www.forbes.com /sites/georgeanders/2014/03/26/inside-sequoia-capital-silicon-valleys-innovation-factory/

Inside Sequoia Capital: Silicon Valley's Innovation Factory

George Anders

20-26 minutes

By George Anders with Alex Konrad

When Doug Leone arrived in Mount Vernon, N.Y. in 1968, the 11-year-old Italian immigrant didn't have a clue. He flunked a math quiz in school because the terms "true" and "false" bewildered him. He wore unsightly slacks from Sears that invited classmates' teasing. After school he watched McHale's Navy alone on a black-and-white television, hoping to learn colloquial phrases that would help him fit in.

A few years later Leone began to get his bearings. "I was working on boats as a teenager, sweating like a pig during a summer job," Leone recalls. "I could look across and see all the kids at the country club's swimming pool. The young guys were talking to the girls. And I was saying to myself: 'I can't wait until I meet you in the business world. You just made your big mistake, letting me in.' "

Ambition. Vulnerability. Vindication. Lots of successful immigrants bottle up those feelings as they rise to prominence. They hide old slights and do their best to blend into America's aristocracy. Not Leone. Even in his perch as a managing partner at venture firm Sequoia Capital, Leone still carries himself like a hard-luck striver, scrambling for his first decent break. "A lot of what keeps me going is fear," he confides.

Step inside Sequoia's spartan offices at Silicon Valley's capital of capital, Sand Hill Road, and see what happens when a handful of hungry perfectionists like Leone band together. Start at the entryway, packed with framed copies of financing documents for 98 companies. The hit parade begins with Apple's initial public offering in 1980; it includes the likes of Oracle, Cisco, Yahoo, Google and LinkedIn. These are Sequoia's children. Since its founding in 1972 Sequoia has backed startups that now command a staggering $1.4 trillion of combined stock market value, equivalent to 22% of Nasdaq.

Yet Sequoia doesn't display its heritage with the well-heeled pride you might find at other top-tier venture firms, let alone the likes of JPMorgan or KKR. At Sequoia the historic IPO filings are crammed into drab, drugstore-quality frames. Sequoia partners don't enjoy luxurious private offices; instead they toil at stand-up desks in a big open hall. Conference rooms are adorned with cheap plastic wastebaskets. It's as if Sequoia's partners haven't fully realized that they might be rich.

The past year Sequoia's scrappy methods have produced the firm's biggest gains ever. A record nine Sequoia partners appear on the FORBES Midas List of the most successful venture capitalists, thanks to the firm's lucrative investment in companies such as Airbnb, Dropbox, FireEye, Palo Alto Networks, Stripe, Square and WhatsApp. At the No. 1 spot is Sequoia partner Jim Goetz, who backed WhatsApp in 2011, well before Facebook agreed to buy the mobile-messaging company for $19 billion. Leone ranks No. 6, followed by colleagues Michael Moritz, Alfred Lin, Roelof Botha, Neil Shen, Michael Goguen, Bryan Schreier and Kui Zhou.

Base pay at Sequoia isn't meant to be dazzling. While the salaries of the firm's nine general partners can top $1 million, Sequoia doesn't bother with Wall Street-style guaranteed bonuses, and some of Sequoia's more junior partners have taken pay cuts to join. That's an easy sacrifice to make. The capital gains vastly exceed base pay.

Consider Sequoia Venture XI Fund, which in 2003 raised $387 million from about 40 limited partners, chiefly universities and foundations. Eleven years later Venture XI has booked $3.6 billion in gains, or 41% a year, net of fees. Sequoia's partners stand to collect 30%, or $1.1 billion, while limited partners get 70%, or another $2.5 billion. Look for even more outsize returns from Venture XIII (2010), which is up 88% a year so far, and Venture XIV (2012). The latter two will split the $3 billion or so Sequoia takes home from the WhatsApp deal. Add it up and Sequoia is turning its own partners into billionaires while keeping outside investors purring.

"We've hired more than 200 outside money managers since I came here in 1989," says Notre Dame's investment chief, Scott Malpass. "Sequoia has been our number one performer by far."

Infographic: Inside Sequoia's Network Of Founders

Sequoia opened for business in 1972, when Don Valentine, a gruff sales and marketing executive in Silicon Valley's chip industry, decided to try his hand at venture capital. The son of a Yonkers, N.Y. truck driver (a few miles from where Leone grew up), Valentine was blessed with an eye for mavericks who could launch great companies. You'll find him in the history books as the fellow who bankrolled Steve Jobs in 1978, even though the 22-year-old Apple founder, by Valentine's later account, smelled odd and "looked like Ho Chi Minh."

When Valentine ceded managerial control of Sequoia in the mid-1990s, Moritz and Leone jointly took over. Superficially they are nothing alike. Moritz started out as a staff writer for Time magazine; he is an Oxford graduate who coins clever phrases all the time. Leone earned a mechanical engineering degree from Cornell and then sold computers for Hewlett-Packard, Prime Computer and Sun Microsystems; he curses to get his point across. Moritz won a full partnership at Sequoia after barely two years; Leone needed five.

Yet both fit the Sequoia mold: feisty, decisive--and ready to back the "dentmakers" of the world. "Every time we invest in a little company, it's a battle against the odds," Moritz explains. "We're always outgunned by companies that are far larger than us, who have threatened us and the founders with extinction. It's incredibly thrilling to prove everyone wrong. You can't get a bigger rush than that."

These days Leone serves as senior partner. Moritz remains an active investing partner but shed his administrative duties in 2012 after being diagnosed with an unspecified illness that, he said, could dim his quality of life in the next five to ten years. In a recent interview with FORBES Moritz said that "staying as fit as possible is the key to everything," adding that he had been swimming for 90 minutes early that morning. Asked if there was any change in his health outlook, Moritz added: "Who knows what fate will deliver?"

Sequoia's partners hear 200 or more pitches a month, while typically funding only two . Regardless of whether a meeting ends with "yes" or "no," founders describe their hour with Sequoia as one of life's most intense experiences. Moritz is the detective, listening to each detail of a founder's story and asking a few eerily perceptive questions. Botha, Lin and Schreier are the growth hackers, looking for ways consumer-oriented startups can rocket ahead even faster. Goguen and Goetz are the mechanics, drawing on 25 years apiece of experience with enterprise technology companies to gauge a startup's chances of prevailing.

Then there's Leone. The boy from Genoa likes to challenge founders right away to find out who is tough enough to succeed. Tony Zingale, a seasoned Silicon Valley executive, recalls a 1990s meeting in which Leone grabbed Zingale's resume, flipped it across the desk and snarled: "What do you know about running a startup?" They bickered for ten minutes before Leone declared: "Okay, now we know you are a smart m-effer. Now we can have the meeting."

Today Zingale is CEO of Jive Software, a Sequoia-backed provider of enterprise/social software. It doesn't matter that Leone can deal out rejections that feel like a punch in the mouth, Zingale says. Slights are forgotten fast; Leone regularly speaks of Zingale as part of the Sequoia family. "He's another fiery Italian, so we get along well," says Zingale.

Borge Hald, the CEO and cofounder of Medallia, encountered Leone's sharp tongue in 2012, when the customer service software company was looking for its first outside capital infusion. Most other venture firms "were sucking up to us and saying we were so good that they wouldn't change a thing," Hald recalls. "Doug challenged us. He said that we needed to build our sales efforts in a big way. He said that in a world that's full of a struggle between energy and chaos, all we amounted to was entropy." In this case Leone's harsh critique paid off; Medallia signed with Leone even though passive competitors offered richer terms.

Part of Sequoia's edge with entrepreneurs comes from a willingness to move fast on the best prospects. Pitch to Sequoia partners on Monday morning and, if everything goes well, you can have a handshake agreement on funding that afternoon. Ask for a term sheet and you'll get the essentials on a single page, rather than a long lawyers' memo. Among the fans of Sequoia's speed is Elon Musk, the CEO of Tesla Motors. Musk remembers that in 1999, when he was building what became PayPal, Sequoia wired him $5 million to get started, even though lawyers hadn't finished all their paperwork.

"Don't complicate our lives," explains Adi Tatarko, the CEO of Houzz, a home remodeling platform. She and her husband, Alon Cohen, cofounded the site in 2009 and have been racing to build it ever since. When Houzz raised money in 2011, another venture firm might have offered a higher valuation. But Sequoia won their loyalty, she says, by being "very direct and really fast."

Tatarko and Cohen grew up in Israel, Musk in South Africa, Hald in Norway. A FORBES analysis shows that a whopping 59% of the startups underlying Sequoia's Midas List calculations were built by at least one foreign-born cofounder . Put flags in a world map and you will see Sequoia connecting with entrepreneurs born in Ukraine, Ireland, Finland, Greece, India, Pakistan, Venezuela and a dozen other countries. (By contrast, Kauffman Foundation data show that barely a quarter of all U.S. startups have at least one immigrant cofounder.)

Sequoia's ties to Silicon Valley's brightest immigrants are hardly an accident. Italian-born Leone rubs shoulders with fellow partners from Wales (Moritz), South Africa (Botha), Taipei (Lin) and old-line parts of the northeastern U.S. who think of themselves as immigrants, too. Native Californians are rare at the firm. Everyone is an outsider, still trying to win acceptance--and success--in a new land.

As a result Sequoia's partners don't mind hunting for great new startups in the ratty coffee shops and low-rent offices where such companies often are born. Other venture capitalists let success draw them into Pebble Beach golf tournaments or the rarefied venues of Davos and Aspen gabfests. "We don't go there," Leone says. "That's not where the next founders are."

The venture capital business often seems as strife-torn as a Kardashian marriage. Ambitious younger partners feud with old-timers. Battles rage within firms about who is good versus lucky, who deserves a bigger share of the profits and who should be booted out. Throw in some personal feuds or indiscreet conduct and pretty soon VCs' quarrels become a feast for lawyers.

Sequoia is the long-running exception. Thanks to some unusual quirks in the firm's hiring habits, everyday work practices--and pay--Sequoia has been able to stay harmonious and rejuvenate its leadership as needed, without any fuss. Older partners cash out. New ones take their place. The firm runs in line with Leone's idea of a big Italian family: lots of personalities, plenty of back-and-forth but a determination to stick together no matter what. Women? Sequoia has none in top U.S. investment roles but says it hopes to hire one someday.

Infographic: Inside Sequoia's Network Of Founders

"We want people who come from humble backgrounds and have a need to win ," Leone says. "And we want a culture where people continuously share credit." Sequoia does hire some recent business school graduates to serve as nonvoting junior partners. But the firm's bigger partnership slots go to seasoned tech executives like Alfred Lin (Zappos), Bryan Schreier (Google) or Omar Hamoui (AdMob). These men are known quantities; they have worked for years at one of Sequoia's portfolio companies.

Schreier, for example, pitched three of his own startup ideas to Sequoia in 2008. Moritz didn't like any of them--particularly a hastily conceived idea about making phones with big buttons so that elderly people could use them. But, as Moritz now recalls, "the best thing about Bryan was Bryan." The big-button phones could wait. Sequoia regarded Schreier's earnest, self-effacing personality as just right for the firm itself.

Sequoia's partners gather each Monday at 8 a.m. to debate investment prospects and review existing portfolio companies. Unwritten house rules reward the humble. "It's about getting to the right decision, rather than being right yourself," says Jim Goetz. "If you talk for more than 90 seconds at a time," adds Aaref Hilaly, a new partner (ex-Clearwell), "you've probably gone on too long."

Unlike Wall Street's activist investors--who agitate for big shakeups that might rocket stock prices upward in a single day--Sequoia's partners help companies relentlessly with the little stuff that will never warrant a press release. When WhatsApp was having trouble hiring engineers, Goetz met at least half a dozen candidates and their spouses for dinner, where he reassured them that this low-key startup really did have a bright future. When Stripe's 23-year-old cofounder, John Collison, wanted help pitching his company's payment services to a big East Coast financial company, Sequoia's Moritz walked him through two rehearsals, sharing ideas about how to sharpen up the story.

When Sequoia partners sweat the details with startup founders, much of the conversation involves tidbits of "tribal knowledge" picked up during the 42 years of firm history. Dropbox, for example, regularly invites Sequoia partner Bill Coughran--a former head of engineering at Google--to share thoughts about how to keep expanding without creating hair balls of complexity.

On a recent visit Coughran leaned back in a plastic chair and reminisced about the four big engineering needs of Google's search division, at a time when "ranking" seemed thrilling and "indexing" seemed dreary. Didn't anyone want to index? Yes, Coughran said: The moment he talked about Google's desire to crank up its indexing capabilities 30-fold over the next several years, indexing suddenly became exciting, too. Dropbox's head of engineering, Aditya Agarwal, smiled. Now he had a new tactic to get people excited about Dropbox's quests, too.

Founders push back if Sequoia tries to offer too much advice. Nir Zuk, the founder of Palo Alto Networks, a computer security company, says he's told Goetz: "If you want to work for me as a product manager, I'd hire you in a heartbeat. But you can't come to board meetings every six weeks and tell me you know more than our full-time product managers do. It just doesn't work that way." Overall, though, Zuk says that what he likes most about Sequoia is that its partners are fellow entrepreneurs who "have gone through what we're going through. They understand us."

Sequoia doesn't always get it right. In the dot-com bust of 2000 the firm suffered big losses from duds such as eToys and Webvan, an online grocer. More recently it sank $25 million into failed photo app Color, which ended up selling at a loss to Apple. Even in Venture XI, the fabulously successful 2003 fund, Sequoia rang up more than $100 million of losses on startups that turned out to be, um, shutdowns.

Periodic losing investments come with the territory. What vexes Sequoia much more are the meetings with tomorrow's legendary founders, when, at the end of the pitch, the firm somehow ends up saying no instead of yes. Pinterest slipped away--and so did Twitter. In 2007 Sequoia had a chance to take a 10% stake in Twitter when the fledgling site was valued at just $20 million. (Twitter's market cap today is more than 1,000-fold higher.)

Live and learn. Sequoia investors put on their hair shirts in 2011 and tried to identify a fixable mistake in their Twitter analysis. Their conclusion: They had been too stubborn about seeking their ideal target of a 20% to 30% stake in startups. Twitter CEO Jack Dorsey had wanted to sell only a smaller amount. In hindsight, says Botha, Sequoia should have agreed. Going forward, partners now are willing to take smaller stakes--at higher than usual prices--when an extraordinary startup is in play.

The worst misstep happened in 2006, when Facebook founder Mark Zuckerberg taunted Sequoia by showing up late at a meeting, wearing pajama bottoms, to discuss an eccentric side business called Wirehog. The farcical presentation was a way of "sticking it to Sequoia," author David Kirkpatrick later reported. (Zuckerberg at the time was taking advice from fellow entrepreneur Sean Parker, who had his own gripes with Sequoia.) Snub accomplished, Zuckerberg won funding from Accel Partners instead, in a deal that eventually produced about a 300-to-1 payoff for that venture firm.

Today relations with Facebook have been mended; since 2012 the big social network has paid top dollar for two Sequoia-funded companies, Instagram and WhatsApp. Even Moritz, who suffered through the pajama presentation, insists that it only deepened his appreciation of Zuckerberg's pluck. "At the end of his slide show," Moritz recalls, "he had this slide saying: 'A Mark Zuckerberg Production.' I remember privately admiring the bravado and self-confidence to insert that line. I would never have had the courage to do that at his age."

Other venture capitalists salute Sequoia's results, though they can't resist the temptation to quibble a bit with its style. "There's a ton of respect," says David Sze of Greylock Partners. "We are both completely dedicated to creating huge successful outcomes to change the world. They are a little more acerbic; we are a little more collaborative."

Years ago, when Kayak cofounders Steve Hafner and Paul English were pitching their travel search engine, Hafner asked Sequoia's partners to help him test the service by offering up airport codes (such as JFK or SFO). When Leone hesitated, some wag interjected: "Doug doesn't know any. He flies private." The comment was a sly dig at superthrifty Leone, who did most of his flying on United at the time and had just agreed, with some trepidation, to rent a few hours of private jet service annually, via NetJets. But Hafner didn't know this. He was "put off his game," and the presentation sputtered. The two were initially turned down before English returned uninvited a day later and convinced the firm to give Kayak a second look.

There's a stereotype in Silicon Valley that venture capitalists become unhelpfully harsh when companies are stumbling and are in too much of a hurry to cash out when things are going well. Sequoia, however, turns those tenets upside down. CEOs such as Brad Peters of Birst, a business-intelligence software company, say Sequoia gives them time and guidance to sort out snags. But Sequoia becomes insatiable when it sees a company doing well and believes that it could be doing even better.

At a recent San Francisco dinner with a dozen CEOs of portfolio companies, for example, Sequoia's Lin asked how many attendees used a technique called net promoter scores to gauge customer enthusiasm. Just about everyone's hands shot up.

"Now, how many of you look at why your ratings come in the way they do?" he asked.

"Only if the numbers are bad," one CEO replied.

"Why don't you look at them when something goes right?" Lin shot back. That was a key part of the winning formula at Zappos during his time there as chief operating officer. Do more of what dazzles your happiest customers, and CEOs can turn strong expansion into hellacious growth.

Sequoia is equally stubborn about maximizing gains from its top-performing companies. (Back in 1979 Sequoia sold its Apple stock after holding it for just 18 months, and Sequoia partners aren't about to make that mistake again.) Unlike other venture firms, which run their limited partners' investment funds for 10 years, Sequoia often looks for ways to extend its partnerships' lives for as much as 16 or 17 years. Sequoia held its Google stock for nearly 2 years after that company went public; it held onto Yahoo even longer in the 1990s.

An especially intense test of Sequoia's willingness to buy and hold involves ServiceNow, a software company providing help-desk services to corporate customers. In July 2011 an unexpected suitor offered to buy the company for $2.5 billion. Sequoia had become a significant investor in late 2009, leading a $41 million investment round, with Leone joining the board. Cashing out at that point would have brought Sequoia about a 10-to-1 return on its investment.

Most of ServiceNow's directors thought the offer was intriguing. Only Leone regarded it as insulting. Rallying some of his colleagues, he worked up a 12-page analysis arguing that directors would be "giving away the company," even at a $4 billion valuation. To his eye, even though ServiceNow was early in its growth curve, its participation in the fast-growing software-as-a-service sector made it a company with vastly better potential than outsiders could see.

After some debate ServiceNow's directors turned down the offer. A year later ServiceNow went public and attracted a $2 billion valuation. Leone's disdain looked a bit off, until ServiceNow shares took off post-IPO. Current market value: $8.3 billion.

Simple math says that Leone's stubbornness made nearly $6 billion more for ServiceNow's shareholders, including company founder Fred Luddy. But it's more primal than that: People like Leone still remember those rich kids at the swimming pool, enjoying the easy life. There's no reason to slow down until old rivals are left far in the dust.