The Entrepreneurs

(From *The Wealth Creators* by Roy C. Smith, to be published by St. Martin’s Press, Feb. 2001)

The 1999 *Forbes* 400 list includes 251 individuals whose source of wealth is described as “self-made.” These include founders of businesses and others who have not relied upon a salary or inheritance to make their fortunes. They number among them the greatest creators of new wealth in the country, the most successful of our living businessmen. But, most of the individuals on this most exclusive list of self-made entrepreneurs are not well known and their business activities are varied beyond belief. They include billionaires whose money comes from medical devices, computer software, railroads, testing laboratories, real estate, home building, stock market investments, trading stamps, oil and gas, computer assembly, direct sales organizations, retailing, health care, mobile phones, music and records, newspapers and media, insurance, cable TV, public storage, plastics, garbage recycling, video tape rentals, sunglasses, sports shoes, credit cards, movie special effects, car dealerships, entertainment, potatoes, and auto rentals. If you add those worth less than a billion, the number and spread of businesses is much larger and more diverse. The self-made are inventors, manufacturers, financial investors, real estate guys, hole diggers, entertainers, and hundreds of other things.
They are what we think of today as entrepreneurs, though the word itself means little more than businessman or investor. In our parlance of the late 1990s, however, entrepreneurs are not just ordinary businessmen -- hired hands and administrators -- they are something more, something much more. They are, first of all, “owners,” who work for no one but themselves. They can be extreme risk-takers, and, colorful, self-confident persons of strong character and personality. Some get a lot of attention, and many have become celebrities and heroes in our complicated society in which traditional hero types are in extremely short supply. Some are nerdish, some dull, some mischievous, and some roguish. Think of Bill Gates, Steve Jobs, Michael Dell, Richard Branson, Ted Turner and Donald Trump. There are also many you never heard of. But stripped of all the hype and filler, what we mean by “entrepreneurs” are simply people who, as individuals or in small groups, have started or acquired businesses and attempted to grow and/or alter them to a point where they could cash in successfully on the rewards. (Not all of them are successful, of course, but their images are projected by those who are). They are founders of enterprises that have made it through the difficult years and been able to profit handsomely from it. Some are more akin to the deal-makers described in the next chapter. We have always had entrepreneurs, though the times have not always been good to them. Today, after two decades of good times, rising markets and thousands of entrepreneurial success stories, everybody wants to be an entrepreneur.

Academics have been studying self-made businessmen for a few decades looking for the keys to success, and a methodology to teach to young
entrepreneurs to be. The literature is rather thin, however, as there really are not a lot of data to study about privately held companies, and the field is endlessly diverse. Most of what we know is anecdotal, and serious scholars are unwilling to conclude much based on anecdotes. We have not yet found, of course, a simple, repeatable formula for turning small or substantially restructured businesses into gold mines. Indeed, many academics believe that great entrepreneurial success is usually a random event, as much influenced by luck as by skill, or by fortuitous (if unwise) risk taking as by any other quality, in which case there is not much to write about. Accordingly, most of the academic and professional literature about entrepreneurship involves macro-economic analyses of the role and importance of small businesses in the economy as a whole, or emphasizes the practical “how-to’s” of small business. Such things as how to develop a good business plan, how to prepare financial forecasts, how to attract venture capital, or how to go about an initial public offering of stock. These are useful, no doubt to people who want to carry out these exercises but don’t know how to, but for those seeking gold mines, well, you won’t learn much.

But we haven’t given up entirely. There is something to be learned, however, from studying what the successful entrepreneurs actually did to become successful. As a result, there is a steady supply of increasingly high quality case studies and biographies of such individuals. There are some patterns that can be recognized when we study their careers, and by analyzing the patterns we can learn something about what seems to work, or would seem to increase the probabilities of success. Or, to put it another way, we can look for
the *sine qua non* of success – those things *without which*, great success probably cannot happen.

**The Bloomberg**

The two best things that ever happened to him, Michael Bloomberg believes, were “getting hired by Salomon Brothers and getting fired by Salomon Brothers.” Bloomberg, now in his late fifties and Chairman of the Bloomberg Group, which he founded in 1981 after being fired, is one of the many self-made entrepreneurs among the *Forbes* 400 who, in 1999, made up more than half the list.

Bloomberg graduated from Harvard Business School in 1966 and joined Salomon Brothers as a trader. He became an equity block-trader, and a partner of the firm in nearly record time. His boss was a colorful but highly controversial character named Jay Perry, who was removed from his position in 1973 following a fist-fight with one of his partners. Bloomberg then became the head of all of the firm’s equity businesses. But he too (in his words) was “pushed aside” six years later in another of Salomon’s periodic palace coups. It was all very Wall Street and Bloomberg was not especially upset by it. He found himself, however, pushed pretty far away from the trading desks he loved and which were the source of all power and fortune at Salomon. He was put in charge of the firm’s back-office computers, something he knew next to nothing about. It was clearly an undisputed transfer to oblivion. The computers then were mainly used for operational purposes, to keep track of settlements of traded securities and of the
firm’s books. All the Wall Street firms used computers then to speed up their back office activities, but nobody who was anybody at Solomon even knew where they were.

Bloomberg wondered why the computers couldn’t be used to assist traders more than they were, to gather up and provide the information they really needed to do their jobs, particularly information about how one security with particular characteristics compared to another. If two essentially similar securities were trading at different prices, a clever trader could buy the cheap one and sell the expensive one and have a position free of market-risk that would be profitable when the market recognized that the two securities were slightly mispriced.

About this time, however, he was fired. Salomon had agreed to be acquired by Phibro Corporation, a large commodities trading house. Salomon’s partners would get cash for their capital in the firm and a new convertible debenture for an equal additional amount to reflect the intangible values of the firm’s franchise. Seven partners, however, would not be asked to join the new company. Mike tells of how he was ushered into the office of Salomon’s chairman, John Gutfreund, and bluntly told he was to be one of those not continuing on. Mike was surprised, and hurt, but also he knew he was rich. His capital and premium were to be paid out to him in cash -- $10 million -- more money than he had ever imagined having. At Salomon, all partners were required to retain their share of all earnings in the firm as a part of its ongoing capital. They were paid 5% interest on their money, and could make withdrawals for
taxes and charitable contributions. But otherwise, the only way a partner could actually get his hands on his own capital was to die, resign (and then be paid out over ten years) or to be fired. If what you wanted was to take your capital out of the firm, of the three options being fired was the best.

Mike immediately knew that he didn’t want to recycle himself through another Wall Street firm, and maybe get fired again. Besides, he now had too much money to go work for somebody else. He wanted to be on his own, and he had his own capital to back a business venture. So he set up a new firm in a small office on Madison Avenue in Manhattan, and went to work trying to think through a business plan. He had been a trader and knew what traders needed. He had been a computer executive and knew what computers could do. Why not put together the ultimate desk-top “black box” for traders, he figured, one that could provide live market data, and could call up from a data base all frequently traded public securities and let the trader compare their various characteristics and prices. The only problem was, such a machine did not exist.

So he set out to design, manufacture and sell one. And to do so in competition with all the major computer makers and software suppliers that serviced Wall Street, plus the now burgeoning technology departments of the firms themselves. And, as he was convinced that the traders on the Street were warming up to what they needed quickly, it would only be a matter a time before someone came up with the black box that every one would want. This “window of opportunity,” Bloomberg figured would only be open to him for a couple of years.
Mike hired some former Salomon colleagues and got to work. Before long he had a pretty good idea of what could be done, and what couldn’t. Then he went out to make some sales calls to Wall Street firms that he thought would be interested. The critical moment came when he went in to pitch his yet unbuilt machine to Merrill Lynch. He had done some consulting work for Merrill and was easily able to set up a meeting with the head of capital markets, who brought his information technology man with him. Mike delivered an impressive performance, solidly making a case for his machine (and inventing it as he went along). “We can give you a yield curve analysis updated throughout the day as markets change,” he said, among other things. He pointed out that no one else had these capabilities on their desks, and it would be a big advantage for a leading trading house like Merrill to have it. The Merrill capital markets head then turned to the technology associate and asked what he thought. “I think we should build it for ourselves,” said the technology man. “Well, when could it be ready?” asked capital markets. The computer guy, confronted as all Wall Street technologists were at the time by a huge backlog of uncompleted work orders submitted by desperate operating departments, grimaced and said “we could probably start working on it in about six months.” Mike immediately saw his opportunity, and went for it.

“Your traders will want this capability long before you can build the machine yourselves. If others have it and you don’t, your guys will be at an expensive disadvantage in the market. And, if your technology people are at all like the ones at Solomon, you shouldn’t take their promised get-started date at
face value. They mean well, but they don’t know what other demands, some
legitimately urgent, will be put upon them over the next year. Every department of
every firm on Wall Street wants to be upgraded to state-of-the-art computer
capability as soon possible. The demands on your guys will be incredible and
deadlines are going to get missed.”

So, he said, he would make Merrill Lynch an offer it couldn’t refuse. “I’ll get
it done in six months and if you don’t like it, you don’t have to pay for it.” The
capital markets man accepted on the spot.

The team at Bloomberg now had a problem – they had to meet their
commitment or eat their costs and perhaps all their plans for the future, too. But
they also had an advantage. They could focus all their efforts on one thing,
without being distracted by other requests. They could also work around the
clock if they had to – they had nothing more important to do -- to accomplish their
goal. But still they had to pull it off, and right up until the last minute, it was not
clear that they would be able to deliver a model that would work well enough. But
they did, and “the rest,” said Mike, “is history.”

Merrill not only ordered a lot of machines, it offered to buy 30% of the
company. Mike was ecstatic. In only three years he had invested over $4 million
of his own money in this venture, and now he had got it back and more. Plus he
had had the world’s biggest securities firm as an confirmed customer. This
relationship would help just about everyone else sitting on the fence decide to
buy a machine as soon as they could.
Mike named the machine *The Bloomberg* and soon traders everywhere had to have one. Just as he had predicted, the traders could not bear to be unequipped with something their rivals were using successfully. They didn’t want a similar machine, they wanted the real thing -- *The Bloomberg*. So orders poured in.

His next breakthrough was to realize that he was not just supplying a trading machine with historical data on it to the securities market, but indeed providing all the “real time” information needed by traders and other businessmen operating in an environment that could not wait for tomorrow’s newspaper. So he redirected his focus towards becoming the equivalent of CNN for all fast moving business and financial news. He would supply the information -- the blades, not just the razors. Thus Bloomberg became a media business unconstrained by its history or vested interests. Bloomberg TV runs 24 hours a day and includes interviews with newsworthy company officers, rating agencies, and Wall Street analysts to present investment information continuously. Bloomberg Radio is a 24-hour news-only radio station. Bloomberg.com gives you all this in extremely user-friendly form on the Internet. There are also the Bloomberg Forum, the Bloomberg News Magazine, and other forms of multimedia information delivery, all of which are available throughout the world. The business, though still heavily dependent on the cash flow from *The Bloomberg*, is self-financing. Mike has since bought back a third of the stock he originally sold to Merrill Lynch, leaving Merrill with 20%, and he still owns virtually all of the rest of the company himself. He has no desire to go public, he says, reflecting his
continuing disinterest in working for other people (i.e., independent shareholders). In 1999, seventeen years after forming the company (and two years longer than he spent at Salomon Brothers), *Forbes* estimated his net worth at $2.5 billion.

**Self-Made Money**

For those who, against long odds, succeed as entrepreneurs in building a business that becomes highly valuable, there are special rewards: wealth, power, and (if you want it) fame and the right to be a bit eccentric.

To do this, though, first requires that you quit your “day job,” the one that has been providing you with a paycheck. When you do this, you start to appreciate the risks that entrepreneurs take from the first day, including the risk of not having any money to support yourself with. You may also have ruined an otherwise promising career by quitting it abruptly without any assurances of being able to return. And for years into the future, you must live with the knowledge that all that you have gained, or hope to gain, could amount to a lot less than what you walked away from, or could be lost tomorrow on a misstep or a sudden change in the market. No matter how else you measure entrepreneurial characteristics, this first, primordial requirement must be present – the willingness to step off into the void, risking most of what other people think of security and well being.

Entrepreneurs usually must beg, borrow and scrape every barrel to collect enough money to get started, and then to meet payrolls and to continue to invest
in expanding the enterprise. Years may have to go by before you can take anything out for yourself. “The Business” becomes an obsession; disproportionately important in your lives – your main reason-for-being -- and it extracts a heavy price from other, more normal relationships. Entrepreneurs worry a lot, and maybe become a bit paranoid, but underneath, there is a feeling that it’s all worth it, a passion is being satisfied. The satisfaction for having done things “your way,” for having succeeded in the “real world” largely as a result of your own vision, follow-through and leadership and organizational skills. Achieving entrepreneurial success may be the greatest challenge available to anyone in business. And, being a founder of a successful business is certainly the best way to make the greatest amount of money, if all goes well, which, of course, often it does not. Indeed, only a very small percentage of entrepreneurs are able to see their efforts culminate in big money.

Today’s business entrepreneurs may have become the cultural replacement for the famous American “rugged individualists” of the last century, the ones who tamed the West and built great industries from nothing. Most of these entrepreneurs own and operate small businesses. According to the Small Business Administration, there were about 6.6 million corporations in the United States in 1996, the vast majority of which were small businesses. This total swells to about 23 million, when sole-proprietorships and partnerships are included, 57% more than in 1982, the first year of the Reagan bull market. These small businesses are engaged in the most humdrum and mundane of all human commercial activities as well as the most exciting, such as the latest bio-medical
and computer software enterprises. Small businesses collectively accounted for 64% of all job growth in the country in the period 1990-1996. Because of their number, small businesses are popular with politicians and attract support from Federal and State Governments for financing and start up assistance. In 1996, 842,000 new small businesses were formed, but there were also 72,000 that failed. Most survive the many hazards of the first few years of existence, but do not reach the point of becoming a publicly owned company, when significant wealth may first appear to be within reach.

Only the most promising of small businesses are able to effect initial public stock offerings, but in good stock markets there is a great deal of demand for them. In 1999, for example, the most recent record year for IPOs, there were 571 offerings, valued at $71.4 billion. In December 1999 there were approximately 9,000 publicly traded companies in the United States, (5,100 on NASDAQ, 3,100 on the NYSE, and 770 on AMEX). Twenty years ago, there were 4,900 publicly owned companies in the United States. Most of the new companies now traded in the market arrived there through an IPO (there have been about 9,500 IPOs valued at more than $500 billion since 1978). Of course, the total number of companies, has also been reduced by several thousand mergers and acquisitions, and many bankruptcies during the twenty-year period.

In the last several years, since the discovery of the Internet and the vast interconnected world of electronics, telecommunications, entertainment and other things, the cycle time of companies from birth to IPO has been shortened considerably. This has been partly due to an eager market to buy stock in small,
promising companies in a new industry area, and partly because the companies have grown so fast many of them have reached the IPO stage sooner.

After an IPO, founders can sell some of their stock or borrow against it to create cash for other diversifying investments, or money for some long deferred extravagance. Alternatively, they can cash out entirely by selling the business to another company when they are ready to give up control of it. In 1999 alone there were about 4,000 sales of domestic companies that did not involve the reporting of a transaction price, usually meaning that the seller was not a publicly owned company.

Most small businesses do not go public. They lack either the profitability or the growth to do so, but nevertheless, they can provide a generous cash flow to their owners. When the owner decides to retire, the business is either liquidated, or sold (often through small-business brokers). The new owner may run the business just as before or try to change it into something that could go public. Meanwhile, other entrepreneurs are setting up new businesses. The organism regenerates itself, and at least for the past twenty years, has been expanding, much to the benefit of the American economy as a whole and to the millions of individuals associated with the small business sector as owners, investors or employees. Indeed, the small business and entrepreneurial sector is responsible for most of the personal wealth in the country. This is the area of the American economy where most of the five million millionaires reside, where most of America’s wealth is concentrated and has been growing most rapidly.
How Do They Do It?

In this chapter, however, we are mainly interested in remarkably successful entrepreneurs, those who, like Bloomberg, have created something fantastic from nothing, making themselves and others quite rich in the process. Can we look at such levels of entrepreneurship as a profession, something that by training and application we can expect to duplicate? That is a question to which serious students of the subject do not feel quite ready to answer, but are certainly inclined to study. What is it that sets the most successful apart from the rest?

The “Vision” Thing

When an entrepreneur decides to enter a business, an equilibrium already exists between those products and services that are in circulation, and those that could be, but aren’t. Unless a new product or service can overcome the existing barriers to entry into the market, it has no chance. This is normal market economics at work -- unless existing products and services can be priced and marketed in such a way as to create some level of competitive barrier to entry, too many new products will get in and destroy the profit opportunities.

The entrepreneur is looking for a way around this equilibrium by finding something new or different that will reset the equilibrium more advantageously. What is sought does not have to be an entirely new product or idea (like Edison’s electric light, which took a long time to introduce and required expensive power plants and transmissions lines), but it has to be new enough to change the
original configurations of the market. This is the central idea, or “vision” of the business. Once it is identified and fixed in the entrepreneur’s mind, the rest of the process is just making it happen by whatever means that seem to work.

Rockefeller did not invent the oil lamp, but after the Titusville discovery in 1859, he saw the opportunity of producing large quantities of kerosene from petroleum to be sold as a cheap, efficient fuel for illumination. Prior to kerosene, whale oil was the principal source of lamp illumination, but it was expensive and not available in the large quantities that surely were to be needed as the American economy expanded. He was not in the illuminants business before Titusville, but he saw an enormous potential for kerosene and decided to focus on refining and distributing it. The market was totally new at the time, and there were no barriers to entry, so a large number of small refiners and oil producers entered the business. They cut prices, and conspired with or against each other to try to make progress, so business conditions in the industry became chaotic. As a result, Rockefeller changed his central idea – instead of just refining crude oil, something for which he had no particular comparative advantage, he would focus on consolidating the refining, transportation and marketing components into a new industry. This decision, a vision of opportunity and a wholly different way to develop it, played to all of Rockefeller’s organizational and administrative strengths – his comparative advantages -- that enabled him to become the success he was.

Sam Walton once worked for J.C. Penney. He didn’t conceive of the low-price, general merchandise chain stores, or the more recent “discount”
department store, but he did see the value in bringing these retailing ideas to places where they had never been introduced, the rural South. The population in this area was scattered and low-income, and the retail stores available to them were limited to relatively high-priced local shops and the occasional small variety store, or “five and dime.” In 1962, Walton opened his first store – Wal-Mart Discount City -- in Rogers, Arkansas. His idea was that the bigger retailers avoided the rural areas because it was too expensive to ship goods to them, and the goods would take too long to sell. Walton designed a system of large central warehouses that could service daily a group of high-visibility stores circled around them. He purchased in bulk, and passed on some of the savings to his customers, but what he really offered them was a much larger assortment of good quality, low-priced goods for everyday use. In 1970 the company went public, and only ten years later, as a result of Wal-Mart’s continuing success from its hub and spoke system of rural retailing, Sam Walton headed the Forbes 400 list as America’s richest man. He died in 1992, leaving a fortune estimated at more than $22 billion.4

Steve Jobs didn’t invent the microprocessor, but he saw the potential for an easy to use desk top, “personal computer” and made the Apple. It was an instant success and Steve Jobs became very rich. Bill Gates was not the first computer programmer, but he too saw the market for personal computers so he dropped out of Harvard College in 1980 to join his friend Paul Allen in developing software for them. Soon afterwards, IBM called to ask for help in developing an operating system for its new personal computers that were designed to complete
with Apple’s. Their operating system, called MS-DOS, rode the rising popularity of the IBM personal computers to become the dominant operating system for all PC’s, when these had to be “IBM compatible” to attract serious business buyers. The Apple computer, however, was not IBM compatible, and despite substantial consumer loyalty to the product, it fell behind the others that were and lost its way.

Ted Waite (Gateway 2000) and Michael Dell (Dell Computers) had the same big idea – to manufacture customized, fully assembled and operational personal computers that could be ordered by customers directly on the phone or the Internet. They could do this by establishing a central assembly location and ship all orders from it. Their competition was established brand-name manufacturers that sold through independent retail stores and discount houses with negligible customer service or assistance. Before long they were assembling computers for customers all over the world.

Ralph Lauren captured a new (“old money”) look in men’s fashion; he called it Polo, and it caught on. Philip Knight conceived of a new kind of sports-shoe company, and Nike was off and running. Backed by prodigious advertising campaigns, both companies quickly gained market share at the expense of their long-established competitors. And so on. There are lots of distinctive ideas among our entrepreneurial companies, and every successful entrepreneurial business is inspired by one, however simple the idea may seem in retrospect.

Starting a business with an idea that is not new at all, something that just presents another choice for the consumer, can be a very tough grind for the
entrepreneur. Another bank branch on the corner, a new videotape recorder, or even another version of an IBM compatible personal computer, may take forever to gain any kind of market share and could divide the total profits available in the market into increasingly smaller pieces. Something somewhat new, however, can capture the market’s attention without having to completely reeducate it. It can quickly change market dynamics, increasing total demand for, say, “tennis shoes” because they are not tennis shoes any longer but performance enhancing footwear favored by professional athletes with a different shoe for every sport. In changing the dynamics of market demand, the relative market shares of the different competitors go up for grabs, giving you a shot at establishing a solid place for yourself relatively quickly. Of course your idea has to be strong enough to alter the dynamics, but it is clear that many of the most powerful new business ideas have not been all that new. Not that new, perhaps, but different enough.

In March 1998, Walt Minnick, then 56 years old became a plant man. That is, he and some partners bought seven stores selling nursery products in Silicon Valley, California from Woolworth, which was getting rid of them, and another, larger store in Phoenix. Altogether the group of stores had sales in 1997 of about $20 million, but barely broke even. Walt and his partners would have to raise $25 million to acquire the properties and make some necessary improvements in them. About half of this money would be in the form of equity, the rest in debt from a high interest rate finance company lender. His plan was to put together a group of profitable, full-service, up-market retail home and garden centers into a
large, “category-dominant company,” and then take it public. He would do this by an aggressive acquisition strategy called a “roll up.”

Walt hardly knew a tulip from a twig. Before becoming a plant man, equipped with business and law degrees from Harvard, he had been Chairman and CEO of TJ International Corp., a NASDAQ traded specialty building products company with $700 million in sales. The company was based in Boise, Idaho, where he lived for about twenty years. The company was subsequently sold, and Walt, a longtime (moderate) Republican, accepted an invitation to run as a (conservative) Democrat against Larry Craig, the incumbent U.S. Senator from Idaho, who was up for reelection in 1996. Walt had very little chance to defeat the popular, deeply conservative Idaho politician, but still he ran a race that was called a “toss up” by The New York Times on election eve. But he lost, and when it was over, Walt had to decide what to do with himself.

He could have retired, or taken an appointment in the Clinton Administration. But he decided he wanted to go back into business and make some money (he hadn’t been paid in two years and his campaign was costly). He was bored with big business, he said, and wanted to have the sort of fun you can only have when you are deeply immersed in something that is very much your own doing. He started to look around for a business to buy, and decided it had to be something simple enough for him to be able to learn quickly, and a business that would need the basic, general management skills he had accumulated over a lifetime. Something he could get hold of, and organize and drive along at a steady pace to create long-term value for himself and his investors. He also
wanted to stay in the Northern Rocky Mountain region that he loved, with its outdoor lifestyle and friendly small town people.

His research acquainted him with roll ups. These involved acquisitions of numerous small businesses in fragmented, low-tech industries that had little history of regional or national consolidation. Businesses that would benefit from some sort of centralized organizational structure, economies and cost-discipline. Real estate and insurance brokerages, funeral homes, auto repair shops, even car washes had attracted attention from venture capital investors as roll up possibilities. They were not franchises (like McDonalds) that were all stamped out of the same cookie cutter, but pre-existing independent businesses often operating under local brand names. The roll up strategy depended on being able to buy the businesses cheaply (which meant they were often in need of fixing up), then apply practical, hands-on management improvements, centralized control of purchasing, good financial management, and focused marketing and advertising expenses. It meant finding good people to fill the operational jobs, and it also meant using leverage to increase stockholder returns. After a few years of wrestling with all sorts of little details, the businesses could grow and before long blend into a sizeable company that could be offered to the public through an IPO, or put up for sale to one of the big national chains.

After his Senate race, Walt and his wife went on vacation in the South Pacific. The idea of buying up family-owned nurseries came to him, and by the time he returned to Boise he had a draft of business plan. He began calling around to his friends for information, and began a fact-finding tour of Western
cities with populations of more than 100,000, camping out in cheap Motel 6 rooms. In Phoenix he met Mike Bergland, who had owned the Desert Winds Nursery for fifteen years. Mike, a chemical engineer who managed chip foundries before becoming burned out with Silicon Valley, was enthusiastic about the idea of a roll up. Together they learned about the sale of the Woolworth stores in California. Minnick negotiated a 90-day option to buy the property for $22 million. Immediately he began to call on fifty or so of his old school friends, former business associates and anyone else he could think of for the seed capital and got his new company, SummerWinds Garden Centers going in 1998. Before he had been able to do much of anything with the stores he had bought, he encountered an opportunity to acquire from a bankruptcy auction an eight-store company in Phoenix that was losing major amounts of money. He snatched them up, for less than the cost of their inventory, and later added another profitable store in Vancouver. Then he started to get everything organized. By the end of 1998, he estimated that on a full year basis the stores he owned produced sales of $33 million, and a loss of $700,000, but nevertheless was running a positive cash flow (earnings before interest, taxes, depreciation and amortization, or EBITDA) of over $1 million. Positive cash flows are very important to leveraged business investments. It was a good start. The next year sales rose to $40 million. He raised some new capital, created an e-commerce venture and watched the company come around into the black. His target, Walt said, was $100 million in sales and cash flow of at least $10 million by 2002. At $10 million of EBITDA the company could be worth $60 or $70 million, which would
represent a six or seven-fold return for his investors in four years. And this return, of course, had almost none of the risk of a new business start up, especially a business with a new product or technology to build a market for from scratch. Everybody likes plants, and lots of people want to buy them. Why do it the hard way?

Making it Big

The new thing, though, to be a big success, ought to lead to a business with a large potential market. The national market for kerosene must have seemed enormous to the young Mr. Rockefeller, who became a billionaire long before the automobile assured the future of the oil business. Ray Kroc, a traveling milkshake-machine salesman, became a billionaire because he realized that a small hamburger stand could be cloned into thousands of McDonald’s stores nationwide through a franchising process. To be big, there has to be a national, or even better, a global market for the idea.

Ted Turner, the founder of CNN, saw that the value of cable television ultimately depended on what went through the cables. He knew there would be many new channels made available through the cable hookups, and these channels would be offered to subscribers who would pay to get certain kinds of programming. Turner was interested in what the subscribers wanted to watch. Turner already owned some sports teams and WTBS, an Atlanta-based “UHF” broadcasting station. (UHF was tuned to a different set of frequencies than the traditional VHF channels used by all the networks). In 1976, he pioneered the
“superstation” concept by arranging to transmit his UHF signal by satellite to content-starved cable system operators all over the country. The idea worked. In 1980, Turner introduced the all-news channel for his system. This was thought of as a bit crazy, because most people could not imagine tuning in just to news all day long. That would be true for the networks, each of which was but a single channel trying to capture as much of the viewer’s time as possible. The cable operator, however, was selling a package of several channels for a fixed cost. You could watch what you wanted, when you wanted to watch it. You paid for it to be there, and many people wanted to be able to check on the news periodically during the day without having to wait for CBS or NBC to put it on. By 1985, the Turner Broadcasting System (cable packages) reached 80% of American homes equipped with cable, and one item in the package that was almost always in demand by subscribers was Turner’s cable news network, CNN. Before long Turner had tens of millions of subscribers paying to have a few minutes each day of CNN in their house (especially after the Gulf War, which demonstrated the effectiveness of the CNN coverage). Later he proved he could do it also with old movies, and cartoons.

Making It Happen

Marc Josephson is an engineer, a specialist in making data cHe worked in the computer field for 10 years, helping to design and build exotic data communications networks. In 1985, he formed a small consulting firm serving both the telecom industry and its clients. In 1995 he formed a new company to
connect New York City’s new Information Technology Center at 55 Broad Street in the Wall Street area to the Internet “backbone” network, which operates at unprecedented speed. This building was to become the focal point of New York’s effort to create a new “information technology industry” in the city that would, of course, be dependent on efficient utilization of the Internet. Marc’s role was to connect (or wire) the building into the Internet so that tenants of the building would have all the access they needed to conduct their high tech multi-media publishing and other businesses. These businesses were already flocking to New York’s “Silicon Alley,” and they didn’t want just to be connected like everybody else using the Internet, through a modem or a dedicated phone line. They needed to be connected to big-time bandwidth (a measure of Internet flow-through capacity) to accommodate their products and services, and to have the fastest possible connection speeds. They also wanted it to be cheaper than other services, more reliable and quicker to install. After all, this was New York, so they weren’t shy about asking for what they wanted, even though no one offered all of this in a single package.

Marc thought he could do it, however. Years before, New York City had been encircled in fiber-optic cable in anticipation of the day when everyone would want it. Several of these cable circuits (backbones) were essentially idle inventory, and contained bandwidth ample for any known purpose. Marc figured out how to connect the building at 55 Broad Street to the cable circuit directly, and was able to pass on the bandwidth advantages, virtually instant connection speed and low costs to the building’s occupants. To capitalize on his discoveries,
he set up a small company to make the investment in the connection and to lease the Internet access to the tenants directly, which he could do at much less cost than the regular access providers.

It all worked like an Intel chip, so Marc offered to wire up the Jacob Javits Convention Center, the next big building to go on-line. Then he persuaded Rockefeller Center to let him wire up the whole complex, which he then had to lease to the tenants, one office at a time. Marc was ecstatic. All his engineering know-how was coming together. His idea worked and people liked it. But he had to think about how to make the most of his success.

Marc had to “build-out” his business, as quickly as possible so some other Internet access provider didn’t figure out what he had done and offer the same service. Once a competitive service was installed in a building, it would be very difficult to get tenants to change. He wanted to exploit this advantage, rather than be exploited by it. To do so, he had to expand rapidly. The problem was doing it right, while still doing it fast and doing it all over the country. Marc’s special high-value service was only as good as his ability to execute the build-out.

For this he needed a team of competent engineers, and he needed capital. Through a lawyer friend he met some small-scale venture capitalists, who invested a few million dollars of seed capital. By the end of 1998, two years after finishing 55 Broad, Marc’s company, now called IntelliSpace, had wired 50 customers for its on-line services in New York City; there would be 140 a year later. The building space wired by the company was growing at 400% per year, and Marc was shaping up plans to replicate its business in Philadelphia, Boston
and Washington DC. For this he needed more capital, which proved surprisingly easy to attract. In 1999 IntelliSpace completed a $35 million second round of financing, all of which was to be used to accelerate the expansion of the business. Marc was able to attract the investment largely because his investors had confidence in his engineering skills and executive ability to carefully plan out a step by step program for building out the business. Marc's ability to do this may in the end prove to be his real comparative advantage.

To act on a big idea means having the ability to execute it effectively. To distribute product to the national or global market quickly, and in such a way as to gain a strong share of the new or different market that has been established, is a very complex and difficult undertaking.

Think of Gordon Moore and his co-founders at Intel. Their idea was that the expanding world of computer technology would require a continuous stream of ever more powerful internal circuits, printed on silicon chips. They recruited top engineers to design these state-of-the-art circuits and sold them readily to all the main manufacturers. But, they had to make them in huge quantities. Intel was just a little company then, but it had bet its entire future on being able to deliver the chips they sold, on time and without defects. They had to set up assembly lines to do this, raise the money for them and to insure that the reject rate didn’t put them out of business. And they had to do this year after year. Making semiconductor chips is a crazy business that was in a constant state of high level innovation (“throw out batch six over there, it’s obsolete now”) as well as being in a viciously cyclical business in which customers suddenly changed from wanting...
millions of chips to wanting none. Without the ability to deliver the chips on schedule, and to stay ahead of dozens of powerful competitors, Intel would never have been heard of.

Bernard Marcus, Arthur Blank and Ronald Brill founded Home Depot Stores. They had worked for years at Handy Dan’s, a hardware chain that was sold to Daylin Inc. The parent company faltered and brought in a turnaround specialist to straighten things out. The men clashed with their new boss, and soon left to start their own business. They knew the hardware business and had observed the successes of Sam Walton and some of the specialized large retailers like Toys R Us and Circuit City and decided to apply them to the do-it-yourself home improvement market. They too organized huge retail stores that could sell thousands of items cheaply, but unlike the others, they had a different idea. They offered professional how-to service to customers in the store and on the telephone (advice and instruction in how to do things). Their competitors didn’t have the equivalent of a master plumber available to discuss your project with you -- but to make the idea work, they first had to accomplish a number of very basic things. They had to set up hundreds of stores, warehouses and suppliers all over the country, and more important, recruit and train thousands of store personnel who could offer the technical service they advertised. And they had to do it quickly, before their many competitors in the off-price hardware businesses caught on. And, they did. You have to wonder, though. Were they so successful because their idea was a good one, or was it mainly in their ability to execute it?
Margins Matter

The best and the biggest ideas, however, will certainly fail if the economic fundamentals are not there and adequate margins cannot be earned. Selling into a huge market means small margins can still be very profitable, but larger margins are even better.

Henry Ford’s mass manufacturing of Model T’s was a operation designed to exploit economies of scale so his cars could be sold as cheaply as possible to get the entire country to shift to internal combustion automobiles as quickly as possible. Although the cars were sold cheaply, the volume was large enough for him to capture healthy operating margins. These permitted Ford to pay generous wages to increasingly skilled assembly line workers he wanted to retain, and to invest in facilities to make almost everything that went into the car at Ford’s huge central factory at River Rouge. These were new ideas in business economics at the time -- providing long-term employment for an increasingly valuable work force and investing heavily in productivity improvements. The investments increased his margins further, permitting even more investments to improve and expand the business. His competitors were still building many different models of cars in small quantities before they noticed that Ford had sewn up more than 50% of the market.

Ted Turner bought obsolete inventories of old movies, discontinued TV series’ and cartoons, then offered special channels to his cable carriers that would carry only these old shows. The carriers then marketed the Turner Classic
Movies and the Cartoon Channel as part of the optional package they offered to millions of subscribers. For a few cents a day, cable fans could have available to them an unlimited supply of old Humphrey Bogart and Ingrid Bergman movies, or *I Love Lucy* reruns. But a few cents a day is a lot of money if its being paid by millions of subscribers, and the margins captured by Turner were very attractive.

One small business I know called MaxFlight, founded in 1994, makes aircraft flight simulators for amusement parks. The founder of the business, Frank McClintic, is a former helicopter pilot and a natural, tinkering mechanic. He was familiar with aviation training simulators, and thought he could improve on their motion characteristics. He did, but decided that to sell it to the military or the airlines would involve obstacles he might not be able to overcome which might destroy his margins. Traditional simulators are sold to a small number of conservative buyers with longstanding suppliers to whom they are loyal. These buyers were more interested in advanced avionics training than in reproducing cockpit motions accurately, especially through extreme maneuvers. So, instead he decided to change his product to make it into a cheaper, glitzier model for the amusement business, where it could be sold by the ride. The product became an enclosed audio-visual enhanced, aircraft cockpit that rotated on all axes, every which way. The rider would be treated to dramatic virtual carrier takeoffs and landings, or dogfights or space flights that were very realistic because of the precise coordination between the controls, the visual display and the cockpit motions. Big park operators thought they could sell a lot of rides. The machines could be big revenue generators for both the park operator and the manufacturer,
providing it worked and the public liked it enough to pay up to $10 for a five minute ride. Frank was confident he could get some of his machines in the big parks, where he would have to complete against other manufacturers of similar game rides.

But he also knew the operators would be squeezing him as others came into the business. If they did so, his profit margins would be under pressure. He knew he had to keep his costs down to control the firm's future, and indeed, if his costs could be kept lower than his competitors, he might be able to create an attractive barrier to entry that could protect his profits into the future. Mostly, his costs were in the sophisticated parts that the machine required, which cost much more than the labor to assemble them. He focused on lowering these costs, working personally on the problem, after hours and whenever he could. He scoured every technical publication available, in search of lower cost replacements for his parts. He found several, including some surplus government equipment that he could buy at a distressed price and substitute for one of his more expensive components. These efforts substantially lowered his costs and maintained his margins well into double digits. But, like Mike Bloomberg, he knows he has to continually re-engineer his machines and improve their performance capability to keep ahead of his competition, all bigger companies than his. MaxFlight, in many ways, is a business designed from the outset to have attractive and defensible margins.

Without paying attention to such details, of course, things can go wrong. The Anglo-French alliance to build the supersonic aircraft Concord was a failure
because the aircraft was too small to ever be profitable – it could not carry enough passengers or fuel to ever amortize its development costs, even if there had been no objection to supersonic flights over land areas. It had negative margins from the beginning. D.K. Ludwig’s billion-dollar commitment to growing cheap pulpwood for paper mills in Brazil failed because the local costs became uncontrollable and could not support the planned scale of the operation.

**Timing**

Michael Bloomberg stepped into the market with his *Bloomberg* machine just at the right moment. He understood the business well enough to know of the machine’s coming importance and that his competitors might be slow to develop a similar product – but only for a while. He moved within his two to three year window and successfully launched his product. Bill Gates’ introduction of MS-DOS was a similar story, indeed he almost sold his business to IBM, but IBM backed away. Dr. Thomas Frist was one of the first on the scene with his Columbia/HCA hospital management and healthcare business. Wayne Huizenga who first sensed the need for inexpensive garbage recycling, then saw the potential for a high-grade nationwide videotape rental system and got in with Blockbuster Video early. Now he is trying to figure out a new way to sell new and used cars at retail. Charles Schwab was an early exploiter of the opportunities in discount stock brokerage, and gained a significant market share and $1.8 billion of net worth in the process.
In early 1998, Greg and Glenn Morello, two brothers in New Jersey decided to expand their Bridgewater Autobody repair business. They already had two shops, and wanted to expand to a dozen or more, and sought to raise capital for doing so. Their idea was to gain some economies of scale by operating at a larger size, but mainly it was to contract with auto insurance companies for bulk-purchases of repairs. By gaining the trust of the insurers, and working directly with them, they estimated that about 15% to 20% of the cost of each repair could be saved. The insurance companies wanted to be sure that the repair shops they used were reliable and honest, but as they were also under pressure to lower their insurance rates, they particularly wanted to be able to contract for repairs at a lower cost. Knowingly or unknowingly, the insurance companies were forcing consolidation in the collision repair industry. The two brothers believe they have a year or two to be able to pull their new company together, before some other more aggressive or better financed auto-body repair chain comes into their market and forces them out. Such businesses already exist elsewhere in the country. Time is critically important for them.

In the late sixties, a friend of mine quit his job and started a computer software company. He had worked for IBM before business school and knew the computer business pretty well. He knew, for example, where the software glitches were, and offered a series of products designed to replace the original IBM software. The company was very successful very quickly, and my friend was happily flying all over the world setting up distributorships and joint ventures. The company went public after only a few years in business. It was an Internet sort of
business of its day, and my friend became the first millionaire I ever knew. But in the early seventies, an economic recession weakened the markets, and the computer business changed to favor mini-computers and the old main frame stuff was not as important. IBM changed its software too, and, well, it all fell apart. A basic trend in the information processing business had changed, and it worked against the interests of my friend’s company. To save the business, my friend put some of the money he had taken out back in. But he couldn’t save the company, which went bust and my friend went back to selling computers, no richer than when he started only a few years before.

In the fragile world of the entrepreneur, a good idea performed too early or too late is not worth nearly as much as one performed at the just right time. Indeed, a good idea may be worth very little if badly timed. But also, a well timed idea may play to great reviews at first, but then fade way if it is not in step with changing market trends. For most hard-pressed entrepreneurs who take one busy year at a time, good timing, however, can mean the difference between being quickly established in a marketplace, or not at all. Getting established is better than not, but the story doesn’t end there. That early market position has to be reinforced and defended against strong competitive efforts, better products and, of course, trend changes.

The Right Stuff

In 1979, author Tom Wolfe published a best seller about the first American astronauts, which he called The Right Stuff. It is a wonderful book about the
experiences, the skills, and the characters of the first Project Mercury team, men like Alan Sheppard, John Glenn, Scott Carpenter, Gordon Cooper, Wally Shirra, Deke Slayton and Gus Grissom. These men were combat fighter pilots, many of them test pilots too, with many hours of flying in dangerous circumstances. Wolfe sensed that as different as they all were from one another, they did have something important in common. They all had something that seasoned aviators knew to be “the right stuff.” That meant that they behaved like people think fighter pilots should -- they were fearless, of course, and somewhat reckless, though always confidently so. They had extremely quick reflexes, were low key and very cool under pressure, and never showed any concern that they might end up among the gruesome statistics of their profession. They were perhaps not overly smart, but smart enough, not overly disciplined, but possessed amazing levels of self-control. Not everyone had the right stuff, but you had to have it to make it to the top in combat aviation or the test pilot business. It was hard to define, but everyone knew it when they saw it.

Wolfe should do a book about successful entrepreneurs. They too must have the right stuff, or their equivalent of it, if they are going to make it big. It’s the special software inside the product that makes amazing things happen. Big time managers of large corporations don’t have it, though they do have their own different set of special attributes. Neither do professional investors or wheeler-dealers. The quintessential American big time entrepreneur is a composite of experiences, skills, toughness of character and self-control that are, like our astronauts, unique to their profession.
To begin with, they have to have a certain mindset that most business people do not have. They want to bet on themselves and their abilities, even if the odds look pretty long. They are not especially concerned with security, or appearances, or creature comforts as they are always too preoccupied with what they are trying to do. They can stay focused on the tiniest of goals for the longest of times – e.g., to increase sales of bird food products in Bensonhurst – without losing interest. They perform well under pressure, and adapt optimistically to even harsh disappointments. They believe totally in what they are doing, but are prepared to change things often, so that what they end up doing may not have been what they started out believing. They often demonstrate a disdain for large, bureaucratic working environments and the lines of authority that go with it, at least until they have their own working environment and authority structures in place, which they think are fine. Many are poor delegators, and most have an unusual capacity to absorb details and worry about them. Many seem paranoid about their competition, their suppliers, and their investors, but as Mike Bloomberg says, “just because you are paranoid, doesn’t mean they’re not out there.” They are absorbed in what they do, and the rest of their life often shows it. They can be hard and ruthless competitors, but, when successful, much more generous with their time and money than those who inherit wealth and slowly feed the old money charities. In short, they are highly driven to succeed, and to do things “their way.” They have a lot of attitude.

Most real estate investors will tell you that the three most important factors in determining the success of a property investment are “location, location and
location.” Most investors in small businesses will tell you that for them the three most important factors are “the CEO and the management team,” in first, second and third place. Not “the product idea,” nor the “size of the market,” or even the expected operating margins.

In the early sixties, a Wall Street broker named Arthur Rock left town to settle in California, where he founded one of the country’s first high-tech venture capital firms. He had great instincts and had early success with Apple Computer, Fairchild Semiconductor, Teledyne, and Intel. He likes to know the companies he invests in well and wants them to be within driving distance of the Bay Area. “You have to pay a lot more attention to who is running the company,” he says, “than whether the products are right or not.”

Other Stuff

But before an entrepreneur has established a track record, it is difficult to tell whether what you might think is the right stuff is the real thing. So investors have to fall back on more conventional criteria to decide whether a proposed new company investment should warrant their attention.

First, the entrepreneur must possess the ability to identify and develop viable plans for capturing an attractive business opportunity. This means coming up with a comprehensive plan that can demonstrate how the economics of the proposed venture can be realized. This is the central idea, requiring some insight or understanding of the opportunity that not everyone else has seen. But it is also the ability to form a team that is capable of putting the idea into action.
Second, the entrepreneur must be able to act charismatically, first to attract competent team members largely on their faith in the leader and the business plan, and then to build confidence in the venture by customers, employees and investors. To be credible, not to mention charismatic, you have to be able to convince people that you know what you are talking about, and that you have sufficient experience in business to be believable. Mike Bloomberg tells students eager to form their own businesses, to gain solid business experience first, which is what most of our big-money entrepreneurs did before plunging ahead on their own (Bill Gates, notwithstanding).

Third, an effective entrepreneur has to be good at operating in the field, out there with the customers, the suppliers and the financial backers. He or she must be able to “make things happen,” to create the “break” that makes the critical sale at the right time, to talk the supplier out of cutting him off, to finalize the last bit of high-priced financing without which the business can not go on. Some of these things may appear to be just luck, and luck is an important factor in all equations for success. But the good field operator helps good luck along by constantly finding other ways to accomplish things, and by marshalling talent and resources just where they are needed at just the right time. The effective entrepreneur will maintain a coolheaded demeanor in the face of difficulty, which is constant in a new business, and to be able to use these qualities to act as a tactical leader, reacting and adapting effectively to the constant changes in the marketplace. Much of what any successful company does several years out was
unpredicted at the time of its beginning. Opportunities continue to change once you get going, and the effective entrepreneur changes with them.

Finally, the entrepreneur has to be capable of growing with the business, to be able to create a workable (if idiosyncratic) corporate organization, to handle people well, and to be able to deal with the increasing administrative burden that falls on any successful enterprise. A great many gizmo inventors, super salesmen, or manufacturing geniuses have fallen by the wayside after getting off to good starts because of their inability to function as the chief executive of an growing and increasingly complicated organization.

Successful investors in small businesses look for all of these qualities, and background, work experience and other references to confirm them. They review the business plan endlessly looking for flaws and for vulnerabilities to changing market conditions. When they decide to go ahead with the investment, they know that in most cases they will be proven to have made a mistake. Only a small minority of such investments turns out to be big winners. It's a risky business.

**Risky Investors**

Investors in small businesses are different from the standard Wall Street sort of financial operator. They invest in very fragile businesses they do not control, and the securities they own have no market, nor are they likely to for some time. They prefer taking these greater risks because when the investments work out the pay-off can be enormous. For every ten investments, they might expect two or three to do poorly, five or six to do no better than the S&P 500, but
only one or two to do exceedingly well, producing, say, a return of twenty to fifty times the original investment in about 5-7 years. What they hope is that their ability to select winners, to move along the mediocre and to manage the losers better than otherwise might be the case, will result in a better risk-adjusted return than the stock market itself. On the whole, this means being able to turn the portfolio into marketable securities that provide “exit,” or profit realization opportunities as quickly as possible.

Most of these investors have their own investors, people who have allocated some of their capital to them in order to achieve a return, over the long-term, which is greater than that for publicly traded stocks and less directly correlated to their returns. During the 1990s these investors were looking for gains of 40% to 50% per year, i.e., a market return plus a premium over that return to account for the extra risk they are taking. This was be a pretty high level of return, especially because the S&P 500 market index had been performing so well. For the five years ending in December 1999, for example, the compounded annual increase in the S&P 500 was about 30%. Add to that whatever you think the small company risk premium should be (say, at least 10% more than the expected S&P500 return), and you were looking at a required total return of about 40% just to breakeven. That is, to give you a reward no better than the market averages after you adjust for the extra risks you are taking. That is a high level of return to actually realize for a whole portfolio, certainly for any length of time. To do so generally meant you had to ask for close to 100% annual
compounded returns in order to average up with $0\%$, after subtracting the losers.

“Gazelles”

The only way to produce such returns is with the winners. These are companies that, whatever operational problems they have to overcome, nevertheless are able to grow at something more than 25\% per year. Such growth can come from spectacular demand for a new product or technology, from a revised distribution system that greatly enlarges its market, or as a result of efforts to consolidate companies within an industry through mergers or acquisitions.

Not all companies, in fact relatively few, are in businesses sectors that have such high growth possibilities. Without the possibility, of course, it can’t happen, no matter how capable management is. With the possibility, no matter how iffy the company’s chances, it could happen. This could is worth something. Companies with such possibilities are called “gazelles” by some of the players in the business. They have the spring in their legs that we are looking for, even if the neighborhood they hang out in is a dangerous one, filled with lions and hyenas.

Companies with low-growth potential, say, below 15\% per year, however well managed are not of much interest to venture investors. They just can’t get there from here. These are called “life-style” companies, and are generally thought to be appropriate for individuals seeking a suitable income and life-style
to own, but not for professional investors seeking high returns. Most American small businesses are life-style companies. They are capable of providing a good income and satisfaction to their owners, and can sometimes be seen as annuities rather than opportunities for substantial wealth enhancement. Companies with expected growth rates between 15% and 25% are in the “maybe” category, and investment in them will depend on a variety of factors including how much money the investment manager has to put to work. An investor might be inclined to go ahead if the company was less risky, i.e., it was already profitable and closer to an IPO than the typical gazelle, and it was willing to accept the investor’s terms and conditions.

Assembling a herd of gazelles has to begin with finding the animals one by one and once spotted, capturing them. In theory, all very small, obscure companies are much the same. No one can know for sure which ones will turn out to be winners, so all are looked upon with equal delight and suspicion. In reality this is not the case. Most candidates for venture financing are obscure and have to fight hard for attention. But, there are some areas that are densely populated with gazelles, such as certain computer applications, telecommunications and biotech companies, and more recently Internet dot-com companies. Such companies can be attractive to investors as soon as they become aware of them. Venture capital firms put themselves in the middle of these densely populated areas, and look for the best. Firms specialize in particular areas of technology clusters, like Silicon Valley in California, in and around Boston and other university towns, and in the northern areas of New
Jersey where so many drug companies have their campus-like research facilities. Newest among these, perhaps, is “Silicon Alley” in New York City, a center for Internet publishing and multi-media activity. Within these clusters, there are people in the know about what’s going on, what’s being worked on, and who is leaving what firm to start up which new business.

**Venture Investors**

Some of these investors in the know are called “Angels.” For the most part they are wealthy business owners or executives interested in investing in things they can understand or wish to encourage, or in persons personally connected with the entrepreneurs in some way.

Angels are wealthy individuals “accredited” by the SEC to invest in unregistered securities, who invest on their own or along side others. They are a large, informal, unorganized group that does not properly constitute a market. But they are important. A 1996 study by the Center for Venture Research at the University of New Hampshire estimated that there were 250,000 active investors in the United States who invested approximately $20 billion annually in about 30,000 small companies. This is a huge amount of financing (more than twice the amount of money invested in venture capital funds in 1996) for a sector in American finance that gets relatively little attention. Still, the study suggests that Angels only supply about a third of the annual demand for new capital investments in American small businesses.10
The better-known part of the small company financing industry is that of the venture capitalists, or “VCs”. The original venture capitalists were angels, often entrepreneurs themselves, who funded promising ventures that came to their attention. A number of wealthy families continued to make such investments after their own capitalist progenitor died. The Rockefellers, Whitneys, Paysons and a number of other families were early venture capital investors. In time some opened their investment funds up to non-family members. In 1946, Harvard Business School professor, Georges Doriot founded American Research and Development Co., the first independent firm to enter the VC business. Subsequently a number of other independent firms were formed, especially in the Boston and San Francisco areas, to manage equity investments in promising new sectors of the economy, especially technology. Most of the money given to them to manage came from wealthy families, university and other endowments and financial institutions. The firms stayed in touch with each other, invested together, and shared information. But the amount of new investment into these venture capital firms was still quite small.

In 1979, however, the US Labor Department, which regulates pension funds in America, declared that the trustees of pension funds were free, as “prudent investors,” to allocate a portion of their funds to “alternative investment classes” in order to achieve greater diversification of their entire portfolios. This led to a flood of money into risky, but potentially very profitable private investments in funds and other vehicles focused on leveraged buyouts, real estate, emerging market securities, and venture capital.
Through their considerable networking activity, venture funds tend to hear first about the most promising new start-up efforts. Promising in the sense of the state of the technology, the prestige and reputation of the team leader and its members, and the early indications about product effectiveness. VC firms are often invited to conduct several weeks of fact-finding and investigation (“due diligence”) of the companies to determine their investment potential. Such investigations are costly and can tie up key people for extended periods. But they are necessary for the venture investor to decide whether, and at what terms, he or she wishes to proceed to make a financing proposal to the company. Once one firm has been given a go-ahead to commence due diligence, it is unlikely that another firm would wish to do so at the same time. If the first firm is happy with the investigation, and makes a proposal that the company accepts, then it will most likely syndicate the financing among a number of like-minded venture capital firms. A firm invited to participate in a piece of business by a prominent venture capital firm rarely refuses, if only to make sure that it continues to receive such invitations in the future. The more prominent the firm’s reputation for bringing out winners, the better the access it will have to the all-important deal-flow of current prospects being advanced by other firms.

The venture investors usually nurse the company along for some time (originally seven to ten years or so, but perhaps less long at the end of the 1990s) until it can create an opportunity for a merger or a public sale of stock. It will place a partner or two on the board and spend a lot of time offering operating advice and helping to deal with personnel problems. Over all, these investors
might expect two out of ten investments to produce significant returns, and two or
three to go bust or nearly so. Overall, the big winners alone make the difference
in whether the firm is successful or not.

One of the most successful venture capital firms is Kleiner Perkins
Caufield & Beyers, of Menlo Park and San Francisco. Founded in 1972 by
Eugene Kleiner and Tom Perkins, and now headed by John Doerr, the firm has
developed into one of the most successful in its field, with a large stable of
winners, such as Intel, Cisco Systems, Dell Computer, and Seagate. The firm's
fifteen partners have significant operating, as opposed to financial, backgrounds.
All have been line managers of companies with responsibility for bringing new
products to market and for their unit's profits. Through their efforts, Kleiner
Perkins has raised over $1.2 billion for its clients, and brought over 100
companies public. The combined market capitalization of these companies
exceeded $80 billion in July, 1999. The firm, like many venture capital firms,
believes in nurturing the businesses that it invests in to improve their chances for
success. They introduce them to potential employees and directors, to people
they need to know to help sell their products, get publicity for them, become
customers of other firms that were clients, raise bank loans, and have access to
technical or business advisers or board members. They also have formed a
business support network that links 175 companies and their executives to help
each learn how to succeed by sharing experiences and ideas.

For an industry segment as powerful as it is, the venture capital business
is fairly small. Though there are lots of little firms around the country that make
venture investments, the greatest successes are concentrated in a couple of
dozen firms that all together probably employ, partners included, fewer that 1,500
people. Many of these people, however, have done extremely well during the
past twenty years, though often they have often had to wait several years for the
firms they invested in to break even. The VC firms acquire shares in the
companies that they invest in at very low prices. In time, the successful
companies will sell out or go public at share prices far higher than the price paid
by the original VC investors. After the offering, the VC firm at some point either
sells the stock or distributes it to the principals of the firm, who then may take
several more years before they sell it into the market at fully seasoned prices.
You can imagine what it would have been like to buy into Cisco Systems at a
nominal price, then watch it rise, year by year, to ever-more incredible prices. It
went public in 1990 at approximately $0.125 per share (adjusted for splits), and
was trading at over $65 per share in early 1999, and at $130 a year later. The VC
investors’ original cost, in terms of today’s price, must have been virtually
nothing; their stake today has to be worth a considerable fortune – for just one
investment.

Indeed, the profits of the business have been sufficient to attract two kinds
of newcomers. One of these is the large pension fund, that invests in the limited
partnerships and other vehicles that venture capital firms set up to attract their
assets for them to manage. As new clients, the pension funds are, of course,
welcomed by the VC industry. At the same time, however, the pension funds
have shifted, in aggregate, huge amounts of money into a small, fragile industry.
In 1998, for example, a record $14.3 billion was invested in venture capital, up 24% from the prior year, and a 78% increase over 1996. Most of the increase in VC funding over these years went into what the pension funds wanted most, technology investments. (In the third quarter of 1999 alone, VC investments totaled over $8 billion, up 180% over the prior year, and 90% of this amount was directed into technology investments). The fear is that all this money coming into the technology sector of the industry will distort prices, and spoil the balance that the VC industry has struck over the years between the risks taken and the returns received.

The other new investor is the non-venture capital VC firm, the “private equity” investment departments for banks, brokerage firms and other financial service players who also try to attract some of the pension fund money. The total number of firms making VC investments has increased by about 25% over the past ten years, mainly to accommodate this new group of participants. However, the amount of money to be invested is many times greater, and much of it is being investment by firms that have little VC experience. Accordingly, the size of new investments by the firms has increased significantly. Now many firms look for deals in which they can invest $15 to $20 million at a crack, instead of $2 to $3 million. And, of course, competition for deals has increased amount the investors. In turn, these larger investments will have to grow into relatively large companies (with market valuations of well over $100 million) for the investors to make the kind of returns they look for. Companies of this size are not just small companies, and what they require to grow into $100 million-plus companies is
different from what a much smaller company needed ten years ago. The industry had shifted to a whole different scale, with many complex requirements that go well beyond the traditional nurturing capacities of the VC firm.

Also, to make the larger investments, the firms began to disregard syndication and make more investments alone. Less syndication meant less cooperation, networking and less assurance of participating in the industry’s future deal flow. Because the minimum investment size has increased so much, many of the investments were not in fact start-up investments at all, but second or third round financings of companies originally backed by others, angels mainly. The angels were bringing their deals to the VCs as feeders, and the VC’s were repositioning themselves further down the risk curve. All hoped to be able to achieve an exit, however, in only a few years – preferably an exit through an IPO into an even hotter market that would push the stock price up even higher. Like Cisco.

**Candy’s New American Dream**

In June 1995, Candace Carpenter and Nancy Evans co-founded iVillage, an Internet media company targeted at women. Both women were designated “Chairpersons” of the Board of Directors, though Candace was Chief Executive Officer and Nancy was “Editor-in-Chief.” Candace, a Stanford graduate, rock-climber and former Outward Bound instructor and all round over-achiever, became a career media person after graduating from Harvard Business School in 1983. She was always starting little enterprises, she said. “At six, I embroidered
all my neighbors’ pillows and charged them for it. I started a café when I was ten. I designed greeting cards and sold them to stores. I was constantly coming up with ideas.” After business school she joined American Express, then became President of Time-Life Video & TV. After that, Barry Diller, the CEO of QVC, Inc. hired her to head up Q2, an upscale version of the shopping channel. She quit QVC when Diller did, and chilled out for a while with consulting jobs at America Online, Inc and Discovery Communications.

At AOL Carpenter recommended creating a number of upmarket “media brand locations” to offer to AOL’s various “grassroots communities.” These communities were really just groupings of AOL customers that shared a common interest and might, if encouraged, collect together at a “community site,” where they could “chat” and share information (and read any advertisements and sales promotions that might be put there by AOL). Carpenter’s idea was to offer a variety of “branded” sites (i.e., advertised to create name recognition and consumer preference) for particular interests (or, topics), especially interests appealing to the “baby boomers” who were then thought to be among the most active and affluent users of the Internet. Ted Leonsis, then President of AOL Studios, apparently replied, “fine, you start the first one.” So she did. Carpenter then recruited Nancy Evans, publisher of Family Life magazine to be responsible for the “editorial quality” and content of all iVillage products and their business was launched.

When she started iVillage, Carpenter was a 43 year-old divorced, single mother of a new baby. She got herself a full-time nanny and cook and coped.
Later, overcoming many difficulties and frustrations, she adopted by herself a second child from Hungary. She knew that “women today are so pragmatic and time-pressed that they would use the Web to find out how to get things done.” She and Evans soon worked out the concept of an Internet “destination” for women that would connect them to interrelated websites (“channels”) that specialized in topics important to working, upscale women, mainly those aged 25 to 50. The hottest topics were health, child-care and financial planning, and the women could use the site to ask questions and make suggestions to each other.

From the outset, iVillage’s strategy has been to promote the use of its branded website and to expand the number of specific content channels that are accessible from it. It also seeks to promote “sponsorships” by manufacturers and distributors of products for women.

Carpenter was able to utilize her close connections to AOL to create an important partnership arrangement for the company soon after its establishment. In early 1996, AOL invested about $1 million, then more and by the time of the IPO it owned 12% of the company. In May 1997 iVillage issued shares of convertible preferred stock to several venture capital investors at a price of $1.95 per share, and in February, March and May, 1998 additional shares were issued at $2.50 per share. By the time of its IPO three principal venture capital firms, each represented on the board together owned a 15% interest in the company. Private equity investors (other than those three) altogether owned approximately 60% of the company. The approximate weighted-average holding period prior to the IPO for the venture capital firms was about 14-18 months, not long.
In November 1998, the company entered into an advertising, promotional and a stock purchase arrangement with the National Broadcasting Corp. (“NBC”). NBC said it invested through a “non-cash transaction” and would pay for its equity stake by swapping some of its inventory of on-air broadcast time for advertising. In the period just before the IPO, NBC owned approximately 8% of the company.

By March 1999, these various promotional and support arrangements, and the funds supplied by the venture capitalists diluted management’s stock holdings (including their stock options) in the company to less than 6%. During the year prior to its IPO, Carpenter, Evans and three other members of management had been issued a total of about 200,000 options exercisable at $6 per share. It was essential, Carpenter and Evans agreed, that the company be able to offer attractive stock option packages to senior management whom they were constantly attempting to recruit to their small company, one that was just getting started in an entirely new communications industry.

Four years after its founding the company launched its shares onto the market with an initial public offering, which at $24 per share valued the company at $554 million. At the end of trading on the first day, iVillage stock had more than doubled to $55 share, valuing Carpenter’s stock in the company at $37.4 million. These happy events occurred despite the fact that iVillage had reported a net loss for the year ended December 31, 1998 of $43.7 million, on revenues of just over $15 million. As Mike Bloomberg might say, “only in America, but, hey,, it’s a great country.”
The company’s business is (working) capital intensive. From the outset, the company’s business operated at a loss, due to the heavy promotional and other expenses required to establish its brand and to create the demand for using its websites, and the acquisition of other women’s media websites for incorporation into the *iVillage* network. Net cash used in operating activities was $8.7 million in 1996, $15.3 million in 1997, and $43.7 million in 1998. Accordingly, the company was constantly in a financing mode since its inception. In 1996 it raised $11 million, in 1997 $24 million, and in 1998, $65 million through the sale of convertible notes, common stock, and convertible preferred stock. The company had made it clear that its future financial activities would resemble those of its past. It would continue to expend increasingly larger sums for promotion and advertising, and would continue to pursue acquisitions, one of which, *iBaby.com*, a website devoted to selling baby-related products, would be financed by applying part of the proceeds of the IPO. Future acquisitions, of course, could be accomplished more easily if the company’s shares traded at a high stock price relative to its future earnings and net worth. It was a typical Internet company of its time – it had no track record, it burned up capital at an incredible rate, had losses greater than its revenues. Having any earnings at all seemed well off into the future. Yet its stock went through the roof.

Within a few weeks of its IPO, the stock price soared above $100 per share, reaching a peak of $130 a month after going public. This was the Internet boom at its best, when stock prices shot to euphoric levels. But in *iVillage*’s case, it didn’t last. Almost immediately after reaching its high, the stock began to
deflate, then collapse. Nine months after the IPO the stock was trading at $22 on its way to touching a low of $13 in January 2000. The company’s business had stayed more or less on track during the post IPO period, though by then it had attracted some new competitors, had some embarrassing personnel defections and some of its accounting practices were questioned. Its losses were greater, but so were its sales and advertising expenses, all more or less what was expected.

At some point the market will require the company to produce some profits, but not, it seems before having invested whatever it took to secure the best and most enduring market share position that it could. Indeed, one theory of valuation of companies like iVillage is to separate out the money spent on business development and technology, and capitalize it rather than expense it as required by accounting conventions. The capitalized amount represents the “intangible” values of the business, which can be separately evaluated rather like a drug company might do with its patents. Intangibles represent a huge portion of the potential of Internet businesses, and this potential is generally worth quite a bit more that the business’s otherwise meager current results.

Candace and Nancy and their investors saw the stock price settle down to about the IPO level by the end of the year. It was certainly disappointing to see it shoot up so high (showing so much confidence in their business) only for the market to change its mind almost instantly. Still, at $24 the stock was not badly priced, and serious analysts could begin to recommend it, and the company could commence its regular journey as a public company. This is not an easy
journey, and for many companies the post IPO experience is disappointing. Companies have to compete for attention in the investment community and struggle to keep trading volumes in the secondary market up to minimums required by institutional investors. A number of companies become discouraged a few years after their IPO and seek to buy back stock or look for another company to buy them.

The original iVillage investors, though showing a profit, have been unable (through December 1999) to sell any stock at all. If this condition continues, they may begin to cast around for an exit opportunity, to get their money and their profits back. Management may not wish for such an exit at the time, but with control of the company resting in large investors, it would be almost impossible to do anything about it. One thing some companies do in such circumstances, however, is to arrange a recapitalization of the company through a leveraged buy-out, in which a group of new investors are brought in to replaced the old ones.

Candace and Nancy are typical of today’s new breed of entrepreneurs. In the old days, it might take a lifetime for a business to be organized, financed and developed to the point where it could be valued at half a billion. It was a struggle that the entrepreneur was usually not able to share with others except a financial partner or two. It was a long hard slog. The iVillage experience is very different, first in being founded by two women. Indeed, these were two well-educated, workaholic professional women who were fortunate to be where they were when opportunity knocked. When the Internet wave passed over them, and they could
put together a feasible idea for a business at a time when everything was chaotic but an important player, AOL, was willing to back them. With AOL’s support, and their ideas, know-how and effort the women were able to attract substantial support from venture capitalists, who will be well rewarded in the end, no doubt, for their contributions. These investors did not ask for quick profits or ordinary business results. They were willing to believe in the idea, regardless of its incredible cash devouring appetite.

Candace and Nancy have shared an experience that few men or women ever have, that of founding a company de novo in a totally new industry, with hardly any investment of their own, and watching it thrive and themselves profit enormously from it, all within less than five years. Henry Ford could not have enjoyed the process more, and it took him a lot longer to do it. Candace once told a reporter she would really like to have about six children and live securely and quietly on a beach some where. Maybe iVillage will enable her to do just that. It’s the new great American dream coming true.
Notes

8 30.15% assuming dividends were reinvested.
9 There is no real agreement on what the premium over the S&P500 return should be. Some argue that the S&P500 return should be discounted about 30% to reflect the lack of liquidity in the investment. This would lead to a risk premium of 10%-15%. Others (Gompers and Lerner at Harvard Business School) argue that if estimates of intrinsic values which increased over the life of the investment, and the benefits of diversification across many different investments were taken into account, the required premium would be between 5% and 10%.
12 Pricewaterhouse Coopers, October 1999.