the person a partner or an associate? Does the person have any experience (or any other portfolio companies) in your industry? On how many other boards does he or she serve? Asking such questions may seem like common sense, but it's shocking how few company founders actually make the necessary calls before signing up for a long-term relationship with a VC. If part of what makes a firm attractive is that it offers expertise, mentoring, and services, the entrepreneur needs to confirm that both the firm and the partner have a track record of delivering them.

MYTH 4
VCs Generate Spectacular Returns

Last year my colleagues at the Kauffman Foundation and I published a widely read report, "We Have Met the Enemy...and He Is Us," about the venture capital industry and its returns. We found that the overall performance of the industry is poor. VC funds haven't significantly outperformed the public markets since the late 1990s, and since 1997 less cash has been returned to VC investors than they have invested. A tiny group of top-performing firms do generate great "venture rates of return": at least twice the capital invested, net of fees. We don't know definitively which firms are in that group, because performance data are not generally available and are not consistently reported. The average fund, however, breaks even or loses money.

We analyzed the Kauffman Foundation's experience investing in nearly 100 VC funds over 20 years. We found that only 20 of our funds outperformed the markets by the 3% to 5% annually that we expect to compensate us for the fees and illiquidity we incur by investing in private rather than public equity. Even worse, 62 of our 100 funds failed to beat the returns available from a small-cap public index.

Venture capital investments are generally perceived as high-risk and high-reward. The data in our report reveal that although investors in VC take on high fees, illiquidity, and risk, they rarely reap the reward of high returns. Entrepreneurs who are distressed when VCs decline to fund their ventures need only review the performance data to see that VCs as a group have no Midas touch for investing.

MYTH 5
In VC, Bigger Is Better

Venture capital in the United States began as a cottage industry, notable in the early years for investments in companies such as Intel, Microsoft, and Apple. In 1990, 100 VC firms were actively investing, with slightly less than $30 billion under management, according to the NVCA. During that era venture capital generated strong, above-market returns, and performance by any measure was good. What happened? During the peak of the internet boom, in 2000, the number of active firms grew to more than 1,000, and assets under management exceeded $220 billion. VC didn't scale well. As in most asset classes, when the money flooded in, returns fell, and venture capital has not yet recovered. The number of firms and the amount of capital have declined since the boom, though they are both still far above the levels of the early and middle 1990s.

What's true for the industry is also true for individual funds: Bigger isn't better. Company founders often feel that signing a deal with a large VC firm lends cachet, just as MBA students may get special pleasure from being offered a job by a big, well-known employer. But industry and academic studies show that fund performance declines as fund size increases above $250 million. We found that the VC funds larger than $400 million in Kauffman's portfolio generally failed to provide attractive returns: Just four out of 30 outperformed a publicly traded small-cap index fund.

ARTICLE

AT A GLANCE

THE IDEA IN BRIEF

Entrepreneurs often feel like they're at the mercy of powerful venture capitalists. Here, the author gives company founders a more realistic sense of the industry.

For one thing, other sources of backing are available to entrepreneurs, like angel investors and crowdfunding. And don't assume VCs are taking big risks with your company or can offer great advice; in fact, VC partners are protected by large management fees, and their efforts at mentoring can vary greatly. Bigger isn't necessarily better: The truth is that overall performance of the VC industry is poor, and studies show that fund performance declines as fund size increases above $250 million. VCs may back innovators, but the industry itself hasn't seen innovation in 20 years.

The historical balance of power is shifting; entrepreneurs now have more choices and can use this new perspective in negotiating with VCs.

MYTH 6
VCs Are Innovators

It's ironic that VC firms position themselves as supporters, financers, and even instigators of innovation, yet the industry itself has been devoid of innovation for the past 20 years. Venture capital has seen plenty of changes over time—more funds, more money, bigger funds, declining returns—but funds are structured, capital is raised, and partners are paid just as they were two decades ago. Any innovation in financing start-ups, such as crowdfunding and platforms like AngelList and SecondMarket, has come from outside the VC industry.

THE STORY of venture capital is changing. Entrepreneurs have more choices for financing their companies, shifting the historical balance of power that has too long tilted too far toward VCs. Entrepreneurs will enjoy a different view as they move from the backseat into the driver's seat in negotiating with VCs. An emerging group of "VC 2.0" firms are going back to raising small funds and focusing on generating great returns rather than large fees. And the industry's persistent underperformance is finally causing institutional investors to think twice before investing in venture capital. As a result, VCs will continue to play a significant, but most likely smaller, role in channeling capital to disruptive start-ups.

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MANAGING THE BUSINESS

How to **Negotiate with VCs**

The term sheet is just the beginning. Here's how to maximize value for the long run.

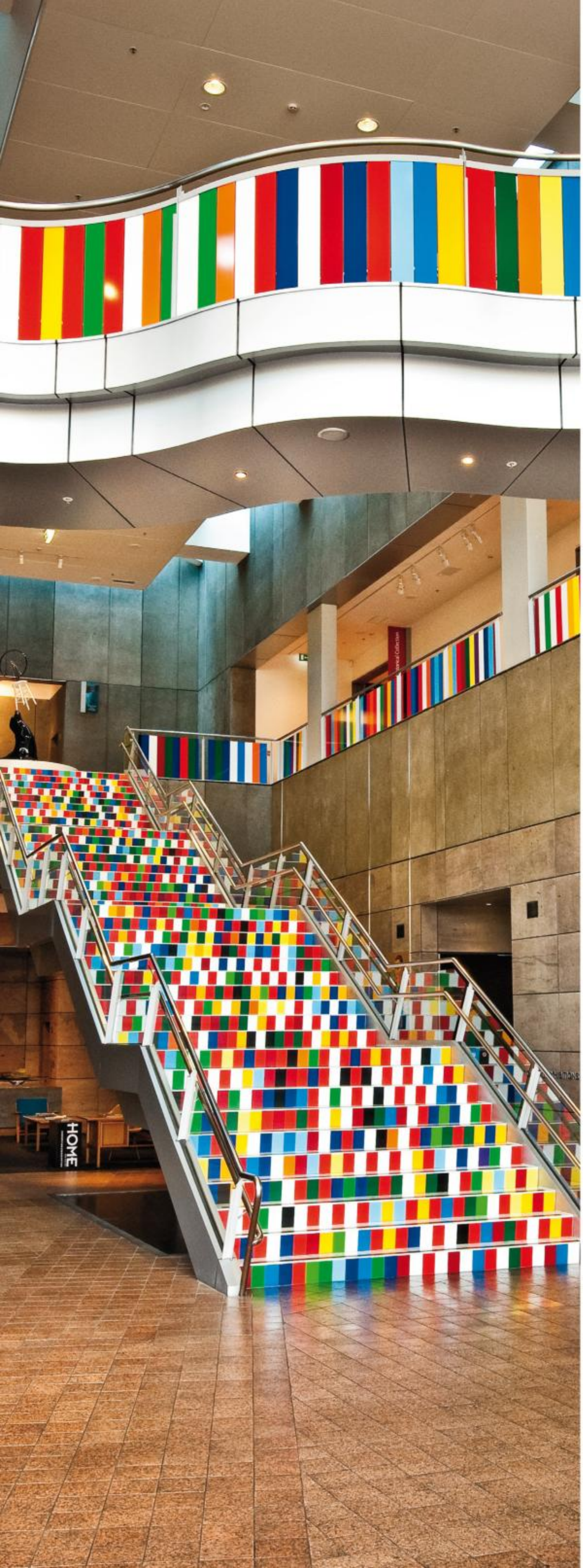
by Deepak Malhotra

A FEW YEARS AGO a venture capital firm hired me to help one of its start-ups negotiate a critical deal. I expected the VC partner who was on the start-up's board to be deeply involved in the strategic discussions. But the VC in question—ordinarily a hands-on dealmaker—was conspicuously uninvolved. His advice and support would have been useful to the founders, especially with respect to opening doors with governments and potential partners overseas, so one day I asked him about his seeming lack of interest.

He described the scene a year earlier, just after his firm had decided to invest in the start-up. "There was a lot of interest in this company, and the founders had a fair amount of leverage. They used every ounce of it to extract a higher valuation," he said. "We kept saying that our firm would bring a lot more to the table than money, and that the mentoring, strategic advice, network resources, and political capital we could offer were almost unmatched. The founders set all that aside and made it about the money. It left a bad taste in our mouth. The deal was still worth doing—barely. But we have less of an equity stake in the company than we would ordinarily want, and given all the other portfolio companies that need my attention, I don't feel any obligation or desire to give these guys additional assistance."

Originally published in May 2013

Artist: Sara Hughes; Photography: courtesy of the artist and Gow Langsford Gallery



In retrospect, the entrepreneurs at the start-up made a costly mistake: Either they undervalued the nonmonetary resources the VC firm had to offer, or they assumed that mentoring and strategic support would inevitably be available. In either case, they negotiated a deal that looked great on day one but proved to be perilously misguided in hindsight.

This happens more often, and in many more ways, than you might think—which is unfortunate, given how valuable and transformative a VC deal can be for entrepreneurs. Few business negotiations contain the degree of high stakes, uncertainty, and emotion present when company founders negotiate with venture capitalists. On the one hand, reaching agreement on a term sheet—the document that lays out how much equity and control a VC will have in return for its cash—is all about assigning rights, carving out protections, and haggling over claims to future returns. On the other hand, these negotiations are fundamentally about picking the right long-term partner and forging a relationship that can survive the inevitable disappointments, resolve the unforeseen conflicts, and monetize the mutually earned successes to come.

I study negotiations in a wide range of circumstances and in recent years have taken a special interest in those between entrepreneurs and their strategic partners, including VCs. As a business school professor, I'm often asked for advice by students and alumni who are launching companies. And for many years I've consulted prominent VC firms, helping them and their portfolio companies with negotiations. These experiences provide a unique lens through which to observe deal-making successes and failures, and the stories in this article are taken from that work (the examples are anonymous, in order to preserve confidentiality). One of the biggest lessons I've drawn from my work is that even skilled negotiators can make costly mistakes. In the pages that follow I'll describe some of those mistakes, exploring why they happen, what they can teach us, and how to avoid them.

Before we begin, let me make three important points. First, this article is not the place to start learning the basics of negotiation, a broad topic on which there are many resources. Second, it does not attempt to introduce all the intricacies of the venture capital industry, which has its own language, protocols, and idiosyncrasies. Third, for any large or complex negotiation with a venture capitalist, you should consult a lawyer experienced in structuring VC deals. Term sheets can be difficult to understand, and you may need help determining what the various provisions—liquidation preference, antidilution protection, pay to play, drag along rights, vesting schedules, no-shop clauses, and so on—imply for your current and future rights and obligations. At the very least, you should contact other companies in the VC firm's portfolio to find out what was negotiable, why they made the choices they did, and what terms were the most consequential in the months and years after the deal.

Given the considerable resources, financial and otherwise, that a VC can bring to the table, these deals can be tremendous assets—but only if they're done well. That means, above all, thinking not just about what will look good in a press release today but also about what will help you create and capture value over the long run. Only with that mind-set can you strike a deal that takes full advantage of your *leverage*, build a relationship based on mutual *trust*, draft a contract that optimizes *value* (not just valuation), and reach a level of *understanding* that ensures that each party will be adequately rewarded for future success. Let's consider each element in turn.

Understand Your Leverage

There are few things dealmakers worry about more than figuring out who has greater leverage and how best to use whatever power they have. It is surprising, then, that they so often ignore crucial sources of power or put themselves in unnecessarily weak positions. This is as true in VC negotiations as anywhere.

One of the most obvious variables in any negotiation is the attractiveness of your alternatives to the deal. In the context of a potential VC deal, the more firms that are interested in your start-up, the more leverage you have. And although you should avoid squeezing long-term partners to their bottom dollar, as the start-up in the opening example did, you should certainly leverage your alternatives to fight for terms that are important to you. Once the deal is signed, discarded alternatives will carry little weight, and any leverage you'll have going forward must come from other sources. Many entrepreneurs worry too much about the amount of power they have when negotiating the term sheet and too little about the amount they'll have after the deal is done.

I recently worked with an early-stage tech company that discovered it would run out of cash in three or four months—much sooner than it had projected, and too early in the product development process. Its initial impulse was to solve the problem by fast-tracking a strategic partnership with a large company that would pay an up-front licensing fee for its technology. But it quickly became clear that it would be unwise to make such an arrangement before the company was further along with development, and so the start-up was forced to explore another round of VC financing.

Perhaps because the start-up was running out of cash and had few options, the one VC firm that was interested offered a low valuation (that is, it would ascribe a low value to the company's current worth) and a big investment. The combination would have squeezed the founders' equity considerably. The CEO declined the offer and decided to pursue his third option: to ask for a bridge loan from his current VC. Bridge loans are often perceived as the "pay day loans" of the VC industry, a last-resort form of short-term financing that generally carries onerous terms. This case was no different: Although sympathetic to the start-up's plight, the VC had to protect his own investment, and the loan would come with a significant dilution of management's equity.

The "running out of cash" problem is not uncommon. Founders often have too much confidence in their business model, too little ability to forecast their burn rate, and too little willingness to give up equity. As a result, they may fail to take in enough money during early rounds of funding.

This start-up might have avoided the prospect of selling equity on the cheap if it had accepted more cash (and sold more equity) during the first round of financing—when it had numerous alternatives and could have commanded a better price. Many founders have discovered that doing a slightly bigger first round than seems necessary—or perhaps negotiating an acceptable formula for future bridge loans at the outset—can pay off in the long run: It's bad when you have few options, but considerably worse when you are running out of options *and* out of money.

The story has an unexpectedly happy ending, one that contains another lesson on identifying and leveraging sources of power even when you're out of money and seemingly out of options as well. The CEO went back to the VC with a different approach, focusing less on his own desperation and more on the VC's interests. He made a simple but elegant case: "Yes, we screwed up, and you have the power to squeeze us on equity. But let's think about what will happen next. How many top people will stay if we dilute their equity positions? Is the premium you'll get worth the potential hit to management morale and firm success?" He persuaded the VC that forcing him to accept harsh terms could be a Pyrrhic victory, because an equity dilution could cause the start-up to falter or even fail, zeroing out the VC's investment. The VC agreed to provide the money, albeit in installments tied to milestones, with no dilution of equity.

This incident is a great illustration of how negotiators who wish to maximize their leverage need to avoid focusing too narrowly on their own options (or lack thereof) and should instead try to fully evaluate the other side's interests. In this case the CEO changed the discussion from whether the VC could leverage the start-up's weak position in order to meet short-term goals to whether doing so would actually achieve the VC's ultimate goals. If you understand the other party's long-term interests and can find an approach that will serve them, you will have leverage even in the absence of attractive alternatives. Fundamentally, power in negotiation is about what you bring to the table that has value for the other side—which means you need to spend a fair amount of time understanding what the other side cares about, worries about, and hopes for.

Maximize Trust

A successful serial entrepreneur told me about a day he spent agonizing over whether to call a VC with whom he was about to close a $10 million financing round. When he had pitched the

VC, a month earlier, his business was gaining momentum, and he had laid out ambitious financial targets. Since then, however, a major strategic partnership suddenly seemed less secure, it appeared that the start-up's pricing strategy might not be working, and a key employee was on the verge of leaving. Although he had no legal obligation to reveal these developments before the close, he did feel a moral obligation, but he worried that the VC would change his offer or walk away from the deal.

Finally the entrepreneur picked up the phone. "This is either going to be the start of a very trusting relationship or the end of the dialogue between us," he said. He held nothing back as he shared the bad news. To his surprise, the VC reacted positively: He didn't pull the plug or try to renegotiate the terms. I later asked the VC why he chose not to factor the developments into the deal terms, as he surely would have had they been known at the start. "That type of phone call is not usually made," he said. "Usually after we make an investment, we wait for what we call the first 'Oh, s---' board meeting, where we learn about something that was not disclosed during the pitch. The founder's full disclosure changed my perspective on him as a person more than it changed my perspective on the company or its prospects. To recut the deal would have reinforced the notion that he will be punished for delivering bad news."

It's hard to overstate the extent to which VCs put a premium on trust—or the extent to which untrustworthy behavior can derail negotiations. Another VC told me about a founder with whom he'd been in conversations about a potential investment. The founder had made no secret of the fact that he was also in talks with another investor, saying he would prefer this relationship but wasn't ready to accept the current terms. The VC offered to make some significant concessions if that would seal the deal. The founder said it would, and the two men shook hands, agreeing that they had a deal. A few days later the VC learned that the founder was shopping the revised offer around. The VC called him and told him the deal was off—he was no longer willing to invest in the company. Multiple apologies from the founder and numerous interventions from his board members failed to change the VC's mind.

VCs expect you to ask for better terms, to comparison shop, and to use whatever leverage you have—but not *after* you have reached an agreement. It may seem obvious that this founder acted unwisely and unethically, but in the fevered pitch of deal making, even smart and well-intentioned people can lose sight of the fact that beneath all the term sheets and financial projections, the VC negotiation is a process in which people are deciding with whom they want to associate for years to come. In VC relationships, as in any long-term partnership, it's much easier to build trust than to rebuild it. If you find you've settled on terms without sufficient consideration or have made commitments you cannot keep, you're better off playing it straight: "I think I may have agreed to something I'm not actually comfortable with." That will be an awkward conversation, and the VC may not be willing to reopen the discussion. But odds are you'll have a better outcome than if you renege on promises when they become costly or inconvenient. Venture capital is a small industry, and, as one entrepreneur puts it, "In my line of work, you don't have a CV. You just have your reputation."

THE IDEA IN BRIEF

Few business negotiations contain the degree of high stakes, uncertainty, and emotion present when company founders negotiate with venture capitalists.

Even experienced negotiators in this situation make mistakes—most of them systematic and predictable. To avoid them, founders should go into the discussion with a focus on optimizing four important variables: leverage, trust, value (not just valuation), and understanding.

Unlike in many negotiations, VCs and founders will need to work together for years after the term sheet is signed. That fact requires both sides to focus on multiple outcome scenarios and to understand how each party can help the other create and capture value over the long term.

Focus on Value (Not Just Valuation)

In simple negotiations, focusing on a single, top-line number sometimes makes sense: If you're selling your house, for instance, you might not even meet the buyers, and despite issues such as inspections, financing contingencies, and the closing date, the selling price is far and away the top priority. In many other negotiations, though, the signed contract is just the beginning of a relationship. In these situations it can be a mistake to focus too narrowly on price and not enough on drivers of long-term value. When negotiating a job offer, for example, people tend to obsess over the starting compensation, but factors such as geography, responsibilities, prospects for learning and advancement, and even length of commute can have a greater impact on their enduring happiness and success.

VC negotiations may exhibit the greatest disparity of any type of deal between how much people *should* focus on a single factor and how much they actually *do* focus on it. The factor that gets disproportionate attention is valuation. This is the metric that will be reported in *TechCrunch*, and it's what your friends (and "frenemies") will ask about when they take you out for drinks to celebrate the deal. But other terms may be far more important, especially if you hope to play a long-term role at the company.

More than one VC has identified this shortsighted emphasis as founders' biggest mistake. "They focus too much on valuation and not enough on control," one VC told me. "It's amazing how much control founders are willing to sacrifice in order to obtain a \$4 million valuation instead of \$3.5 million. These numbers don't matter much in the long run, but the impact of diminished control can last forever." The tendency is especially remarkable when you consider the passion most founders have for what they are trying to create, for their company's mission, and for their vision of its future. Once founders have sacrificed board control or ceded voting rights on too broad a category of decisions, those decisions are, of course, technically out of their hands. Most VCs are very reluctant to use their control rights to contravene the wishes and objectives of management, but if conflict or a breakdown in trust between management and the board occurs, founders may find themselves severely constrained, if not replaced.

None of this means you should ignore valuation—it's an important consideration. But it's a mistake to confuse it with value, given that most founders also care a lot about factors such as their role, prestige, self-identity, and autonomy. To maximize valuation without regard for nonfinancial considerations is to sign something of a Faustian bargain.

Strive for Understanding

Even when control is not the concern, you ought to pay close attention to terms other than valuation; there are additional provisions that can have a huge impact on how much money you'll eventually see. And if you look at them carefully, the terms a VC firm proposes can help you understand its unspoken concerns and assessments of your start-up's future.

Let's consider an example involving two of the items often spelled out on a term sheet—*liquidation preference* and *participation*. Liquidation preference gives a VC firm the right, at the point of sale or at another liquidity event, to recoup its investment (or a set multiple of it) before the founder takes any return. Participation refers to whether the VC is entitled to a share of the value that remains once the liquidation preference has been paid out. Liquidation preferences are often set at one to two times the size of the investment, and participation can range from none to full.

Imagine that a VC invests $2 million for a 20% stake in a start-up—implying a valuation of $10 million. She negotiates a 2x liquidation preference and full participation rights. This means that if the company is sold for $14 million, she'll receive twice her investment ($4 million) plus 20% of the remaining $10 million ($2 million), for a total of $6 million. In other words, she'll receive almost 43% of the sale price, even though her equity stake was only 20%. Note that the $10 million valuation in itself has little bearing on how the wealth is ultimately distributed. Even the same $2 million investment on a much lower valuation—say, $8 million—would hardly alter the final distribution; that figure would give the VC 46% of the sale price. It's a stark reminder that if you focus only on valuation when you're negotiating a deal, you could be fighting for something that might not, at the end of the day, give you what you want.

Imagine that the same company is sold for $200 million. The VC again takes $4 million to cover the liquidation preference, but now that's a tiny percentage of the sale price; most of her return—$39.2 million of $43.2 million—comes from her full participation. And she gets only 21.6% of the sale price—much closer to the proportion of her equity stake.

These scenarios show that liquidation preference, which is designed to protect a VC's up-front investment, tends to have a big impact on how much wealth is transferred to the VC if the company enjoys moderate success but has much less impact if the company performs spectacularly. If you think about these issues carefully during a negotiation, you will discover that a VC's preferences about such terms can reveal his interests and his assessment of a company's prospects. A VC who insists on enhancing the liquidation preference may believe that the valuation proposed by the founders is too high. The liquidation preference serves as an insurance policy that protects the VC's downside risk from founder overconfidence. Think of it this way: If a founder receives a high valuation in exchange for a high liquidation preference, the liquidation preference constitutes a side bet between the VC and the founder regarding whose expectations are more accurate.

Participation is more like a lottery ticket than an insurance policy. If a firm hits it big, participation gives the VC a huge windfall—so a VC who focuses on full participation may be projecting optimism about the start-up's eventual fortunes. A VC who focuses on board seats, voting rights, or other terms that define control may be less confident in the management team and is perhaps thinking ahead to when it will be replaced. There is nothing inherently wrong with any of these situations, but a careful understanding of the dynamics can help founders ask

FURTHER READING

ARTICLES

Making Sense of Corporate Venture Capital
by Henry W. Chesbrough
HBR, March 2002
Product no. R0203G
This article presents a framework to help companies decide whether to invest in a particular start-up. Learn the four types of corporate VC investments, each defined by its primary goal and the degree of operational linkage between the start-up and the investing company.

Negotiating the Spirit of the Deal
by Ron S. Fortgang, David A. Lax, and James K. Sebenius
HBR, February 2003
Product no. R0302E
Experienced negotiators spend so much time ironing out the letter of the deal that they often pay little attention to the spirit of the deal—the social contract. That can lead to a signed deal's eventual demise. Learn how to have a true meeting of the minds *before* signing an agreement.

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better questions, engage in a more productive dialogue about expectations, and ensure that they choose the right partner given their own goals.

Many other terms warrant careful consideration in any VC negotiation, of course. My interest here is simply to emphasize the importance of understanding the consequences of seemingly abstruse provisions on the term sheet and to underscore how the choices a VC makes when negotiating it can serve as useful signals.

A LEAD NEGOTIATOR for the National Football League once told me that the only way to really understand the stakes involved in negotiating a collective bargaining agreement with the players is to compare the deal to a marriage. Except, he added, his negotiations are harder than marriage: "You can divorce your spouse, but we can't divorce the players." Having worked with scores of founders who have negotiated with venture capitalists, I believe a related metaphor helps capture the economic and emotional stakes involved: Founders are like single parents looking for a spouse who will love and nurture their children as much as they do. And yet, despite the tremendous value that can be created with a VC–entrepreneur partnership, these negotiations can yield poor outcomes. The mistakes are usually not immediately apparent; they manifest themselves over months and years, as the parties come up against issues of power, trust, control, and much more. It's important to recognize that some of the mistakes are systematic and predictable—and hence solvable.

In my experience, most VCs are extremely well-intentioned and competent. Many are driven, just as many entrepreneurs are, by a desire to create value for society; a few are nothing short of visionary. But all of them are human, and whenever you're dealing with human beings, you need to look well beyond the contract and far beyond today. The lessons offered above are targeted toward those who are striving to create strong partnerships with VCs—but they are relevant for anyone negotiating in a world where a signed contract is not the end but merely the beginning.

Deepak Malhotra is the Eli Goldston Professor of Business Administration at Harvard Business School and author of *Negotiating the Impossible* (Berrett-Kohler, 2016). Twitter: @Prof_Malhotra

HBR Reprint R1305F

Lessons for Dealing with VCs

1 VC attention and support are limited resources, and you'll be competing for them with other portfolio companies. A VC firm's willingness to spend time and political capital on you is a function of both its equity stake and its emotional stake in your company. You stand to lose if you negotiate these stakes down too low.

2 Beware of entrepreneurial overconfidence. When you're raising money, take into account the possibility that your progress will be slower than expected and that your business model will evolve. That may mean selling somewhat more equity up front than seems necessary, so that you can avoid negotiating for more cash later, when you have fewer options.

3 Your leverage is not only a function of your alternatives—it has just as much to do with the VC's alternatives. Having few options is not so terrible if the VC needs you to thrive. Seek to understand his interests and be prepared to educate him about why his exercising too much power could hurt *both* parties in the long term.

4 Transparency is often less costly than you fear. Experienced VCs have seen most problems before, and if you're honest about setbacks, they may have useful advice to share. Even if being transparent decreases your leverage, it will increase their trust in you—a trade-off worth making.

5 You can build trust most easily when the other party is vulnerable. It's when you *could have* exploited them but chose not to that others learn to trust you. If the VC is vulnerable, use the opportunity to build trust rather than to seek advantage. In a long-term relationship, trust built today enhances opportunities in the future.

6 Play it straight. If you're not in a position to make a commitment you can stick to, say so. If you *have* overcommitted, don't renege. Instead, own up to it quickly. The VC may be open to renegotiation if you have been forthright.

7 Beware the allure of valuation. Negotiate about *all* elements of interest to you, not just the investment level and equity dilution. Don't forget that you had many nonfinancial motives for becoming an entrepreneur.

8 Use your bargaining power wisely. Valuation and equity stake matter only if your company eventually succeeds—and if it does, other provisions could have a greater impact on your ultimate financial reward. Consider multiple scenarios for your firm's success and calculate what various terms would yield.

9 Pay close attention to which terms the VC accentuates in her demands. Her focus can reveal important information about her core concerns, underlying interests, and future plans for your firm.

MANAGING THE BUSINESS

How to Launch Your Digital Platform

A playbook for strategists

by Benjamin Edelman

FOR ONLINE PLATFORM BUSINESSES, customer mobilization challenges loom large. The most successful platforms connect two or more types of users—buyers and sellers on a shopping portal, travelers and hotel operators on a booking service—and a strong launch usually requires convincing early users to join even before the platform reaches scale.

Customers find Skype worth installing only if there are people on the platform to talk to. Who would join PayPal if there were no one to pay? Every platform starts out empty, making these worries particularly acute. For multisided platforms, which need not only many users, but many users of different types, the risk is even greater. It's not enough for a ride-sharing platform to have a large base of customers who want to book taxis by smartphone. It also needs drivers willing to accept those bookings.

Despite these challenges, the number of online platforms has spiked in recent years. It's not hard to see why entrepreneurs are drawn to these businesses: They create significant value by enabling communication and commerce that might not otherwise occur. They have modest operating costs because they don't usually manufacture tangible goods or hold

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Adriean Koleric

inventory. And network effects protect their position once established; users rarely leave a vibrant platform.

I have been studying the dynamics of platform businesses for 10 years, and, with colleagues including Peter Coles, Chris Dixon, Tom Eisenmann, and Andrei Hagiu, I have documented and analyzed case studies on dozens of platform sites and products. In the following pages, I draw from this research to offer a framework to help aspiring entrepreneurs make the right strategic decisions as they build their own platforms. The framework involves asking five basic questions:

Can I Attract a Large Group of Users at Once?

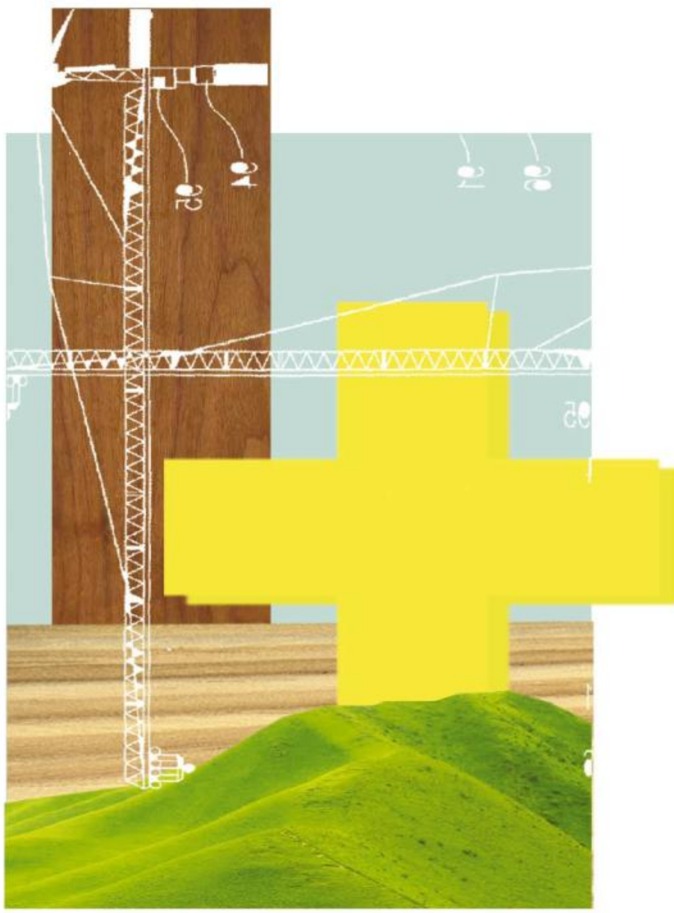
The first question entrepreneurs should ask is whether they can quickly attract a large group of users. Getting a mass sign-up at the outset can almost eliminate uncertainty about a platform's prospects because it effectively builds critical scale into the platform's network from day one. But in my experience, a new platform can do this only if at least one of two conditions is true:

The company already has the users it needs on another platform. Consider Google's 2003 launch of the AdSense contextual advertising service, the now-ubiquitous "Ads by Google" that appear on myriad websites. At the start, advertisers were hesitant to buy these placements. They worried that website publishers might click ads on their own sites (increasing the site's revenue but depleting advertisers' budgets) and that their ads might be placed on inappropriate sites (such as those with adult content).

But advertisers had already joined Google's popular AdWords platform, providing advertisement text and payment details in order to obtain search engine advertising. By enrolling these advertisers in AdSense, Google set the platform up for a successful launch. With many advertisers, Google had relevant ads to place on most publishers' sites, ensuring high revenue to publishers. Of course, this approach raised legal questions: Could Google provide advertisers with a new service they hadn't asked for? The company had written its contract to retain great discretion over where ads could be shown, and to date advertisers have not succeeded in challenging unwanted Google ad placements.

User data is publicly available. Consider Zillow's early efforts to present profile pages for most houses in the United States, including "Zestimate" prices, information about neighborhoods and school districts, and more. Zillow was able to gather this information from government records, circumventing the impossible task of soliciting information from property owners for a site that was, at the start, unproven. Zillow's initial information was good enough to attract consumer interest, at which point property owners happily contributed corrections, photos, and other information. Indeed, real estate agents were soon willing to pay to show their advertisements in and around Zillow's property listings.

Zillow's approach typifies a three-step process for launching an advertising-supported platform: (1) Collect data from public sources, and organize it to create a useful service that attracts consumers. (2) Encourage users to submit improved data directly to the platform.



(3) Charge companies for preferred ad placement. Even Google's widely used search engine is grounded in this approach. Initially, the company collected page contents by scraper; then it accepted structured data feeds from sites; and now it charges advertisers billions of dollars to appear adjacent to search results. It's a proven path to success—one that overcomes the mobilization barriers that initially challenge so many platforms.

Can I Offer Stand-Alone Value?

If signing up large numbers of users is not feasible, platform businesses should look for ways of providing value to individual users even if no one else is on the platform. Consider the VCR in the 1980s. The challenge was that owning a VCR was useful to viewers only if they could get enough videocassettes to watch—and content owners would bother to make the tapes only if enough people had VCRs to watch them on. The problem was exacerbated by competition among incompatible formats.

The VCR could have been a flop, but its recording capability came to the rescue. The device could tape television broadcasts—and this benefit didn't require that anyone else own a VCR or that any studio offer content on videocassette. Thanks to the wide popularity of the recording function (its legality was confirmed in a 1984 Supreme Court decision), VCRs avoided the mobilization problems that hinder many multisided platforms.

Creating stand-alone value can present difficulties, of course, especially when extra features require costly hardware. But it's easy to add functionality to a software program or an app. Suppose you find that your taxi-booking app is unpopular with passengers because few drivers accept bookings through it. Perhaps the app can provide train and bus schedules too, or give phone numbers for traditional taxi dispatchers. With the right additional content, the app could attract enough passengers to make the platform appealing to drivers, who would then pay to be included.

As you try to figure out what kind of stand-alone value to offer and which customers you should be offering it to, consider two strategies:

Start with an industry niche. A good approach for many platforms is to target customers in a relatively narrow market where the platform can more readily gain traction. The Yelp review site now evaluates almost every small business in the U.S. (and many international businesses too), but initially it focused on a much smaller sector: ethnic food in San Francisco. With that base, the company attracted dedicated reviewers and interested readers. Word of mouth and participants' travel facilitated growth—first to covering other cities and then to reviewing sectors other than restaurants. As it grew, Yelp naturally expanded from reviews to other functions, such as accepting reservations, forwarding online orders, and offering discounts.

THE IDEA IN BRIEF

THE CHALLENGE
Digital platforms are attractive businesses because they create significant value and network effects protect competitive advantage. But they face considerable start-up challenges.

WHY IT HAPPENS
Every platform is empty at the outset. And most require multiple types of users. It's not enough that many people want to book taxis by smartphone, for instance. Drivers must also be willing to accept smartphone bookings.

THE SOLUTION
To launch a platform successfully, consider quickly attracting a large group of users, offering features that provide value even if few users sign up, establishing credibility, and ensuring that the platform works with legacy systems.

In a world focused on getting big fast, it's all too easy to overreach. Having built a general-purpose review platform, Yelp could have tried publishing reviews of all businesses everywhere from the outset. Instead, it stayed focused on a narrow sector until it had attracted devoted fans and higher-quality content, which paved the way for subsequent success.

Find or build small social groups. For some platforms, success comes through identifying and serving the social needs of small groups. Two people can use Skype and immediately enjoy its free, high-quality calls; they get these benefits even if no one else ever joins. Skype spread exactly this way—a student calling parents, far-flung friends staying in touch—with users often joining in pairs who call only each other. Of course, Skype becomes even better when most people have accounts.

Skype expanded naturally because users were motivated to spread the word and encourage others to join in order to get the most out of the platform. But not all platforms are inherently social, so businesses may need to build that capability into the value proposition. Computer and video games, for example, are not necessarily a social activity; historically, gamers have played alone. Zynga reimagined online games as "games with friends." In running an imaginary farm on Zynga, a player might run out of key supplies and need to borrow from a real-life acquaintance playing the same game. Social features like this accelerated Zynga's spread; having friends to call on helped people perform better, giving them an incentive to recruit more friends to the platform. Another approach to building in sociability is discounter LivingSocial's offering of a free restaurant meal, spa visit, or other local service if a customer can find three friends who will buy the same thing. The approach has helped expand the service while reducing the high marketing expenses that have strained competitors.

These strategic choices are all largely within the control of a platform designer. As first envisioned, a platform might require thousands of diverse users—hundreds of taxi drivers in every city, or a full suite of movies playable on a new device. But the right adjustment can make it attractive when used by just a few people—or even by a single person.

How Will I Build Credibility with Customers?

When there are competing platforms in your space, users need some reason to believe that your platform will be worth joining, especially if doing so involves a significant investment, as is the case with game consoles. To attract initial users, a new platform must satisfy those concerns by building credible expectations for its future success.

The basic strategy for credibility building is to attract a marquee platform contributor. Gaming console makers, for example, need to demonstrate that highly sought-after games will be available, so they often pay a well-known game developer to provide a given game on the console. In some cases, console makers have bought the developer outright: Once Microsoft acquired Halo, for example, there was no doubt that its eponymous game would be available on Xbox. For the greatest effect, the marquee contributor's participation should be exclusive. That's why Microsoft pays some game developers a premium to provide their content on Xbox only. If devoted gamers want those games, they have to buy an Xbox console.

Exclusivity with a marquee user can drive growth; however, a platform must compensate that user for the profit it could have made by joining other platforms. The costs can be prohibitive, giving incumbents a big advantage.

While the high costs of attracting such users may tempt platform businesses to build their own capabilities, there are downsides to relying too much on in-house development: Prospective users may see it as competition. For example, starting in 1984, Apple's hardware lineup included printers. Suddenly other printer manufacturers thought twice about making them for Macs, figuring (not unjustifiably) that Apple was bound to give its own devices some advantages. After weighing the modest printer profits against the risk of losing key partners, Apple exited the printer business in 1997.

The Platform Builder's Checklist

AMASS A LARGE USER BASE
- Leverage existing user groups
- Use publicly available data as a substitute for one user group

OFFER STAND-ALONE VALUE
- Add a service that is useful even if few others join the platform

RECRUIT MARQUEE USERS
- Pay them to join
- Buy the marquee brand

REDUCE USERS' RISKS
- Offer pay-as-you-go pricing
- Subsidize early users

ENSURE COMPATIBILITY WITH LEGACY SYSTEMS
- Offer just enough compatibility to attract new users
- Anticipate resistance from legacy systems

How Should I Charge Users?

Building a vibrant network has always required making choices about how to charge users and which users to charge. But the functionality of digital platforms offers increased flexibility in making these choices, and platform entrepreneurs have more scope to challenge industry norms. Let's look at how successful platforms have worked two important pricing levers:

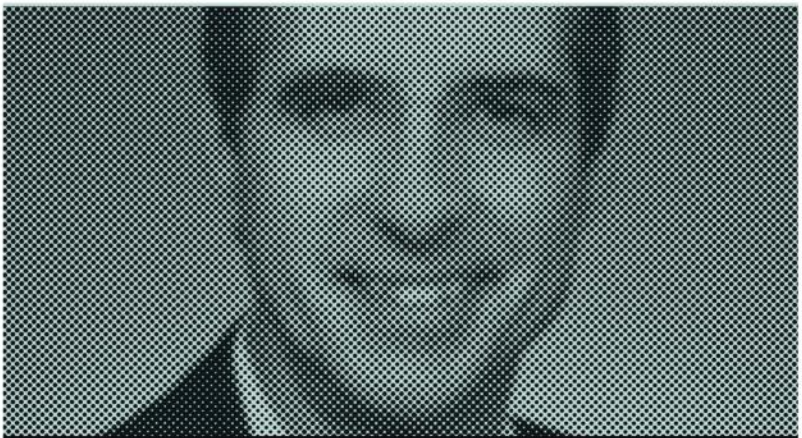
Pay-as-you-go. Offering pay-as-you-go pricing is a powerful way to reduce the risks of a platform for some types of users. Groupon, for example, could have sold advertising to restaurants on a flat-fee basis, letting them reach all Groupon consumers in a city at one low price. Like the familiar print-advertising model, this would have yielded simple, predictable pricing. But it would also have created significant risks for restaurants—that Groupon's consumer sign-ups would fall short of expectations and that those who did sign up would be uninterested in a given restaurant's offer. Instead, Groupon charged restaurants only when a consumer bought a voucher. This approach raised other problems but protected restaurants against the risks of low user counts and limited interest.

As the Groupon case illustrates, pay-as-you-go pricing is a feasible option in more and more cases because technology can easily capture and record individual transactions automatically. It would not have been feasible to equip an early fax machine with a counter that recorded how many pages were sent and received. Anyone renting a device with a by-the-page fee would have had a strong incentive to turn back the dial to reduce fees, and a tamper-proof counter would have added to the cost of an already-expensive device. But today, platform operators have many ways to let users try the service before committing in full, making pay-as-you-go a viable option for most platforms.

User subsidies. Whether it's launching a cereal brand or opening a restaurant, marketers widely use discounts and promotions to encourage consumers to try new offerings. For platform businesses, subsidies play an even more important role, because low usage at the outset often means that a platform's early benefits are not great enough to outweigh the cost or hassle of joining.

Lyft, the ride-sharing service, is a case in point. To attract drivers, Lyft could have offered them a higher fee per minute and per mile, but they probably would have been reluctant; with few early passengers, drivers would have worried that even at a higher rate, zero customers still equals zero dollars. Instead, Lyft restructured compensation to early drivers: Rather than paying them for minutes worked and miles driven, it sometimes paid them simply to be on call in case passengers sought rides.

At the same time, Lyft stimulated passenger interest through generous promotions—in some cities, it offered five free rides to anyone who joined early. Notably, the two promotions reinforced each other: Having already paid drivers to be on call, Lyft could provide free rides to promote the service at no additional cost. Subsidizing both sides of a platform like this implies significant expenditures, which consume



AMERICA'S FIRST E-BILLING SYSTEM
An Interview with Paytrust Cofounder Ed McLaughlin

HBR: WHAT WAS PAYTRUST OFFERING?

McLaughlin: We enabled customers to receive and pay household bills online—quite a thing in 1998. Customers would tell companies to send their bills to Paytrust. We'd convert the paper bills to genuine electronic bills—not simple PDFs—and then alert the customers by e-mail that they had a bill, which they could view on our site and pay from anywhere. We also offered other functionality, like custom alerts, automatic payment rules, and payment history. Essentially, we did away with the old process of receiving a bill by mail, tearing off a stub, attaching a check, and mailing it to the biller, who would then need to get the check converted into electronic money.

WHO WERE YOUR FIRST CUSTOMERS?

Back then, many people were uncomfortable with the internet, let alone using it to pay bills. In fact, when people started using Paytrust, they'd make payments to themselves first to see if it worked. So we focused our marketing on frequent e-mail users and people with at least one e-commerce transaction to their name. We also looked for people who traveled a lot, or who had second homes, because they risked not receiving paper bills on time. We focused on urban areas, where many people pay the same companies, which made bill conversion easier. We soon saw customer groups forming by themselves. Parents, for instance, would use Paytrust to pay their college kids' bills.

WHAT WAS YOUR VALUE PROPOSITION TO BILLING COMPANIES?

We offered a way to move to a completely paper-free billing process, connect with their customers online, and dramatically reduce their costs of billing and collection. An e-bill is a lot better as a customer touch point than a paper document. You can better understand your customers and easily offer additional products and services.

WHAT WAS YOUR REVENUE MODEL?

We offered free trials. Once people got used to the system, they converted to paying a monthly subscription fee of $7.95 pretty willingly. When we raised the price to $10.95, we didn't lose many customers. As we built up our payer base, more companies wanted to partner with us in a complete e-billing and e-payment system, which attracted yet more payers. Banks began licensing our technology for their own bill-payment services. We sold the company to a bank and payment processor, which licenses the consumer service to Intuit. The service is flourishing, and I still use it to pay my own bills.

Ed McLaughlin, a cofounder and the former CEO of Paytrust, is currently the chief information officer at MasterCard.

a platform's capital. But once a platform gains scale, users' desire to connect to others (for example, drivers' interest in reaching riders) should reduce the need for subsidies.

Even when they have scaled up, however, platforms often continue to subsidize one type of user in order to attract more of that type, because the platform can then charge higher fees to other, more lucrative types. Google, for example, provides free services including search, e-mail, and maps in order to attract more consumers, allowing it to charge higher fees for ad placements to another side of the market: advertisers. (For details on perpetual one-sided subsidies, see Thomas Eisenmann, Geoffrey Parker, and Marshall Van Alstyne, "Strategies for Two-Sided Markets," HBR, October 2006.)

Can I Make My Platform Compatible with Legacy Systems?

Few platforms create entirely new networks. Typically, users migrate to a new platform from some prior system. Building in compatibility with legacy systems is often key to a successful launch, though it may involve marrying yourself to outdated technology.

Consider the launch of Paytrust, the online bill-payment service, in 1998. Paytrust sought to let customers log on to a secure site, see their bills, and click to authorize payment, thereby avoiding the need for paper, envelopes, or stamps. As initially envisioned, Paytrust's strategy involved recruiting major billers to send bills and receive payments electronically. This approach would obviously have reduced billers' costs for paper and postage, but it was unrealistic to ask, say, Comcast or Verizon to connect its systems to an unproven start-up that at the outset had no users.

Instead, Paytrust encouraged customers to update their billing addresses so that their bills would be sent directly to Paytrust, which scanned each bill and posted it to the corresponding person's account. Meanwhile, with information about a customer's bank account, Paytrust could write checks on the customer's behalf. Thus, Paytrust made itself compatible with billers' legacy systems, so the service was useful to consumers even before billers "signed up." With a viable product to attract consumers, Paytrust's pitch to billers was much more appealing, and billers were soon able to justify digital data transfers that eliminated paper and scanning.

Today, platforms typically rely on interoperability, data conversions, and information synchronization to reduce the costs of switching. For example, a new Gmail user often has an existing e-mail account that will continue to receive messages. Google's MailFetcher feature pulls those messages into Gmail, thereby reducing the barrier to switching.

Compatibility doesn't have to be perfect—just good enough. Consider smartphone apps. At its launch, in 2007, Apple's category-defining iPhone had no capacity for users to install apps from third parties. (Apple added the App Store

Building in compatibility with legacy systems is often key to a successful launch, though it may involve marrying yourself to outdated technology.

and third-party apps more than a year later.) The company provided selected tools through preinstalled apps, but initially users could not add programs from anyone else.

However, the iPhone's web browser allowed users to access web-based applications. Although those apps, designed for use on a desktop, did not fully exploit the iPhone's capabilities, there was enough user interest to demonstrate an opportunity. Rapid iPhone adoption soon motivated developers to write native apps that took advantage of the device's full capabilities.

Many platforms now offer this kind of imperfect compatibility: It attracts new users and then gives them an incentive to switch more fully to the platform. Users can run DOS apps on Windows, but they lose key Windows benefits (such as shared clipboard and device drivers). Blu-ray devices can play standard-quality DVDs, but without the improved quality that is Blu-ray's main selling point. It's a delicate balance: Platforms must offer enough compatibility to showcase potential benefits, yet not so much that users delay switching to reap those benefits.

Of course, not every business welcomes compatibility. If the owners of incumbent systems feel threatened by a new entrant, they will attempt to block compatibility. Consider RealNetworks' 2004 launch of Harmony, a digital music subscription service and player that would compete with Apple iTunes. As an incentive to customers who had already bought iTunes files, Real provided a converter that let iTunes files play on Real devices. It was a clever hack and positioned Harmony to take off. But Apple quickly changed its file formats to block Real's converter. Facing ongoing format changes and the threat of litigation, Real was forced to withdraw efforts at compatibility. For this and other reasons, Harmony ultimately flopped. (Antitrust litigation that challenges Apple's tactics as unlawfully extending its dominance from devices to media sales is ongoing.)

Google similarly sought to block data synchronization for its AdWords platform. From 2006 to 2013, Google banned the creation of tools to help advertisers copy their campaigns from AdWords into competing search engines like Microsoft Bing and Yahoo. Only when competition regulators challenged the practice (after I flagged it in 2008 testimony) did Google lift the restriction—a move that now enables one-click copying to other ad platforms.

FOR NUMEROUS online services and other platforms, launch is both the most exciting moment and the most difficult. Platforms usually provide exceptional value to multiple types of users—if the platforms are widely adopted. Yet at the outset they are not used at all, and every prospective user reasonably fears wasting time and resources signing up for a service that may fail to gain traction. At first the problem may seem as insurmountable as solving the chicken and the egg puzzle. But by using these strategies, entrepreneurs can improve their odds of a successful launch.

Benjamin Edelman is an associate professor at Harvard Business School. He also advises numerous companies that rely on or compete with some of the platforms mentioned in this article, including Google.

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FURTHER READING

ARTICLES

Reputation Warfare
by Leslie Gaines-Ross
HBR, December 2010
Product no. R1012D
Small-scale snipers in command of new-media and social-network weapons can inflict large-scale damage on a company's reputation—and fast. Gaines-Ross outlines six defensive tactics for companies whose good names come under assault.

Preparing for the Perfect Product Launch
by James P. Hackett
HBR, April 2007
Product no. R0704B
The CEO of Steelcase explains the fallibility of a "can do" attitude and describes how he transformed the company's "doing" culture into one of "thinking before doing."

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The Right Way to Use **Compensation**

To shift strategy, change how you pay your team.

by Mark Roberge

I WAS THE FOURTH EMPLOYEE hired at HubSpot. I'd met the two cofounders when we were all pursuing graduate degrees at MIT's Sloan School of Management. They're smart guys with a big mission: to help companies transform their marketing by using online content to draw potential customers to their websites—a practice known as "inbound" marketing.

My job was to build the sales team. An engineer by training, I'd never worked in sales—I'd begun my career writing code. But my background proved to be more of an advantage than I'd expected. It led me to challenge many conventional notions of sales management, using the metrics-driven, process-oriented lens through which I'd been trained to see the world. For instance, instead of hiring by instinct, I meticulously tracked data on sales, identified predictors of success, and looked for people whose traits and skills closely resembled those of our top sellers. Instead of training new recruits by having them tag along on a successful salesperson's calls, I created a regimented training program that gave them firsthand experience with our technology and then taught them to systematically work leads.

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That approach worked well: Within seven years of its founding, HubSpot crossed the $100 million run-rate revenue mark and had acquired more than 10,000 customers in over 60 countries. In the fall of 2014 our company went public in an offering worth $125 million.

When I look back on the various strategies I used to grow our sales force from zero to several hundred people, I realize that one of the biggest lessons I've learned involves the power of a compensation plan to motivate salespeople not only to sell more but to act in ways that support a start-up's evolving business model and overall strategy.

Whether you're a CEO or a VP of sales, the sales compensation plan is probably the most powerful tool you have. Most of the critical strategic shifts that HubSpot made as a business were executed through changes to the sales compensation plan. In this article I will look at how we did this and at the general principles you should keep in mind when designing your own firm's plan.

Knowing What You Need and When

Business leaders often ask, "What's the best sales compensation structure to use?" It's a complicated question. The ideal plan is contextual—tailored to both the type of business and the stage of growth the company is in. Start-ups typically go through three key stages: customer acquisition, customer retention and success, and sustainable growth. In the first seven years at HubSpot, we used three different sales compensation plans, each of which was appropriate for the stage our business was in at the time.

1 **The customer acquisition plan.** HubSpot's first compensation plan was oriented toward "hunting" new customers. When we put it in place, we had 100 customers and an annual run rate of barely $300,000. Like most start-ups at this stage of development, we needed to acquire customers quickly so that we could see how valuable our offering actually was to them. We'd been pretty good at gathering feedback

from potential customers as we'd developed our product—which is true of most new ventures—but the real test would be asking customers for money.

The first plan paid salespeople a base salary and $2 up front for every $1 of monthly recurring revenue they brought in. To protect the company if customers defected, we implemented a four-month clawback on commissions. This meant that if a customer jumped ship within the first four months, HubSpot took the entire commission back (deducting it from the salesperson's earned commissions the next month). Once a customer had stayed on the platform for four months, the salesperson could keep the entire commission even if the customer later canceled.

This plan was simple, clean, and hunting oriented. It worked well to accelerate the pace of new customer acquisition. In under six months our base shot up to 1,000 customers, and our revenue hit $3 million.

2 The customer success and retention plan. With plenty of customers on board, we could now analyze how well the company was progressing toward "product/market fit"—the point at which product features and pricing are aligned with the market's preferences. The biggest sign that the fit wasn't perfect was a clear problem with customer retention. Among our early customers, the level of churn was unsustainable. This was not surprising. It's rare that a start-up finds a fit on its first attempt with customers. That's why a fast feedback cycle, proper diagnosis of the issues, and quick, disciplined iteration are necessary during this stage. At this point in a start-up's evolution, it's key to figure out who your best customers are and what steps will make them successful.

Looking for answers, we studied the data. At the time, each new customer was being assigned a postsale consultant, who would set our service up and train the customer's staff in how to use it. Our first theory was that some of the postsale consultants were doing a better job than others. If we could identify which consultants were most successful, we could dig into their processes, understand what they were doing differently, and introduce the best practices across the team. However, when we examined customer churn by postsale consultant, the levels were similar across the team. That particular theory didn't check out.

Next we analyzed customer churn rates by salesperson. Eureka! Here was our answer. Across the organization, there was a more than 10-fold difference between the lowest and highest churn rates among salespeople. We did not have a customer onboarding problem. We had a sales problem. Our customer retention was predicated on the types of customers the salespeople chose to target and the expectations they set with each new account.

I immediately shared the analysis with the sales team, revealing each salesperson's churn rate and how it compared with the team average. I educated the team on the importance of retention, both to our business and to our customers. I said that I would be adjusting the sales compensation plan, in order to align customer retention performance with commission checks.

The ideal plan is tailored to the company's stage of growth.

Sure enough, the next quarter I followed through on my promise. I stack-ranked the sales team from the person with the best retention rate right down to the person with the worst rate. Then I segmented the team into quartiles. The top-performing quartile would earn $4 per $1 of monthly recurring revenue from then on. "Congratulations," I said to this group. "I'm doubling your commission payments. Why? Because you bring in the best customers. Keep it up."

I moved on to the next quartile. "Good work," I said. "You now earn $3 per $1 of monthly recurring revenue—a 50% increase above your previous rate."

"For the folks in the third quartile, there is no change. You will be paid the same rate of $2 per $1 of monthly recurring revenue."

I concluded with the most difficult message. "For the fourth and worst-performing quartile, your earnings are cut to $1 per $1 of monthly recurring revenue. Why? Your customers are not succeeding. On average, they're unprofitable for our company. More important, you are wasting our customers' money by not setting proper expectations about how to succeed with our service. We have initiated training on better customer expectation setting. We need you to take that training seriously. We are here to help you through this skill development."

The combination of a different set of incentives and better training worked: Within six months, customer churn had dropped by 70%. Once again, a sales compensation plan had driven the results of the business.

3 The sustainable growth plan. Thanks in part to plan two, HubSpot had quickly closed in on product/market fit. Unrealistic expectations set by sales were now almost never among the reasons customers gave for quitting our service. Churn in general was far lower, and the reasons for cancellations were not alarming. It was time for our start-up to focus on achieving faster, profitable growth—in other words, scaling up the business. To do that, we had to align the sales compensation accordingly.

To ensure healthy growth, I needed to incorporate what we had already learned on our journey. I certainly wanted a strong incentive for the sales team to acquire new customers at a rapid clip. However, I needed to keep the team aligned with maximizing customer retention, since that would obviously offset acquisition costs and increase profitability.

One important insight we'd had earlier was that it was important for the customer to be committed to adopting inbound marketing. Though it can transform the way an organization gets its message to customers, inbound marketing is not a turnkey solution. It takes work. Customers must understand that to succeed. We had already worked to get salespeople to set realistic expectations, but we now had to find a way to focus them on clients who would make a real investment (of time, energy, and money) in learning to use HubSpot's service. How could I align the sales team with this goal in a clear and measurable way?

The answer was advance-payment terms for new customers. When we looked at the data, we realized that our customers who paid month-to-month were less committed to the overall HubSpot service and were far more likely to defect. Those that prepaid annually were more committed to the service and ultimately were more successful. (Of course, advance payments also had a positive impact on HubSpot's cash flow—another factor that becomes important for a start-up as it reaches scale.)

As a result, our third plan was designed as follows: (1) Salespeople would earn $2 per $1 of monthly recurring revenue. (2) The commission would be paid out as follows: 50% on the customer's first month's payment, 25% on the sixth month's payment, and 25% on the 12th month's payment.

So if a customer signed up paying month-to-month, the salesperson would wait a full year to earn the last quarter of the commission for that customer. However, if the customer paid a full year's subscription in advance—a factor that was completely under the control of the salesperson—the entire commission would be earned immediately.

AT A GLANCE

THE IDEA IN BRIEF

THE CHALLENGE

A start-up often changes direction as it grows. As the strategy shifts, it's critical that the employees who bring in the revenue—the sales force—understand and behave in ways that support the new strategy. The sales compensation system can help ventures achieve that alignment.

THE PRESCRIPTION

Revise the incentive system to focus salespeople on new goals at each growth phase. The start-up HubSpot did this; it implemented a plan that encouraged rapid customer acquisition early on, but switched to a second plan to promote customer retention and then to a third geared for sustainable growth.

THE RESULT

Changes to the sales compensation plan helped HubSpot quickly grow its business to $100 million in annual revenue and acquire more than 10,000 customers in 60 countries.

Before this plan was put in place, the average prepayment commitment was 2.5 months. After the plan was rolled out, that average jumped to seven months. Customer churn was checked; in fact, retention improved. The new customers were profitable to HubSpot. Salespeople felt in control of their destiny. Mission accomplished.

Before You Change the Comp Plan...

HubSpot is still a young and growing company, and we may have to adjust the sales compensation formula again as the business evolves. Drawing on what we've learned during our first eight years, my team has developed a few questions that we ask about any potential change: Is it simple? Is it aligned? And is it immediate?

Let me elaborate.

Simplicity. Salespeople should not need a spreadsheet to calculate their earnings. If too many variables are included, they may become confused about which behaviors will lead to the largest commission check. They might throw the plan aside and just go sell the way they know best. The opportunity to drive the desired behavior through the compensation plan is lost. Keep the plan simple. It should be extraordinarily clear which outcomes you are rewarding.

Alignment. Look ahead to the next year and ask yourself, "What is the most important goal the company needs to

Boosting Performance with Sales Contests

Contests are almost as effective as compensation plans when it comes to motivating the sales team. Contests bring a fun, dynamic aspect to a sometimes mundane daily routine. They can be designed to promote desired behaviors and, unlike commission plans, can be temporary. They can even be used to build team culture.

For these reasons, I ran a sales contest at HubSpot almost every month, especially in the early years of team development. Here are my six best practices for sales contest design:

1

Align the contest with a short-term behavioral change. For example, fearing a summer slump, you may want to boost activity in June. This increase would be difficult to pull off through the commission plan, but holding an activity-based contest for one month would do the trick.

2

Make the contest team based. This approach has a remarkable effect on team culture, especially early on. For the first three years at HubSpot, every contest I ran was a team contest. I'd often see high-performing salespeople help out teammates who were lagging, and the low performers would start working late to avoid letting their teams down. When I finally ran a contest based on individual performance, I heard accusations of cheating and saw backstabbing behavior for the first time. We immediately returned to team contests.

FURTHER READING

ARTICLES

How to *Really* Motivate Salespeople
by Doug J. Chung
HBR, April 2015
Product no. R1504C
New research calls into question traditional methods of compensating your sales force. Chung explains the findings from the field on practices like setting and adjusting quotas, capping commissions, and engaging every level of performer.

The CEO of Automattic on Holding "Auditions" to Build a Strong Team
by Matt Mullenweg
HBR, April 2014
Product no. R1404A
After first hiring through résumé screening and interviews, Mullenweg realized that eloquence in an interview often had little bearing on job performance. So his company introduced tryouts: Final candidates are paid to spend several weeks working on a project before they are actually hired.

More Reading @ HBR.org

achieve? Customer count? Profitability? Customer success? Market share? New product distribution? New market penetration?" Once you've identified that goal, ask yourself, "How can the sales compensation plan be aligned with this objective?" Don't underestimate the power of the compensation plan. You can tweak sales training, redesign marketing materials, attend customer conferences—you name it. Regardless of those efforts, if the majority of your company's revenue is generated by salespeople, properly aligning their compensation plan will have greater impact than anything else will.

Immediacy. When salespeople succeed, they should see it reflected in their paychecks immediately. When they fail, they should feel the pain in their paychecks immediately. Any delay between good (or bad) behavior and the related financial outcome will decrease the impact of the plan.

Whenever I considered changing the compensation plan, I always involved the sales team in the redesign. To kick things off, I usually held a "town meeting" with the team. After communicating the goals for the plan, I would open up the floor to structural ideas. The brainstorming would begin. As the meeting progressed, I would share some of the structures that were being considered and invite people to offer their feedback.

3

Make the prize team based. Choose a reward that the team experiences together: Rent a limo to take the winners to a casino. Buy them a golf outing. Send them sailing for a day. Making the prize team based maximizes the positive impact on culture. The winners return to the office with photos of the great time they had—together. People feel good about their colleagues. Teams feel motivated to win the following month.

4

Send out updated contest standings daily. At least once a day, publish the contest standings to the entire sales team (if not to the entire company), even if you have to compile and post them manually. This is such a critical execution point. Without daily updates, contest effectiveness will drop precipitously.

5

Choose the time frame wisely. The contest period needs to be long enough to bring about the desired behavioral change but short enough that salespeople stay engaged. A daily time frame is too short. Weeklong contests are on the briefer end of acceptable. A quarterly time frame is probably too long. Monthlong contests are ideal.

6

Avoid contest fever. Don't read this and implement five simultaneous contests. Overlapping contests will dilute one another. Run one contest at a time for a given group of salespeople.

As a follow-up, I often created a page on the company wiki, reiterating the reasons for changing the plan, stating the goals, and describing some of the structures that were being considered. The conversation would then continue online with ideas and reactions. I responded to most comments. This digital format allowed salespeople to catch up on and participate in the conversation when they had time.

Throughout the process, I was very explicit that the commission plan design was not a democratic process. It was critical that the salespeople did not confuse transparency and involvement with an invitation to selfishly design the plan around their own needs. Most of them appreciated the openness, even when changes were not favorable to their individual situations. During the process the sales team contributed some great ideas. Each commission plan change we made included at least one structural element that had originated from a salesperson during our discussions. Because of this involvement, when a new plan was rolled out, the sales team would understand why the final structure had been chosen.

COMPENSATION IS just one of the tools I learned to use while scaling up HubSpot's sales force. Our hiring, training, and sales coaching programs have also been vital to our success. The common thread among them is that they rely on close analysis of what works and what doesn't, rigorous use of data and metrics instead of intuition or improvisation, and systematically reducing what does work into a formula that can be replicated.

Am I recommending the same evolution of compensation plans for every business? Absolutely not. The sales compensation plan should reflect the type of business you're in and the stage of business you're at. The evolution of HubSpot's plan illustrates this point and provides a real-world example of the impact that a change in plan can have on business results. It also illustrates how, in an era when managers can access data on everything that happens inside their firms, successfully managing a sales force should be much less of an art and much more of a science.

Mark Roberge is a full-time Senior Lecturer at Harvard Business School and former SVP of Global Sales and Services of Boston-based HubSpot. This article is adapted from his book, *The Sales Acceleration Formula* (2015), with permission of its publisher, Wiley.

HBR Reprint R1504E

WINTER 2016

"Strategy without entrepreneurship is central planning. Entrepreneurship without strategy leads to chaos."

Lean Strategy
—page 82

ENTREPRENEURSHIP

22 | The Questions Every Entrepreneur Must Answer

Amar Bhidé

Diversify your product line. Stick to your knitting. Hire a professional manager. Watch fixed costs. Those are some of the suggestions that entrepreneurs sort through as they try to get their ventures off the ground. Why all the conflicting advice? Because in a young company, all decisions are up for grabs.

Based on his observations of several hundred start-up ventures over eight years, Amar Bhidé has developed a three-step sequence of questions that all entrepreneurs must ask themselves in order to establish priorities among the vast array of opportunities and problems they face: What are my goals? Do I have the right strategy? Can I execute the strategy?

Before entrepreneurs can set goals for a business, they must articulate their personal goals. They may want, for instance, to attain a certain lifestyle, experiment with technology, or build an institution that can outlive them. Only when entrepreneurs decide what they want from their businesses can they determine what kind of company they must build, what they are willing to risk, and whether they have a well-defined strategy.

Great strategies, however, don't guarantee great execution. A venture may fail if its founders do not hire the best people, attract capital, invest in organizational infrastructure, and shape a culture to suit the venture's strategy.

Founders must also consider the evolution of their personal roles. Entrepreneurs cannot build self-sustaining companies simply by "letting go." While they sketch out the future, entrepreneurs must manage as if the company were about to go under. They must continually acquire new skills—and continually ask themselves where they want to go and how they will get there.

HBR Reprint 96603

34 | Natural-Born Entrepreneur

Dan Bricklin

Every aspiring entrepreneur can recite the truisms of the business: Feel comfortable with risk, hire the best people, do what you love, and don't do it for the money alone. Nevertheless, the road to success can be a scramble from one slippery rock to another. And no one knows that better than Dan Bricklin, creator of VisiCalc, the first electronic spreadsheet.

In this first-person account, Bricklin, now on his fourth start-up, describes his life as an entrepreneur and professional tinkerer. In addition to the usual suspects for creating a business—solid training, talent, and good timing—he suggests that entrepreneurs need a few more tricks in their bags to thrive during the inevitable ups and downs.

First, entrepreneurs need to understand what value they bring to their endeavors. They have to know their limits, both in terms of evaluating their penchant for risk and personal sacrifice and of recognizing when their ambitions exceed their skills. They may, for instance, need others to step in when their own talents don't match their businesses' current needs.

Second, entrepreneurs shouldn't wait to get started. Or if they do wait, they should understand that as time goes by, they may become less willing to sacrifice their standard of living for their businesses.

Third, entrepreneurs need to recognize that they are not their businesses. They must remember that their companies' failures don't make them awful people. Likewise, their companies' successes don't make them geniuses or superhumans.

Indeed, training, talent, and good timing are essential, but entrepreneurs must also have a true passion for what they're doing, and they must possess the humility to know when they need help. Many of today's dot-com entrepreneurs, Bricklin says, have paid a price for their arrogance. Others can learn from their mistakes.

HBR Reprint R0108B

40 | A Test for the Fainthearted

Walter Kuemmerle

Just a few years ago, becoming an entrepreneur was pretty simple. All you needed was some idea—any idea—a little experience, and venture capital funds to get you going. Many young people started to believe that entrepreneurship was a viable, even safe, career choice. Older folks, too, underestimated the risks of financing start-ups, and, as a result, they ended up throwing millions of dollars into doomed ventures.

The economic downturn has laid waste to those illusions. So now is a good time to ask potential entrepreneurs and their financial backers the hard questions unheeded in the days of the Internet boom: What makes an entrepreneur? What characteristics set successful entrepreneurs apart, enabling them to keep their company alive even when the going gets tough? This article addresses those questions, reminding us that becoming a successful entrepreneur is decidedly not a squeaky-clean affair; you may end up making powerful enemies, risking your own financial security, or even, in extreme cases, looking at jail time.

Specifically, the article explores the key qualities that make someone a successful entrepreneur. Walter Kuemmerle has distilled these characteristics into a kind of litmus test of the following five straightforward, albeit disquieting, questions you should ask yourself if you are considering starting your own venture: Are you comfortable stretching the rules? Are you prepared to make powerful enemies? Do you have the patience to start small? Are you willing to shift strategies quickly? Are you a closer? Answering these questions honestly will help you decide if you have what it takes to become an entrepreneur.

HBR Reprint R0205J

46 | What Entrepreneurs Get Wrong

Vincent Onyemah, Martha Rivera Pesquera, and Abdul Ali

Salesmanship is central to a start-up's success, but many entrepreneurs ignore this simple fact. They may believe that their idea will sell itself or that there's no point visiting a prospective customer without a finished product in hand. Those who search for sales advice find mostly tools and techniques for established companies.

In a study of 120 entrepreneurs in six countries, more than half fully developed their products before getting feedback from potential buyers. Looking back, most said that was a mistake. Those who did start selling early did not spend enough time listening to prospects' reactions. Other mistakes included offering discounts to close initial deals, making early sales to family and friends, and failing to choose first customers strategically.

When they did go on sales calls, the entrepreneurs fielded tough questions about the efficacy of their products, their credibility and experience, the size of their companies, their prices, and the cost of switching to an unproven offering.

A sales model geared to entrepreneurs accounts for the fact that information gleaned during the sales process can be crucial in designing (or redesigning) the product itself. The model calls for meeting with prospects as soon as an idea is conceived to learn if it has broad appeal. The answer to that question determines whether the entrepreneurs jettison the idea, return to the drawing board, or proceed to prototype development and further testing with potential customers.

HBR Reprint R1305D

52 | The Global Entrepreneur

Daniel J. Isenberg

For over a century, start-ups began by focusing on their home markets. More and more, however, are now being born global—chasing opportunities created by distance, learning to manage faraway operations, and hunting for the planet's best manufacturing locations, brightest talent, most willing investors, and most profitable customers wherever they may be—from day one.

That's not easy. Isenberg, a professor of entrepreneurship practice, has found in his research that global start-ups face three challenges. First are the logistical problems and psychic barriers created by distance and by differences in culture, language, education systems, religion, and economic development levels. Even something so basic as accommodating the world's various workweek schedules can put a strain on a small start-up's staff. Second is managing the challenges (and opportunities) of context—that is, the different nations' political, regulatory, judicial, tax, and labor environments.

Third, like all new ventures, global start-ups must find a way to compete with bigger incumbents while using far fewer resources.

To succeed, Isenberg has found, global entrepreneurs must cultivate four competencies: They must clearly articulate their reasons for going global, learn to build alliances with more powerful partners, excel at international supply chain management, and create a multinational culture within their organization.

Entrepreneurs shouldn't fear the fact that the world isn't flat. Being global may not be a pursuit for the fainthearted, but even start-ups can thrive by using distance to gain competitive advantage.

HBR Reprint R0812J

58 | Blitzscaling

Reid Hoffman, interviewed by Tim Sullivan

Reid Hoffman is one of Silicon Valley's grown-ups. After helping to found PayPal, he moved on to launch LinkedIn in 2002—an endeavor that turned him into a billionaire. He was an early investor in Facebook and now serves as a partner at the venture capital firm Greylock.

In this edited interview with Tim Sullivan, of HBR Press, Hoffman explores his idea of "blitzscaling"—the discipline of getting very big very fast. In today's networked landscape, the path to high-growth, high-impact entrepreneurship can be chaotic and grueling. It involves rapidly building out a company to serve a large and usually global market, with the goal of becoming the first mover at scale.

And there's no playbook to guide you, Hoffman notes. "You throw yourself off a cliff and assemble your airplane on the way down."

Hoffman emphasizes that blitzscaling is not just about growing revenues and the customer base but also about scaling the organization. People naturally focus on the first two, and "if you don't get those right, then nothing else matters." But very few businesses can succeed on those fronts without also building an organization that has the capability and the capacity to execute at a high level in the face of extremely rapid growth.

The challenges, risks, and headaches of blitzscaling go beyond the operational; they can take a toll on organizational happiness. "But the thing that keeps these companies together—whether it's PayPal, Google, eBay, Facebook, LinkedIn, or Twitter," Hoffman says, "is the sense of excitement about what's happening and the vision of a great future."

HBR Reprint R1604B

66 | Start-Ups That Last

Ranjay Gulati and Alicia DeSantola

Why do so many promising start-ups go off the rails? Often they have trouble scaling. Founders may resist imposing discipline for fear of losing agility and control—but the price may be chaotic operations and unpredictable performance.

Drawing on extensive case studies and 75 years of research, the authors outline four activities that can help companies handle greater complexity as they seek new avenues for growth. Firms should:

- Hire specialists in functions such as sales, HR, marketing, R&D, and manufacturing. This lets them tackle work more efficiently and catalyzes future growth by creating slack in the rest of the organization.
- Add management structure. A few people at the top can't effectively supervise everyone's increasingly specialized daily work—and it's hard for employees to stay focused and engaged without guidance and processes.
- Establish a framework of plans and goals. Otherwise, improvisation may amount to aimless riffing.
- Sustain the culture. Articulate the founding values in mission statements and job descriptions, and hire and reward for cultural fit.

Between the extremes of ad hoc and prescriptive organizing lies a useful middle ground—and leaders who can find it gain an important edge on their rivals.

HBR Reprint R1603C

74 | Beating the Odds When You Launch a New Venture

Clark G. Gilbert and Matthew J. Eyring

Despite the popular image of entrepreneurs as risk-loving cowboys, the reality is that great entrepreneurs don't take risks—they manage them. The authors counsel managers to recognize that not all risks are created equal and that they should be addressed in order of importance and affordability.

When you're launching a new venture, first consider *deal-killer risks* that, if left unexamined, could kill the whole business. Next tackle *path-dependent risks,* ones that could sabotage the project if it takes a direction you're not currently anticipating. Then focus on *high-ROI risks*—the questions you can answer without spending much money (but that will trip you up if left unanswered).

Once you've identified the most important risks facing your new venture, manage those risks the way the best venture capitalists do: Spend a little bit of money at a time; create experiments that will test your assumptions; keep your timeline as short as you can; test only one thing at a time; and listen carefully for what an experiment's results are really telling you. Hint: You should be trying to prove that your assumptions are wrong, not simply to confirm your own biases.

HBR Reprint R1005G

82 | Lean Strategy

David Collis

Strategy and entrepreneurship are often seen as polar opposites. Strategy means rigorously defining and pursuing one clear path, while entrepreneurship involves continually changing direction to take advantage of new opportunities. Yet the two desperately need each other: Strategy without entrepreneurship is central planning; entrepreneurship without strategy leads to chaos.

There is a way to reconcile the two, through the *lean strategy process*. It ensures that start-ups innovate in a disciplined fashion so that they make the most of their limited resources. Lean strategy helps company builders choose viable opportunities, stay focused, and align the entire organization.

The process begins with setting the venture's vision, or ultimate purpose—perhaps the only aspect of strategy that should be permanent. To deliver on it, senior executives agree on a deliberate strategy, defining the firm's objective (the near-term goal that describes success), scope (what the firm will and will not do), and competitive advantage (how it will win). The deliberate strategy sets the bounds within which experiments will take place and guides daily decisions. But the results of those experiments and decisions lead to learning that reshapes the strategy. Though priorities evolve, at each point in time it's clear to everyone in the firm which ones take precedence.

HBR Reprint R1603E

88 | Why the Lean Start-Up Changes Everything

Steve Blank

In the past few years, a new methodology for launching companies, called "the lean start-up," has begun to replace the old regimen. Traditionally, a venture's founders would write a business plan, complete with a five-year forecast, use it to raise money, and then go into "stealth mode" to develop their offerings, all without getting much feedback from the people they intended to sell to. Lean start-ups, in contrast, begin by searching for a business model. They test, revise, and discard hypotheses, continually gathering customer feedback and rapidly iterating on and reengineering their products. This strategy greatly reduces the chances that start-ups will spend a lot of time and money launching products that no one actually will pay for.

Blank, a consulting associate professor at Stanford, is one of the architects of the lean start-up movement and has seen this approach help businesses get off the ground quickly and successfully. He believes that if it's widely adopted, it would reduce the incidence of start-up failure. In combination with other trends, such as open source software and the democratization of venture financing, it could ignite a new, more entrepreneurial economy.

There are numerous indicators that the approach is catching on: Business schools and universities are incorporating lean start-up principles into their curricula. Even more interesting, large companies like GE are applying them to internal innovation initiatives.

HBR Reprint R1305C

96 | Six Myths About Venture Capitalists

Diane Mulcahy

As the director of private equity for the Kauffman Foundation and a former venture capitalist, Mulcahy has observed the industry closely. In 2012 she and two Kauffman colleagues published a report titled "We Have Met the Enemy…and He Is Us," based on a comprehensive analysis of the foundation's more than 20 years of experience investing in nearly 100 VC funds. Her research and experience led her to advise aspiring entrepreneurs against falling victim to these common myths about venture capital:

1. *It's the primary source of start-up funding.* (Actually, angel investors fund 16 times as many companies, and in 2012 more than 18,000 entrepreneurs raised nearly $320 million through a single crowdfunding site.)
2. *VCs take big risks with start-ups.* (Often they're insulated against risk by hefty annual fee streams.)
3. *Most VCs offer great advice and mentoring.* (To avoid disappointment on this front, ask the CEOs of other portfolio companies how they'd rate the firm.)
4. *VC generates spectacular returns.* (Since 1997 less cash has been returned to VC investors than they have invested.)
5. *Bigger is better.* (Research shows that fund performance declines as fund size increases above $250 million.)
6. *VCs are innovators.* (Apparently not. The innovation is coming from online platforms such as AngelList and SecondMarket.)

HBR Reprint R1305E

100 How to Negotiate with VCs

Deepak Malhotra

VC–entrepreneur partnership agreements often contain flaws that become highly damaging as the parties come up against issues of power, trust, and much more. Yet many of the flaws are systematic and predictable—and hence preventable. The author, a longtime consultant to the VC industry, outlines four recommendations for entrepreneurs sitting down at the table with prospective funders.

Understand your leverage. Your leverage is not only a function of your alternatives; it has a lot to do with the VC's as well. Seek to understand them, and be prepared to educate the VC about why his exercising too much power could hurt *both* parties in the long term.

Maximize trust. Beneath all the financial projections, the VC negotiation is a process in which people are deciding whom they want to associate with for years to come. If the VC is vulnerable, use the opportunity to build trust rather than to take advantage.

Focus on value—not just valuation. Nonfinancial considerations such as control are also important.

Strive for understanding. Seemingly abstruse provisions can be highly consequential. And bear in mind that the choices a VC makes when negotiating can contain important clues about her assessments and expectations.

Above all, when you're negotiating with a VC, think not only about what will look good in a press release today but also about what will help you create and capture value over the long run.

HBR Reprint R1305F

108 How to Launch Your Digital Platform

Benjamin Edelman

The ubiquity of internet access has caused a sharp rise in the number of businesses offering platforms that connect users for communication or commerce. Entrepreneurs are particularly drawn to these platforms because they create significant value and have modest operating costs, and network effects protect their position once established—users rarely leave a vibrant platform.

But these businesses also raise significant start-up challenges. Every platform starts out empty. Platforms need to immediately attract not only many users but multiple types of users. For example, it's not enough that many customers want to book taxis by smartphone. Drivers must also be willing to accept smartphone bookings.

Harvard Business School professor Ben Edelman has been studying the dynamics of platform businesses and strategies for launching them for 10 years. In this article he draws on research on dozens of platform sites and products to offer a framework for building a successful platform business. It involves asking five basic questions:

- Can I attract a large group of users at once?
- Can I offer stand-alone value to users?
- How can I build credibility with customers?
- How should I charge users?
- Should my platform be compatible with legacy systems?

HBR Reprint R1504H

114 The Right Way to Use Compensation

Mark Roberge

When Mark Roberge joined HubSpot as its fourth employee, he had no sales experience but still was charged with building the sales team. His background proved to be an advantage, however: With his engineering training, Roberge brought an analytic rigor to the task. And he quickly realized that the sales compensation plan could motivate salespeople not only to sell more but also to behave in ways that advanced the start-up's evolving strategy. Each time the firm entered a new stage of growth, Roberge revised the comp plan to support its changing priorities:

Customer acquisition. Early on, HubSpot needed to bring in lots of customers and see how well its offer was working. So it rewarded salespeople for customers who stayed at least four months, and soon grew to 1,000 customers.

Customer success and retention. In the second phase, HubSpot focused on ensuring that its product fit the market. Realizing that many customers were jumping ship because they'd been given the wrong expectations, Roberge began tying commission rates to the rate of customer retention.

Sustainable growth. After it fixed retention, HubSpot saw that its service worked best for customers who made a commitment to it. So the firm's third plan rewarded salespeople for customers who signed up for a full year at a time.

The continual adaptation paid off: In seven years HubSpot hit $100 million in sales.

HBR Reprint R1504E

What makes entrepreneurs entrepreneurial?

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What makes entrepreneurs entrepreneurial?

Professionals who work closely with them and researchers who study them have often speculated about what makes entrepreneurs "entrepreneurial". Of course, entrepreneurs also love to hold forth on this topic. But while there are as many war stories and pet theories as there are entrepreneurs and researchers, gathering together a coherent theory of entrepreneurial expertise has thus far eluded academics and practitioners alike.

What are the characteristics, habits, and behaviors of the species *entrepreneur*? Is there a learnable and teachable "core" to entrepreneurship? In other words, what can today's entrepreneurs such as Rob Glaser and Jeff Bezos learn from old stalwarts such as Josiah Wedgwood and Leonard Shoen? Or even within the same period in history, what are the common elements that entrepreneurs across a wide variety of industries share with each other? In sum, is there such a thing as "entrepreneurial thinking" that can be applied across space, time and technology?

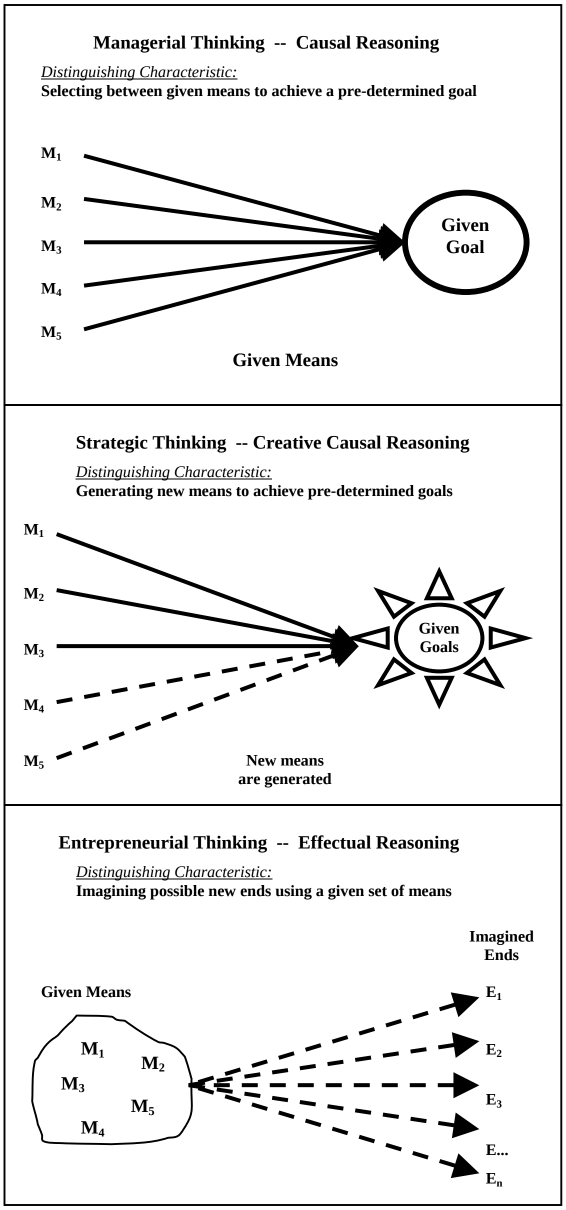
In 1997, I set out on a rather perilous but exhilarating journey to investigate this question. Traveling across 17 states in the US over several months, I met with 30 founders of companies ranging in size from $200 M to $6.5 B and spanning a variety of industries from steel and railroad to teddy bears and semiconductors and bio-tech. The idea behind the study was not merely to interview these founders, but to get behind their stories and understand how they reason about specific problems in transforming an idea into an enduring firm. The entrepreneurs worked their way through a 17-page problem set over two hours, talking aloud continuously as they each solved exactly the same ten decision problems to build a company starting with exactly the same product idea. Rigorous analyses of the transcribed tapes led to rather surprising but eminently teachable principles. This set of principles, when put together, rested on a coherent logic that clearly established the existence of a distinct form of rationality that we have all long recognized intuitively as "entrepreneurial". For reasons that will become clear in the next section, I have termed this type of rationality "effectual reasoning".

Effectual reasoning: The problem

The word "effectual" is the inverse of "causal". In general, in MBA programs across the world, students are taught causal or predictive reasoning – in every functional area of business. Causal rationality begins with a pre-determined goal and a given set of means, and seeks to identify the optimal – fastest, cheapest, most efficient, etc. – alternative to achieve the given goal. The make-vs.-buy decision in production, or choosing the target market with the highest potential return in marketing, or picking a portfolio with the lowest risk in finance, or even hiring the best person for the job in human resources management, are all examples of problems of causal reasoning. A more interesting variation of causal reasoning involves the creation of additional alternatives to achieve the given goal. This form of creative causal reasoning is often used in strategic thinking.

Effectual reasoning, however, does not begin with a specific goal. Instead, it begins with a given set of means and allows goals to emerge contingently over time from the varied imagination and diverse aspirations of the founders and the people they interact with. While causal thinkers are like great generals seeking to conquer fertile lands (Genghis Khan conquering two thirds of the known world), effectual thinkers are like explorers setting out on voyages into uncharted waters (Columbus discovering the new world). It is important to point out though that the same person can use both causal and effectual reasoning at different times depending on what the circumstances call for. In fact, the best entrepreneurs are capable of both and do use both modes well. But they prefer effectual reasoning over causal reasoning in the early stages of a new venture, and arguably, most entrepreneurs do not transition well into latter stages requiring more causal reasoning. Figure 1 graphically depicts the different forms of reasoning discussed above.

Figure 1



While causal reasoning may or may not involve creative thinking, effectual reasoning is inherently creative. The simple task of cooking dinner may be used to contrast the two types of reasoning. A chef who is given a specific menu and has only to pick out his or her favorite recipes for the items on the menu, shop for ingredients and cook the meal in their own well-equipped kitchens is an example of causal reasoning. An example of effectual reasoning would involve a chef who is not given a menu in advance, and is escorted to a strange kitchen where he or she has to explore the cupboards for unspecified ingredients and cook a meal with them. While both causal and effectual reasoning call for domain-specific skills and training, effectual reasoning demands something more – imagination, spontaneity, risk-taking, and salesmanship.

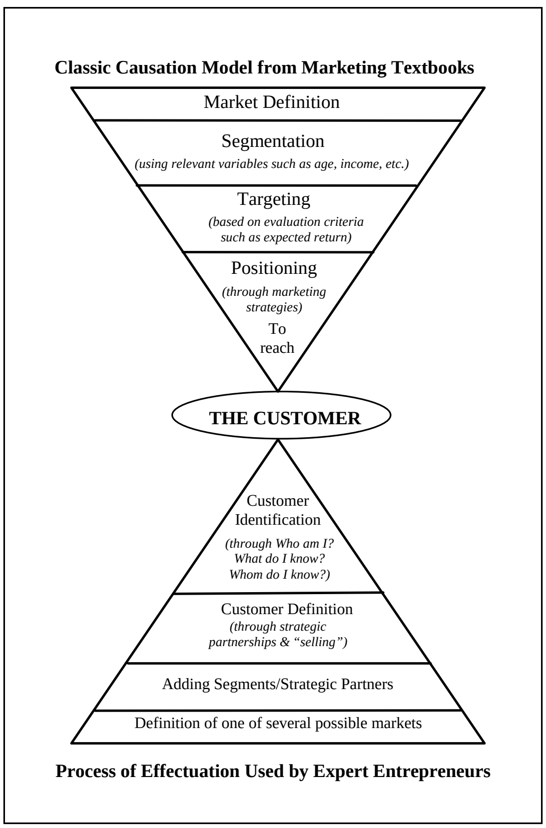
Effectual reasoning: The process

All entrepreneurs begin with three categories of means: (1) Who they are – their traits, tastes and abilities; (2) What they know – their education, training, expertise, and experience; and, (3) Whom they know – their social and professional networks. Using these means, the entrepreneurs begin to imagine and implement possible effects that can be created with them. Most often, they start very small with the means that are closest at hand, and move almost directly into action without elaborate planning. Unlike causal reasoning that comes to life through careful planning and *subsequent* execution, effectual reasoning lives and breathes execution. Plans are made and unmade and revised and recast through action and interaction with others on a daily basis. Yet at any given moment, there is always a meaningful picture that keeps the team together, a compelling story that brings in more stakeholders and a continuing journey that maps out uncharted territories. Through their actions, the effectual entrepreneurs' set of means and consequently the set of possible effects change and get reconfigured. Eventually, certain of the emerging effects coalesce into clearly achievable and desirable goals -- landmarks that point to a discernible path beginning to emerge in the wilderness.

Yet, in our classrooms, we teach potential entrepreneurs an extremely causal process – the sequential progression from idea to market research, to financial projections, to team, to business plan, to financing, to prototype, to market, to exit, with the caveat, of course, that surprises will happen along the way. Seasoned entrepreneurs, however, know that surprises are not deviations from the path. Instead they are the norm, the flora and fauna of the landscape, *from* which one learns to forge a path through the jungle. The unexpected is the stuff of entrepreneurial experience and transforming the unpredictable into the utterly mundane is the special domain of the expert entrepreneur.

Let us consider how the two processes operate in the simple case of building a restaurant. Imagine an entrepreneur who wants to start an Indian restaurant. In the causal process that we teach, she would start with some market research into the restaurant industry in the city of her choice; select a location very carefully based upon the market research; segment the market in a meaningful way; select target segments based on estimates of potential return; design a restaurant to appeal to her target segments; raise the required funding; bring her team together; and finally, implement specific market strategies and manage daily operations to make her restaurant a success.

Figure 2



In the effectual process, it would all depend on who our entrepreneur is, what she knows, and whom she knows. For the sake of understanding the process here, let us say she is a good Indian chef who is considering starting an independent business. Assuming she has very little money of her own, what are some of the ways she can bring her idea to market? When used as a class exercise, students usually suggest courses of action such as partnering with an existing restaurant, participating in ethnic food fairs, setting up a catering service and so on. Let us say that the actual course of action she decides to pursue is to persuade friends who work downtown to allow her to bring lunch for their office colleagues to sample. Let us further say that some customers then sign up for a lunch service and she begins preparing the food at home and delivering lunches personally. Eventually, she could save up enough money to rent a location and start a restaurant.

But it could equally be plausible that the lunch business does not take off beyond the first few customers, but instead our entrepreneur discovers that the customers are actually interested in her ethnic philosophy and life experiences or Indian culture or other aspects of her personality or expertise or contacts or interests. She could then decide to go into any one of several different businesses contingent upon the ensuing feedback. To cite but a few possibilities, her eventual successful enterprise could turn out to be in any one or all of the following industries -- education, entertainment, travel, manufacturing and packaging, retail, interior decoration, or even self-help and motivation!

Figure 2 graphically depicts and contrasts the causal marketing process with the effectual one.[1] Real life examples of effectual processes in entrepreneurship abound. In fact, the stories of effectuation permeate and saturate the history of entrepreneurship since at least as far back as the eighteenth century: In the eighteenth century, a potter named Josiah Wedgwood, realized that pots can carry people's aspirations for social mobility; in the twentieth, King Gillette began toying with the idea of creating something that customers would want to

[1] It is easy to see that the inverted causal triangle at the top can be moved to the bottom below the upright effectual triangle and that would capture the marketing life cycle of most entrepreneurial firms. Once the market had been clearly identified and defined, one can now apply the traditional causal marketing process to capture market share and grow the company.

repeatedly re-purchase and while shaving one morning, hit upon disposable razors as a possibility; Tom Fatjo, a respectable professional in Houston, practically got *dared* into founding the garbage giant BFI during a suburban subdivision meeting to solve the community's garbage disposal problems; and closer to the twenty-first century, while trying to build an interactive cable channel with progressive content, an ex-Microsoft executive named Rob Glaser fell in love with Mosaic, and set out to give voice to the mute Web in the form of RealNetworks; and so it goes.

Effectual reasoning: The principles

Does all this mean, though, that we are once again resorting to tales by the campfire? It turns out that all these stories have some common principles of reasoning that invert their counterparts in causal reasoning. Moreover, these principles tie together into a coherent logic that demonstrates that this is indeed a convincing alternative to causal rationality:

- While causal reasoning focuses on expected return, effectual reasoning emphasizes affordable loss;
- While causal reasoning depends upon competitive analyses, effectual reasoning is built upon strategic partnerships; and,
- While causal reasoning urges the exploitation of pre-existing knowledge and prediction, effectual reasoning stresses the leveraging of contingencies.

<u>The affordable loss principle</u>

While managers are taught to analyze the market and choose target segments with the highest potential return, entrepreneurs tend to find ways to reach the market with minimum expenditure of resources such as time, effort, and money. In the extreme case, the affordable loss principle translates into the zero resources to market principle. Several of the expert entrepreneurs I studied insisted that they would not do any traditional market research, but would take the product to the nearest possible potential customer even before it was built. To quote but one of them, "I think I'd start by just... going... instead of asking all the questions I'd go and say.. try and make some sale. I'd make some… just judgments about where I was going -- get me and my buddies -- or I would go out and start selling. I'd learn a lot you know.. which people.. what were the obstacles.. what were the questions.. which prices work better and just DO it. Just try to take it out and sell it. Even before I have the machine. I'd just go try to sell it. Even before I started production. So my market research would actually be hands on actual selling. Hard work, but I think much better than trying to do market research".

In finding the first customer within their immediate vicinity, whether within their geographic vicinity, within their social network, or within their area of professional expertise, entrepreneurs do not tie themselves to any theorized or pre-conceived "market" or strategic universe for their idea. Instead, they open themselves to surprises as to which market or markets they will eventually end up building their business in or even which new markets they will end up creating. Starting with exactly the same product, the entrepreneurs in the study ended up creating companies in 18 completely disparate industries!

<u>The strategic partnerships principle</u>

Another key principle of effectual reasoning is the focus on building partnerships rather than on doing a systematic competitive analysis. Since entrepreneurs tend to start the process without assuming the existence of a pre-determined market for their idea, detailed competitive analyses do not seem to make any sense to them at the startup phase. As one of the subjects explained, "At one time in our company, I ordered people not to think about competitors. Just do your job. Think only of your work."[2] Instead entrepreneurs focus on building partnerships right from the start. In fact, the ideal beginning for a successful startup seemed to be the induction of customers into strategic partnerships. Again, to hear it from the

[2] He went on to add, "Now that isn't entirely possible, we do a lot of competitive research now." At the time of the study, his company was a 3 Billion dollar company. The evidence shows that as an entrepreneurial company grows beyond a critical size, effectual reasoning has to be supplemented with and even replaced at times by causal modes of thinking.

horse's mouth, "Traditional market research says, you do very broad based information gathering, possibly using mailings. I wouldn't do that. I would literally, target, as I said initially, key companies who I would call flagship, do a frontal lobotomy on them…. The challenge then is really to pick your partners, and package yourself early on before you have to put a lot of capital out"

In fact, the strategic partnerships principle dovetails very well with the affordable loss principle to bring the entrepreneurs' idea to market at really low levels of capital outlay. Furthermore, obtaining pre-commitments from key stakeholders helps reduce uncertainty in the early stages of creating an enterprise. Finally, since the entrepreneur is not wedded to any particular market for their idea, the expanding network of strategic partnerships determines to a great extent which market or markets the company will eventually end up in.

<u>The leveraging contingencies principle</u>

The third principle of effectual reasoning is the heart of entrepreneurial expertise – the ability to turn the unexpected into the profitable. As one of the subjects in the study put it, "I always live by the motto of *Ready-fire-aim*. I think if you spend too much time doing ready-aim-aim-aim-aim, you're never gonna see all the good things that would happen if you actually start doing it and then aim. And find out where your target is."

Great entrepreneurial firms are products of contingencies. Their structure, culture, core competence, and endurance are all residuals of particular human beings striving to forge and fulfil particular aspirations through interactions with the space, time and technologies they live in. For example, we could speculate whether Wedgwood pottery would have been possible if the potter Josiah Wedgwood had not met the gentleman philosopher Thomas Bentley and wooed him into a partnership that created a brand and a great company that has lasted over two centuries. The key to the Wedgwood fortune was the realization that people put their money where their aspirations are and that pots and vases could become vehicles of social mobility. Similarly, in our time, researchers speculate what Microsoft would have been if IBM had written a different type of a contract or if Gary Kildahl had not been out flying his airplane the day IBM came calling. Yet, it is not the contingencies themselves that shaped the companies in the foregoing examples. It is how the entrepreneurs *leveraged* the contingencies that came upon them that has to form the core of models of effectual reasoning. The realization that not all surprises are bad and that surprises, whether good or bad, can be used as inputs into the new venture creation process differentiates effectual reasoning from causal reasoning which tends to focus on the avoidance of surprises as far as possible.

Effectual reasoning: The logic

Underlying all the principles of effectual reasoning is a coherent logic that rests on a fundamentally different assumption about the future than causal reasoning. Causal reasoning is based on the logic, *To the extent that we can predict the future, we can control it.* That is why both academics and practitioners in business today spend enormous amounts of brainpower and resources on developing predictive models. Effectual reasoning, however, is based on the logic, *To the extent that we can control the future, we do not need to predict it.*

How does one control an unpredictable future? The answer to this question depends on our beliefs about where the future comes from. Is the future largely a continuation of the past? To what extent can human action actually change its course? While the future is always uncertain, not all uncertainties are the same. In fact, the simplest way we can model the different types of uncertainties is through the classic statistical model of the future as an urn containing different colored balls wherein the drawing of (say) a red ball, results in a reward (of say, \$50). Assume the first urn contains 10 red balls and 10 green balls. In this case, the player can calculate the odds as an expected return of \$25 on every draw since there is a 50-50 chance of winning \$50. This is the model of a risky, but predictable, future. Entrepreneurs, as well as most human beings in the real world, however, usually have to operate without such predictability. The urn they have to deal with does not have a given number of balls of known colors. Instead it contains an unknown number of balls of unknown colors, but the game remains the same. In this case, the best strategy for the player is to draw balls randomly several times and to carefully note the result of each draw so that the distribution of balls in the urn can be *discovered* over time. This is a model of an uncertain, but learnable future that becomes predictable over time. Using the causal logic -- *to the extent we can predict the future, we can control it* – makes sense in both these cases.

But entrepreneurs choose to view the future through effectual logic. Consciously, or unconsciously, they act as if they believe that the future is not "out there" to be discovered, but that it gets created through the very strategies of the players. In other words, the entrepreneur using effectual logic says: "Whatever the initial distribution of balls in the urn, I will continue to acquire red balls and put them in the urn. I will look for other people who own red balls and induce them to become partners and add to the red balls in the urn. As time goes by, there will be so many red balls in the urn that almost every draw will obtain one. On the other hand, if I and my acquaintances have only green balls, we will put them in the urn, and when there are enough, will create a new game where green balls win." Of course, such a view may express hopes rather than realities, and many entrepreneurs in the real world do fail. But the fact remains that entrepreneurs use this logic to try and build new urns and devise new games all the time. In fact, several of the expert entrepreneurs I studied explicitly stated that being in a market that could be predicted was not such a good idea, since there would always be someone smarter and with deeper pockets who would predict it better than they could. But being in an unpredictable market meant that the market could be shaped through their own decisions and actions working in conjunction with pre-committed stakeholders and customer-partners. Together they could use contingencies along the way as part of the raw materials that constitute the very urn they are constructing.

Expert entrepreneurs are not usually in the ball counting business or the gaming business. Instead they are actually in the business of creating the future, which entails having to work together with a wide variety of people over long periods of time. Sturdy urns of the future are filled with enduring human relationships that outlive failures and create successes over time[3].

Embodied in a network of such enduring relationships, effectual logic is particularly useful and effective in domains such as the introduction of new products in new markets, an area often referred to as the suicide quadrant (See Figure 3), exactly the area where traditional marketing techniques are ineffective.

Figure 3

	Existing Market	**New Market**
Existing Product		
New product		**Suicide Quadrant**

That is because effectual logic is people dependent, unlike causal logic, which is effect dependent. In other words, when a particular effect has already been chosen such as a target segment within an existing market, the people we hire and partner with will depend on the effect we want to create or the market we want to penetrate. Effectual logic, however, does not assume pre-existent markets and builds on the idea that the markets we create will be predicated on the people we are able to bring together. In fact, in effectual reasoning, markets are in essence stable configurations of critical masses of stakeholders who come together to transform the outputs of human imagination into the forging and fulfillment of human aspirations through economic means.

[3] This is again a topic that is largely ignored in our entrepreneurship curricula which tend to focus on market research, business planning, new venture financing and legal issues. As far as I know no entrepreneurship programs offer courses in creating and managing lasting relationships or stable stakeholder networks, nor on failure management.

Experienced professionals in the entrepreneurial arena, whether they are bankers, lawyers, VCs or other investors have always agreed with successful entrepreneurs that finding and leading the right people is the key to creating an enduring venture. These entrepreneurs know that such "right" people are not on the job market waiting for the jobs and incentives the entrepreneurs can offer them. Instead the "right" people need emotional ownership in the goals and objectives of the endeavor and can only be incentivized by the belief that the effects they create will embody their deepest passions and aspirations while enabling them to achieve their best potential.

But great entrepreneurs realize something more about the central role of people in shaping the urn. Using effectual logic, they understand that they too cannot wait around to find the "right" people all the time. Besides continually striving to attract the "right" people, they learn also to nurture and grow them in their own backyards. As Josiah Wedgwood wrote, "We have to make artists of mere men." And more recently, the founders of AES Corp., a multi-billion dollar electric power company with operations in dozens of countries around the world say, "[AES] is fun because the people who work here are fully engaged. They have total responsibility for decisions. They are accountable for results. What they do every day matters to the company, and it matters to the communities we operate in."

There is, however, a dark corollary to the use of effectual logic in entrepreneurial activity. Since they do not assume specific pre-existent goals or effects and let these effects emerge through the process, in using effectual logic to create products and markets, entrepreneurs and their partners may also end up creating harmful and problematic effects for the society they live in. The effects they create may reflect the ignorance and cupidity as well as the will and aspirations of the people who participate in the creation of new urns and games of the future. But our awareness of the existence of effectual reasoning should alert us more sharply to the role of entrepreneurs and the market system in shaping our future as a species, not merely as contributors to GDP.

The creation of U-Haul: An exemplar of effectual logic

In 1945, newly married, and with barely $5,000, Leonard Shoen set out on his effectual journey that led to the creation of U-Haul. By the end of 1949, it was possible to rent a trailer one-way from city to city throughout most of the United States. When we examine his journey, we find that this feat could not have been accomplished except through the use of effectual reasoning. When students today set out to write a business plan for this venture (using causal processes), they conclude that the plan is financially infeasible, or even psychologically infeasible, since it requires a large and risky capital outlay, most of which gets locked up in relatively worthless assets such as trucks and location rental. Moreover, the logistics of starting the business at a much smaller scale and growing it as fast as Shoen did overwhelms the analytical prowess of the best of causal thinkers. The final nail in the coffin usually is the complete lack of any entry barriers to imitators with deep pockets after the concept is proved on a smaller scale.

Shoen, however, did not do elaborate market research or detailed forecasting and fund-raising in the sense in which we use the terms today. Instead, using effectual means, (who he was, what he knew, and whom he knew), he plunged into action, creating the market as he grew the business. In his own words, "Since my fortune was just about enough to make the down payment on a home and furnish it, and knowing that if I did this we would be sunk, we started the life of nomads by putting our belongings in a trailer and living between in-laws and parents for the next six months. I barbered part time and bought trailers of the kind I thought we needed to rent from anybody who happened to have one at the price I thought was right. By the fall of 1945, I was in so deep into the trailer rental deal economically that it was either make it or lose the whole thing."

At that time he moved with his wife Anna Mary Carty Shoen and their young child to the Carty ranch in Ridgefield, Washington. There, with the help of the Carty family, the Shoens built the first trailers in the fall of 1945, painted in striking orange with the evocative name *U-Haul* on the sides, using the ranch's automobile garage (and milk house) as the first manufacturing plant. Shoen then practically gave away the initial trailers to renters so they could establish dealerships in cities they moved to. He would also purchase trailers and trucks and sell them to employees, family members, friends, and investors who would then lease them back to AMERCO, the parent company of U-Haul. He contracted with national gas station chains to utilize their unused space for parking and to manage the paperwork. Together, this vast network of stakeholders formed a substantial entry barrier to any imitator who would have to risk a large capital outlay to compete. Advertising was entirely limited to Yellow Pages and to the sudden and startling sight of growing numbers of distinctively painted vans being driven along the freeways of the country.

At any given moment, U-Haul could have failed, but the resulting financial fall-out would not have been a disaster since the investments were spread across so many stakeholders. This brings us to the key implication of effectual reasoning for the success or failure of entrepreneurial ventures. Effectual reasoning may not necessarily increase the probability of success of new enterprises, but it reduces the *costs* of failure by enabling the failure to occur earlier and at lower levels of investment.

So, what makes entrepreneurs entrepreneurial?

Entrepreneurs are entrepreneurial, as differentiated from managerial or strategic, because they think effectually; they believe in a yet-to-be-made future that can substantially be shaped by human action; and they realize that to the extent that this human action can control the future, they need not expend energies trying to predict it. In fact, to the extent that the future is shaped by human action, it is not much use trying to predict it – it is much more useful to understand and work with the people who are engaged in the decisions and actions that bring it into existence.