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Hungry Start-Up Strategy: Creating New Ventures with Limited Resources and Unlimited Vision

by Peter S. Cohan
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To Robin, Sarah,
and Adam

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PREFACE

THIS BOOK IS AN EFFORT to sate my own hunger.

Let me tell you where my hunger comes from. I've spent most of my career—about thirty years—in the field of business strategy. For most of that time, the work of Michael E. Porter, a business strategy guru whose work I will discuss more fully in Chapter 1, has dominated the field.

Then, in 2005, I began teaching undergraduate and MBA students at America's leading school of entrepreneurship, Babson College. Its curriculum, probably like most around the world, pounds Porter's ideas about strategy into students' heads.

I discovered that when I asked students about the usefulness of Porter's ideas for their own business, they replied with frustrated stares that signal a desire to change the subject.

This frustration came to a head during a faculty meeting I attended in August 2010. There, one of my colleagues reported that executives were tired of hearing about Porter. When I heard this comment, my thought was: *Bashing Porter is fun, but does my colleague have any better ideas?*

More specifically, I wondered whether there were better ideas to help start-ups make strategic decisions. Why do start-ups matter to me? I've invested in six of them: Three were sold for a total of $2 billion and three went out of business. I also started my own business in 1994 to provide strategy consulting to business and governments, and venture capital (VC) to start-ups.

My interest in start-ups may have something to do with my family background. My great-grandfather was an entrepreneur who owned, among other businesses, a chain of gasoline stations in Massachusetts. One grandfather started and ran a clothing retailer in Missouri. The other started and ran one of central Massachusetts's largest accounting firms. And, with his MIT roommate, Amar Bose, my uncle co-founded Bose, the sound-system company.

Before I started my own business, I never anticipated great success working as someone else's employee. But I sensed implicitly that there was no way I could start a company unless I knew how to do something socially useful. When I entered college, I had no idea what that might be.

By 1994, I had left graduate school, tried IT and strategy consulting, and worked in insurance. I took a shot at starting my own strategy consulting firm—focusing on helping high-tech companies identify, evaluate, and profit from growth opportunities created by changing technology.

And in so doing, I had a chance to realize another goal—to invest in start-ups. I was lucky that I had published a book, *Net Profit: How to Invest and Compete in the Real World of Internet Business*, just as the wave of Internet start-ups was gathering momentum.

When the book came out in 1998, audiences around the world paid me to present my roadmap on which specific sectors of the Internet would make the best investment opportunities for business and individual profits—and which ones to avoid.

Internet start-ups found value in my relationships with print and TV media. As a result, many companies gave me the opportunity to invest in them and, in some cases, to help them develop growth strategies.

A few lessons have emerged from my start-up investment experience. The most important of these is that it's pretty simple to tell which start-ups will succeed and which will fail. The ones that have a growing customer base are going to survive and the ones that spend all their money refining their product before getting users will not. For the purposes of this book, we'll call the first type of start-up "hungry start-ups."[1]

Two examples come to mind. One software company raised capital with a video of the founder discussing how its customers were using the product to evaluate the effectiveness of their Web sites. The other sought capital using a team of well-educated people to describe a general approach to a new kind of software (not specified) that would support partnerships.

I invested in both companies. The first one was sold for $440 million after filing for an initial public offering. The second one never figured out a product and never took on a customer; not surprisingly, it shut down after burning through its cash.

In general, I have seen two kinds of capital-raising pitches from entrepreneurs. The first, and by far the most common, uses an abstract calculation of a huge potential market for the company's product but lacks detailed insights into the customers who will make up that market. The second tries to persuade me that the start-up wants to solve a real problem facing real people, by explaining the results of individual conversations with real customers.

Why do you suppose it is so rare for an entrepreneur to present the second kind of business plan (when that is the one with greater odds of foreshadowing start-up success)? I think it's because the entrepreneur:

- Lacks a deep passion for the business and is mostly interested in building the venture to make a quick buck.
- Prefers working behind a compuer screen or sitting in a research laboratory than talking to real people.
- Thinks that there is no point in talking to customers before the product is ready to sell.

To paraphrase the late Peter Drucker, the purpose of a business is to get and keep customers. So start-up CEOs need good answers, which they can apply to their own start-ups, to the following questions:

- How do we pick the right goals?
- How can we get customers before too much time and money have been spent?
- How do we decide which customers to target, and how do they win over enough of these customers to keep going?
- How do we raise capital?
- How do we decide who to hire?
- How do we adapt to unpleasant surprises and unexpected opportunities?

This brings me to the hunger that prompted me to write this book: The need for better answers to the questions start-up CEOS are facing.

For readers who are not familiar with Porter, he offers concepts to help managers deal with two fundamental questions of strategy.

- *Where should a company compete?* Porter argues that managers should compete in industries with relatively high return on investment based on the relative strength of five forces that shape their future profitability: (1) the threat of new entrants, (2) the bargaining power of buyers, (3) the level of rivalry among existing competitors, (4) the bargaining power of suppliers, and (5) the threat of substitute products.[2]
- *How can a company win in its selected industry?* Porter suggests that earning superior returns in an industry comes from its choice of *generic strategy—low-cost producer* (selling a product at the industry's lowest price and setting costs below that price) or *differentiation* (selling at a high price by offering a better product that costs more to make and deliver).

These two questions are important ones facing start-up CEOs, but I've found that Porter's answers are more effective for big companies and that start-up CEOs need answers to some questions that Porter does not address.

In 162 interviews, I have learned that start-up CEOs are hungry in two ways, one that appeals to their right brains, and the other to their left brains. On the right—the one that pertains to emotions—entrepreneurs hunger to create a working world in which they want to live. And on the left—the analytical side—they need to make choices in six dimensions (reflected in the questions on the previous page), so they can turn their emotional hunger into a thriving enterprise whether or not they start with sufficient money and staff.

Sometimes, entrepreneurs' hunger for meaning exceeds their urge for wealth. Consider Jeff Hammerbacher, a 2005 Harvard College graduate who worked at Bear Stearns and Facebook before starting the data-analysis firm Cloudera, in 2008. A Facebook colleague described Hammerbacher as "scary smart, a maverick, individualistic, dynamic, a sponge when it comes to new ideas, and his interests evolve quickly."

When Hammerbacher started Cloudera he walked away from a fortune in Facebook stock—a move he dubbed an egregious act of wealth destruction. But trying to realize Cloudera's mission—to apply the computing power he had built at Facebook to solve more important problems—satisfied Hammerbacher's hunger more than those extra Facebook millions ever could.

Instead of helping to answer what a group of friends "like" the most on Facebook, Cloudera customers would be able to answer questions such as, "Which gene do all these cancer patients share?"[3]

At Harvard, Hammerbacher took a core course on moral reasoning which required him to read philosopher John Rawls's concept of *The Veil of Ignorance*. As Hammerbacher described it, Rawls's idea was that if the moment before you were born, you could decide which part of the world you would be born into, how would you design that world so you would have a fair shot at life?[4]

Hammerbacher's vision is to build Cloudera to last. He said, "The vision is to build an exceptional, standalone enterprise software company respected for its technical depth and expertise. We'd like to help commoditize the infrastructure for analyzing all kinds of data at arbitrary scales, so that companies can derive more business value from the data they generate. DEC, Tandem Computers, and Sun are companies that, in their prime, had cultures similar to the one we're trying to build."[5]

Hammerbacher is not the only hungry start-up CEO. The MBA students I've been teaching since fall 2011 have demonstrated a big appetite for them. I have created and taught two courses on hungry start-up strategy, and they have both been oversubscribed, I think for the following reasons:

- *Failure of big organizations***.** The 2007 financial crisis has collapsed the assumption of people in college that they would be able to get a job in a Wall Street bank, a big company, or government. With unemployment rates around the world at very high levels—nearly 25 percent in Spain by July 2012 and above 8 percent in the United States, for example—the job market for college students is very difficult. And tales of the frustrations of working in large organizations have persuaded many young people that if they want to have a meaningful career, they will have to start their own companies.
- *New start-up environment.* The environment for start-ups in 2012 is different in important ways from the one in 1998 about which I wrote in *Net Profit*. Back then, successful IPOs created high returns for VC firms. These firms are partnerships that sell limited partner interests to foundations, endowments, and wealthy individuals, and their general partners typically earn management fees of 2 percent of the assets under management and 20 percent of the profits they generate during the decade-long life of their funds. VC returns spiked at 83.4 percent for the decade ending June 1999, and huge checks were written to plow those returns back into new start-ups. Much of that money went into splashy parties and marketing. Since the dot-com crash of 2000, VC returns have turned negative—plunging to –5.1 percent for the ten years ending June 2010—and most start-ups can't get those big checks, nor can they borrow money against their houses as they did until 2008. In response to this lack of capital, start-ups have reengineered their approach to strategy around the concept of hunger.[6]

This book is not just for entrepreneurs. My conversations with large, established organizations suggest they are also hungry—for more growth and innovation. Sure, many of them have succeeded in lowering their costs by outsourcing and achieving growth by exporting to developing markets.

But plenty of big companies are not growing as fast as they wish, and disappointing growth is cutting into their stock prices. They are looking for strategies that can produce more rapid growth, and start-ups provide an attractive option for achieving that.

Now that I've written the book, my hunger is still not satisfied. That won't happen until I see whether the ideas in the *Hungry Start-Up Strategy* actually take hold.

Ultimately, start-up CEOs are not satisfied with merely achieving a competitive advantage; they want to change the world. It's my hope that *Hungry Start-Up Strategy* will help satisfy their appetite to do just that.

Peter Cohan
Marlborough, Mass.
July 2012

INTRODUCTION

THERE ARE PLENTY of reasons not to start a company. Here are just four:

- *Odds are good that you will fail.* As an investor in private companies, I have repeatedly been told that a venture capitalist is thought to have a successful track record with one big success out of ten bets. I was considered unusually successful because only half of the ones in which I invested went out of business.
- *If you, friends, family, or others invest money in the start-up, chances are that the money will be lost.* A corollary of the high odds of start-up failure is that any money invested in the start-up is likely to be spent without generating a return for investors. Unless you do a good job of preparing investors for this, you may damage important relationships when your start-up goes down.
- *You may not have what it takes to be an entrepreneur.* Considerable research has been conducted on the traits of a successful entrepreneur. But as a very small-scale entrepreneur myself, and one who has interviewed hundreds of others over the years—either for my research or to decide whether to invest—I have noticed that successful entrepreneurs seem to share several common characteristics (Chapter 9, Resources, offers more about that).
- *Your reason to start the company may not be good enough.* Based on my investing experience, I have noticed that people sometimes can't say why they are starting a company. In at least one case, a start-up failed because the CEO realized that he was not really very interested in the product the company was trying to build. As a result, the company floundered until it ran out of money. Given the long hours and low pay required to get a start-up off the ground, be sure to have a well-thought-out and deeply felt reason for starting your company.

What are some concrete reasons to start a company? Most commonly, people start companies to capture what they perceive as an irresistible opportunity or to solve a vexing problem; the entrepreneur often assumes that if he can come up with a workable product, then enough other people will buy it to make the company grow.

Once you figure out a good reason to start the company, you need to make six key choices to turn your vision into a viable business. To illustrate these choices, let's look at the case of BrewDog.

James Watt and Martin Dickie, a pair of Fraserburgh, Scotland, twenty-somethings, liked to brew beer. There must be hundreds if not thousands of home beer brewers around the world. But Watt and Dickie were different. They thought it would be fun to try to turn their hobby into a real business.

By May 2012, BrewDog was a successful public company that provided a world in which the co-founders wanted to work, while also feeding customers, employees, suppliers, partners, and shareholders with custom-cooked meals that satisfied their distinctive cravings.

My interview with co-founder and captain, James Watt, reveals how.

Why did you and your co-founder start BrewDog?

BrewDog's co-founders started the company because they were bored with their conventional jobs, disliked conventional beer and the conventional corporate cultures they represented, and wanted to do something they loved.

As Watt said, "The idea to start our own brewery certainly wasn't something we consciously set out to do.[7]

"I guess like any good idea it just had this natural flow about it that . . . kept rolling and has never really stopped. BrewDog officially began in April 2007 but it was some months before that, when [Martin and I] were having a beer that BrewDog was 'born.' The subject of monotony and the fact that all supermarket or big brand beers taste the same was the topic of conversation.[8]

"[With Martin] having just finished a degree in brewing, beer often took precedence in our conversations, but this time words became actions and we decided to try and create our own beer as a means of remedying the stuffy ales and fizzy yellow lagers that had come to dominate the UK drinks market.[9]

"That evening we set up a makeshift and pretty sketchy looking brewery in Martin's garage and created the first batch of what has now become known the world over as Punk IPA."[10]

Their next move was to see if anyone in the world would like what they had brewed. Watt continued, "From here we took our pilot beer to a series of open tastings and—by chance—were discovered by the late beer guru Michael Jackson at an event in Glasgow. Upon tasting our beer, Michael told us to quit our jobs and go into brewing fulltime. This is exactly what we did."[11]

Their next challenge, with very little money and difficult access to more, was to build a brewery big enough to meet that demand. As Watt explained, "Both only 24 years old, we leased a building, got some scary bank loans, and poured our heart, soul, and life savings into a fledgling business we weren't even sure would take off."[12]

"BrewDog started with only $48,000 [bank loan] so the first year involved living, eating, and sleeping at the brewery—a drafty warehouse on Fraserburgh's coastline. Exposed to the elements and running short on funds, Martin and I often worked twenty-hour shifts, . . . to stay afloat but also to stay warm."[13]

They were delighted to learn that through a combination of media savvy and brewing skill, they were generating a wave of popularity. Watt pointed out, "Within a year, there was already a buzz beginning to form around our beers, a media buzz that was starting to brand us as a scourge to society with our 'reckless and irresponsible' approach to brewing. The same buzz caused other people to see our beers as wildly innovative, contemporary, and making progressive changes and twists to long outmoded classic beer styles. Many people are still making their mind up over which brush to tar us with."[14]

Had you previously worked for other companies?

Both BrewDog co-founders had earned university degrees and gone to work at conventional firms. But for different reasons, they did not feel that they fit.

Dickie seems to have gotten more benefit from his education than Watt. As Watt explained, "Martin and I had both been to university in the years before BrewDog's conception and . . . studied very different subjects. I, for example, [became] bogged down in the rather tedious world of law while Martin . . . pursued brewing and consequently was working at a number of different breweries in England. After graduating [I] managed to get a place at a law firm but within two weeks [I] walked out."[15]

If so, what did you like about working there? What frustrated you about it?

Watt's revulsion with law was visceral and he quit his job quickly. He said, "Law—in a word—is dull and there was a big part of me that totally panicked thinking 'f*ck is this it?' The last thing I wanted to do with the next forty years of my life was to sit behind a desk, sorting out paperwork and other people's problems, constrained by a nine-to-five and a smart casual wardrobe. When I quit I didn't know what I would do, but literally a week later Martin and I started experimenting with beer, so I wasn't stuck watching daytime TV for long."[16]

What were the factors that led you to decide to turn your hobby—home brewing beer—into a business?

Watt and Dickie founded BrewDog because they were passionate about it and they thought the consequences of failure were minimal.

Watt said, "The opportunity to do something both Martin and I were genuinely passionate about was the main driving factor. Passion, drive, and determination are the key ingredients when starting any business, so it was just as well we felt that way about beer.[17]

"We also wanted to see if we could make a change. Martin and I were both in the perfect position to take that gamble—young enough and stupid enough to take big risks which—should they fail—wouldn't change our lives too dramatically."[18]

They found out in retrospect that there had been a big opportunity, but they did not have any idea it would be so significant when they decided to launch BrewDog. According to Watt, "Even now I'm surprised our business managed to stay afloat and [has] achieved some incredible things—exporting to over twenty-seven countries, being stocked in the UK's largest supermarkets, and having 1,300 shareholders invest in our brewery because they share in our vision, to name but a few."[19]

When you decided to start the company, what were the most important values you wanted to represent in your product and your relationships with others?

BrewDog is driven by a passion to create good-tasting beer in a very different way from its corporate brewer competitors.

As Watt explained, "Passion is the key value—we want people who drink our beer to get a sense that it's been produced by people who genuinely love beer. As the old BrewDog adage goes—'we're selfish because we only create beers we like.' If you aren't 100 percent interested or committed to your product then you're setting yourself up for a fall."[20]

"BrewDog is also the antithesis of corporate culture. Our staff aren't so much staff but more like family—dogs included—so it's pretty difficult to implement any kind of regulation when your employees are friends and your office is essentially a 24/7 parlor of chaos."[21]

Nevertheless, the founders needed procedures to help manage their growth. As Watt explained, "That said, it's far from a frat party in a brewery. The business is growing so quickly that we can often barely keep up in terms of the number of people we need as well as the internal procedure and infrastructure that are key to keep the whole thing from falling down around us.[22]

"The growth of BrewDog means the rest of the team and I spend a lot of time putting out fires, whether that's explaining to a loyal customer that their beer isn't ready yet or trying to get our online store fully stocked."[23]

BrewDog's beer-manufacturing approach reflects that anti-big–company ethos. According to Watt, "The problem with beer is that it's a completely organic product in that it takes time to grow and mature. If we were an automated, machine-driven multinational with millions of pounds at our disposal, then we could quite happily pump our beers full of artificial flavorings and chemicals to get them out the door as quickly as possible.[24]

"Thankfully, however, that's not the way we operate and we spend our time focusing on redefining the industry whilst beating our customers from our front door with a stick."[25]

BrewDog remains highly motivated to persuade people who buy corporate-brewed beer to switch to their crafted product. Watt said, "For us, everything comes back to one simple thing, one overarching ambition, one guiding light: to make other people as passionate about great craft beer as we are. We want to show people there is an alternative to monotone corporate beers and introduce them to a completely new approach to beer and elevate the status of beer in our culture.[26]

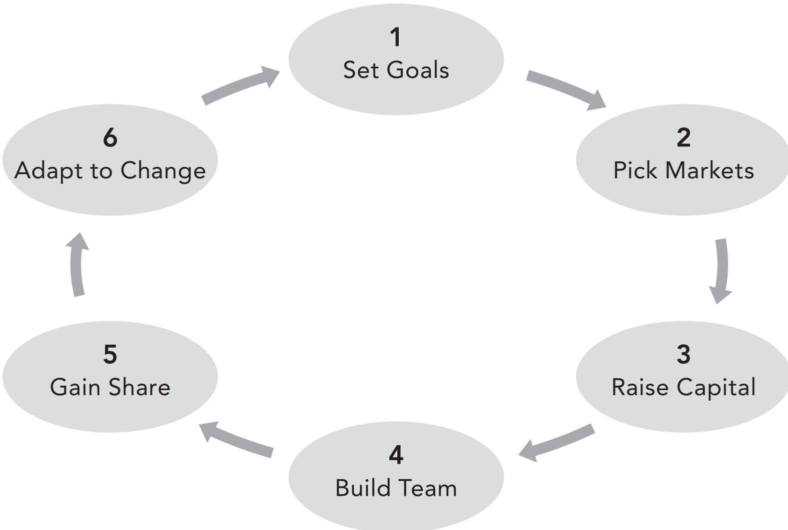
"Drinkers in Scotland are constrained by lack of choice. Seduced by the monolithic corporate brewers that have huge advertising budgets. Brainwashed by vindictive lies perpetrated with the veracity of pseudopropaganda. They can't help but be sucked down the rabbit hole. We are on a mission to open as many people's eyes as possible. This single goal is what gets us through pretty much anything."[27]

Its marketing approach also reflects this anti-corporate bias. As Watt explained, "Whether it is wrangling with industry regulators, pushing the boundaries in high ABV [alcohol by volume] brewing, smashing bottles of generic beer with a baseball bat, or doing a Saturday morning tasting at a local street market. This is why we work sixteen-hour days and why we only hire the most committed and passionate craft beer fans to work at BrewDog."[28]

The six hungry start-up strategy choices in Figure I.1 illustrate BrewDog's story, as follows:

1. *Set goals*. Watt and Dickie started BrewDog because they enjoyed making beer, they did not like working in corporate settings, and they wanted to create a working world for themselves and others who shared their passion for making craft beer. To make this vision a reality, they created a series of short-term goals—representing small, but ever-higher-stakes bets on BrewDog's future. If they could achieve these goals, they might be able to take the company to a higher level. Here is how they sequenced their goals:
   - *Goal 1:* Find something to do after they quit their corporate jobs.
   - *Goal 2*: After realizing that crafting beer was a good thing for them to do, create some buzz among influential beer bloggers.
   - *Goal 3*: Get a distributor in the country where they had created buzz.

FIGURE I.1 Six Hungry Start-Up Strategy Choices.



- *Goal 4*: Convince a bank to lend them money to build a facility that satisfies customer demand.

2. *Pick markets*. The co-founders picked the craft beer market because they liked making and drinking craft beer. They initially hoped to sell it in Scotland but ran into a brick wall. Instead of giving up, they decided to try sending samples of the product to a beer blogger in Sweden who loved the product. The blogger's influential review opened up Sweden to BrewDog's products.
3. *Raise capital.* BrewDog was able to cobble together capital in a fairly unusual way. It got a bank loan for its initial operations and then sold shares of stock to 1,300 of its customers in an innovative program called "Equity for Punks." BrewDog also raised capital by trying to delay payments to suppliers while speeding up cash collections from its distributor customers. BrewDog pays suppliers for their raw materials—such as hops, malt, and bottles—when they are ordered, but it typically has to wait sixty days to get paid by its distributors. To speed up customer payments, BrewDog offers a 3 percent discount to those who pay within ten days. But these customers are in the minority—most of them must pay before BrewDog ships its product to them. Only "rock solid" partners—such as those in Sweden and Norway (which are government-owned) do not have to pay before BrewDog delivers.

4. *Build team.* Watt makes it very clear that the values that drive BrewDog's efforts to gain market share—a passionate devotion to making high-quality, craft beer and an anti-corporate bias—also influence the kind of people BrewDog hires. Moreover, Watts suggests that this anti-corporate bias means that BrewDog's work environment demands very long hours and may not be as efficient as that of a large corporation.
5. *Gain share.* BrewDog's values and comparatively weak capital base led it to gain share through so-called guerrilla marketing techniques. It produces very clever and humorous videos that are inexpensive to produce and tend to attract many viewers through viral growth. Watt noted that a one-page magazine advertisement in the United Kingdom might reach a few potential customers for $8,000; however, BrewDog was able to reach 250,000 people around the world with a humorous YouTube-style video that it created for $2,400. Meanwhile, its initial market in Sweden was a result of sending a sample of its product to a prominent beer blogger there whose endorsement of the product made it much easier for Watts to sign up a big distributor in that market.
6. *Adapt to change.* BrewDog is trying to expand to more countries, and everywhere it wants to go there is plenty of competition. But Watt has a corporate North Star that helps him navigate these churning waters—his passionate belief in making a craft beer that its founders and customers crave.

BrewDog's battle for survival is typical of start-ups. Since they are born scrambling to come up with the cash to keep going, they cannot afford to wed themselves to old ways of running a business.

To that end, different questions keep start-up CEOs up at night and the answers differ from the prescriptions provided by Michael E. Porter, Bishop William Lawrence University Professor at Harvard Business School (HBS), whom I mentioned in the preface. He is a leading authority on company strategy and the competitiveness of nations and regions. And I worked at his consulting firm, Monitor Company, and directly with him on two projects.

While I have great respect for his ideas and intellect, there are important differences between his ideas and the concerns and concepts most pressing to entrepreneurs. Table I.1 summarizes these differences. The most important of these differences is that since they sprout from a hunger to create a new world with scant resources, all start-up choices are shaped by different pressures from those in large organizations.

For example, start-ups choose where to compete not based on analysis of impersonal factors but on their own skills and passions. Start-ups shape their choices as to where and how to compete based on their limited capital.

TABLE I.1 Hungry Start-Up versus Competitive Strategy

Start-Up Choice	**Hungry Start-Up Strategy**	**Porter's Prescription(s)**
Set Goals	Set three different kinds of goals: ▪ *Mission* that communicates why founders are passionate about the venture. ▪ *Long-term goal* that describes the ultimate outcome of the venture—such as becoming the leading publicly traded company in the market. ▪ *Short-term goals* that spur the start-up to make a series of frugal experiments that can help them find a business model that ultimately leads them to achieve the long-term goal.	Earn above average risk-adjusted return on equity (ROE).
Pick Markets	Start-up CEOs pick markets in a very personal way—based on their own industry experience and the opportunities they believe they are uniquely qualified to capture. Company founders only attempt to estimate the size of the markets when seeking outside capital.	Focus on market segments and strategic groups with favorable and improving structural attractiveness based on the so-called five forces.
Raise capital	The availability of capital—or lack thereof—pressures founders to map out their short-term goals as a series of frugal experiments and approach capital raising differently for each.	Finance is a support activity tasked with minimizing the cost of capital. General corporate finance advice is first to choose the strategy and later to find financing.

And they use the power of their mission and long-term goals to make up for their inability to pay high salaries when recruiting their teams.

Ultimately, start-ups can gain market share—not through one of Porter's generic strategies—only through the recognition that they must offer customers a huge leap in value over competing products in order to overcome the risk to a customer of building a business relationship with a potentially ethereal supplier.

TABLE I.1 *(continued)*

Start-Up Choice	Hungry Start-Up Strategy	Porter's Prescription(s)
Build the team	With a sufficiently compelling mission, a start-up CEO can attract a top team despite a lack of cash to pay big-company salaries. The passion underlying the mission drives the values that shape start-ups' decisions of whom they'll hire, how they should act, and who gets promoted and fired.	Human resources is a support activity.
Gain share	Start-ups gain share by providing customers a Quantum Value Leap (QVL)—combining both of Porter's generic strategies with a twist. One extreme example of a QVL is a so-called freemium strategy, giving away a basic version of the product for free and, in the small number of cases where there is demand, charging customers for a more fully featured version.	Choose generic strategies: low-cost producer or differentiation and lower mobility barriers.
Adapt to change	Boundaryless company development helps start-ups to identify critical listening posts in their competitive environment and filter out the noise from the critical few signals—key threats or opportunities—to which they must respond.	Monitor rapidly evolving five forces.

WHY START-UPS MATTER TO THE ECONOMY

The typical start-up is a pretty fragile economic entity. So it might surprise you to learn that start-ups play a critical role in creating new jobs for the U.S. economy. Between 1977 and 2009 nearly all the roughly two to three million new jobs created each year were contributed by start-ups. Big companies contributed no net new jobs.

Dane Stangler, a research manager at the Kauffman Foundation, explained his views on the importance of start-ups and provided the data to back them up. According to Stangler, there are about 500,000 new businesses created annually.[29]

These new firms help maintain a total of two million start-ups—at 30 percent there are more of them than any other type of company. And between 48 and 50 percent of start-ups survive to their fifth year. If you net out job turnover, those start-ups create about two net new jobs every year.

Stangler points out that there are good reasons the start-ups produce most of the net new jobs. First, there are more of them. Second, the larger and older businesses tend to hire many people during economic upturns and then terminate them during periods of economic contraction and expansion.

Stangler suggests that large companies and start-ups have different attitudes toward innovation. The large companies invest in incremental technologies that have more controllable risks—and predictable returns. By contrast, start-ups invest in breakthrough innovation.

The different incentive structures for managers and investors help explain why. After all, even when a large company encourages risk-taking, there are limits to how much money a bet on innovation can lose before the person responsible for it pays a career price. By contrast, for a start-up, it is understood at the beginning that there is a one-in-ten chance of hitting it big, and if that happens, the reward will be a massive return on investment.

An interesting feature of start-ups is how they're financed. Stangler estimates that between 1 and 3 percent of the financing for start-ups comes from VC firms. And that comes later in their development. Stangler cites a 2009 study by Paul Kedrosky, *Right-Sizing the U.S. Venture Capital Industry*, which found that 16 percent of the 900 Inc. 100 companies between 1997 and 2007 took VC.[30]

During a start-up's initial stages, the funds come from friends, family, and founders. As a start-up grows, the money comes from bank loans, credit cards, and, before 2008, home equity. And only if the start-up has reached a further stage of development does it get equity investment.

Duke University researcher Vivek Wadhwa has surveyed thousands of students from China and India who returned home after getting their degrees in America. They ran into so much difficulty trying to make a go of it here that they started their companies back home instead. And China is taking steps to encourage its natives to return home to start their businesses.

Graduates of research universities such as MIT and Stanford account for a huge number of start-ups. In February 2009, MIT professor Edward B. Roberts and Charles Eesley discovered that MIT alumni started 25,800 active companies that employ about 3.3 million people and generate global sales of $2 trillion.[31] Eesley is currently conducting a similar study to estimate the economic impact of Stanford.[32]

The final reason start-ups matter is somewhat theoretical, but quite interesting. According to Stangler, for a company or a society there are diminishing returns to complexity. Initially, investment in more complexity generates an attractive return. But eventually, more complexity produces negative returns.

In Stangler's view, start-ups reset the complexity curve. Through breakthrough technological innovation, they extend the productivity frontier of companies and society. And they create new opportunities to make high-return investments in increased complexity before those diminishing returns again set in.

HOW HUNGRY START-UP STRATEGY WILL BENEFIT YOU

If you agree that start-ups are important, then Hungry Start-Up Strategy will help you. This book provides different benefits to different groups of readers, including:

- *Entrepreneurs.* Start-up CEOs and their management teams will learn how best to make six key strategic choices, how capital providers view them, and the kinds of big companies that can train them before they launch their ventures.
- *Entrepreneurship professors and students.* Business schools that teach entrepreneurship will have a new approach to strategy that complements traditional strategy frameworks. And students will benefit from advice on whether they are cut out to be entrepreneurs.
- *Capital providers.* Venture capitalists, banks, and angel investors will use the book to attract potential portfolio companies and to show them how to achieve their goals.
- *Big companies.* CEOs of large companies—particularly those that are threatened by upstart competitors and changing technologies—will learn how a handful of large companies are incorporating start-up strategies into their own organizations to create and capture growth opportunities while meeting quarterly performance targets.

Welcome to the world of the hungry start-up. If this introduction has increased your appetite to learn more, may the rest of this book sate your hunger.

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PART ONE

Six Start-Up Choices

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CHAPTER 1

Setting Goals

What Makes You Hungry?

START-UPS ARE BORN HUNGRY—their demand for money exceeds their supply. So start-ups need a different currency—a powerful emotional magnet that draws in talent.

Why would anyone go to work for a start-up? The hours are sure to be longer than they would be at a more established company, and the pay is likely to be lower as cash will be in short supply.

The simple answer is that some talented people are able to defer short-term economic gain in exchange for meaningful work with the possibility of a longer-term payoff.

Of course, this puts entrepreneurs in the difficult position of persuading talented people that they should stop whatever they are doing and work for them instead. And as we'll see in Chapter 3, entrepreneurs must also persuade capital providers to part with their cash to invest in their start-ups.

To recruit talented employees, entrepreneurs must mint emotional currency by way of three *hungry start-up goals*. These three goals answer the basic questions a talented potential employee might have before going to work for your start-up.

- *Why should I join your start-up?* ***Mission.*** The mission is the entrepreneur's most compelling case for why the start-up is going to achieve greatness. At the core of this case is a passionately held belief that what the start-up aspires to do is important. As we'll see, that passion might come from the desire to make the world a better place, the excitement that comes from being certain that the start-up could capture a great economic opportunity that nobody else has seen, or the simple desire to solve a problem that perplexes the founder.
- *How will I get a return on the stock I receive in exchange for giving up my life to your start-up over the next five years?* ***Long-term goals.*** Long-term

goals describe a tangible way that the entrepreneur will measure the venture's success, say, five years into the future. Long-term goals include being the leader in an important new market, becoming a big public company, being acquired by a bigger company, or remaining permanently private and independent.

- *How will you actually deliver on that promise?* ***Short-term goals as a series of real options.*** Short-term goals are specific milestones that the entrepreneur sets over a period of months, and the idea of real options means that each short-term goal is a frugal experiment. Setting good short-term goals reflects how effective the CEO is at getting stuff done. Many of the start-ups I interviewed tend to view these short-term goals as a sequence of go/no-go decisions. For example, the first short-term goal might be to figure out the start-up's business model, the next might be to get customers to use or pay for the product, and the third to expand success from one market to five around the world. If the entrepreneur can figure out, say, the first goal—e.g., the start-up's business model—then she continues on to the second one. Otherwise, she shutters the venture.

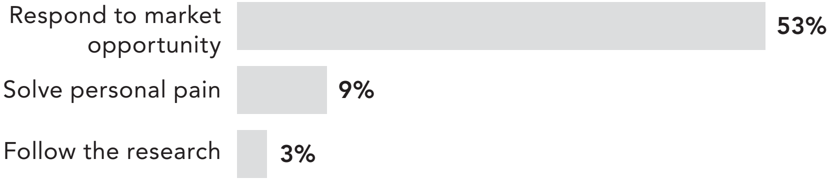
MISSION: RESPOND TO MARKET OPPORTUNITY, SOLVE PERSONAL PAIN, AND FOLLOW THE RESEARCH

As Figure 1.1 illustrates, entrepreneurs have different ways of picking a start-up's mission.

Entrepreneurs get the ideas to start companies from three sources:

- In many cases, it appeared clear that the founders did not consider their emotional or intellectual connection to the start-up to be a sufficiently compelling reason to devote themselves to a company. Instead, they felt a need to go beyond that personal impulse and determine whether there was a big enough market opportunity to justify the investment of time and money in starting the venture.

FIGURE 1.1 Why Entrepreneurs Start Companies, by Percent of Interviewees.



- This is not to say that the ventures that were started purely to relieve personal pain or develop an intellectual interest did not eventually coincide with a market opportunity. Rather, these entrepreneurs were willing to defer identifying that opportunity at the time they started the company. Of the start-ups I interviewed, 24 percent sprang from a combination of personal pain *and* perceived market opportunity, and 10 percent were born of a combination of or intellectual interest *and* perceived market opportunity.

Let's take a look now at examples of each kind of mission.

Respond to Market Opportunity

Responding to market opportunity is the most common reason that entrepreneurs start companies. Their mission is to satisfy that unmet need better than the competition and build a significant enterprise in the process.

The specific nature of the market opportunity varies for each start-up and some are more studious than others when it comes to talking with customers to get external evidence to support their belief that the market opportunity is real.

Among the start-ups I interviewed were for-profits and social enterprises. And one interesting feature of these examples is that two of them—SoFi and m-Via—combine pursuit of market opportunity with a bigger social purpose. Here are some examples of the market opportunities that the for-profit start-ups perceived:

> I saw an opportunity in the $1 trillion student loan market to lower the rates that students pay on their loans while creating an attractive investment opportunity for alumni.[33]
>
> —**Mike Cagney, co-founder and CEO of SoFi**, and former vice president and head trader of Wells Fargo. SoFi raises capital from alumni at colleges to help finance loans to their students.

> ExtraHop was founded in early 2007; my co-founder and I saw an underserved market. We are targeting a large, fast-growing market. After all, Gartner estimated that the market for network and application performance monitoring products hit $3.8 billion in 2011 and is growing at an 8.5 percent annually. And we were eager to solve the problem. We spent over two years working on building a product that would work well for the customers with whom we collaborated.[34]
>
> —**Jesse Rothstein, CEO of Extrahop**, a sub-$50,000 appliance that provides IT managers with real-time system health and performance information.

> I see a big opportunity in a very fast-growing industry. IDC reports that between 2001 and 2011, the market for our product—virtualization storage—grew from scratch to $11 billion. Before founding Tintri, I oversaw the development of all server virtualization technology for VMware as its VP of R&D from 1999 to 2006. I recognized the problem server virtualization created for storage early on and resolved to shift my career focus to solve this storage dilemma. To that end, I founded Tintri—it's Gaelic for "lightning." My aim was to extend the benefits of virtualization from the server side to storage—what could be a lightning bolt of efficiency if carried out.[35]
>
> — **Kieran Harty, CEO of Tintri**, which helps companies store and retrieve information more efficiently.

> While working at a mobile gaming start-up, I grew increasingly outraged as I analyzed the way the cross-border money transfer business has skillfully avoided disruption of its tactics over the last thirty years. I felt that it was unfair to exploit the weakness of people sending money home and became convinced that I could develop a service that would offer them a lower-cost, safer way to transfer money.[36]
>
> — **Bill Barhydt, CEO of m-Via**, which helps people wire money to their families in Mexico and other countries.

From these examples, the takeaway is simple. Start-up CEOs should set their start-up's mission based on their own experience. But the mission should be bolstered by some external validation: ideally, in-depth customer research that confirms that what is important to the founder will also be important to a sizable audience.

This same principle holds for social enterprises—set up not for profit, but to make the world better. What's different about them is that they face a unique challenge in their efforts to achieve what is most commonly a very noble social purpose. It's challenging for social enterprises to make enough money to perpetuate doing social good. Here are some examples:

> One of the reasons I started PoverUP was that in the summer of 2008, I volunteered in a border refugee village in Thailand. That's where I realized that a little money—I bought 50 donuts for $1—could go a long way to helping poor people start businesses that would lift them out of poverty.[37]
>
> — **Charlie Javice, co-founder and CEO of PoverUP**, a social network for university students to get involved in social enterprises.

I developed the idea for a peer-to-peer donation service in 2005 while pursuing my master's degree in Industrial Engineering at Stanford after visiting Indonesia a few months before the December 2004 tsunami struck. Following the relief efforts, I saw stockpiles of usable medicine, large enough to overflow a football stadium, not only not being used but also costing Indonesia millions of dollars to dispose of as toxic waste. I started SIRUM to solve the supply chain problem that prevented perfectly good medicine from getting to the people who needed it.[38]

— **Adam Kircher, founder of SIRUM,** a nonprofit that gets medication that would otherwise be dumped or incinerated into the hands of poor people in California.

A mother living in a rural village outside of Bangalore, India, gives birth to a baby two months prematurely. Her family cannot afford to go to the city hospital in Bangalore, so her husband, who raises silkworms that he warms under lamps, decides to care for the baby in the same way. A few days later, their insufficiently warmed baby dies. Stopping this tragedy—20 million low-birth-weight and premature babies are born each year—is the primary mission of Embrace.[39]

— **Jane Chen, founder and CEO of Embrace, which** makes a sleeping-bag–like baby warmer that helps improve the odds of survival for premature babies born in developing countries.

Lacking the potential to attract people motivated by an opportunity to become wealthy, the missions of these social enterprises must be particularly compelling. And these examples do share the following common characteristics:

- They all spring from emotionally powerful and compelling stories about why the organization was formed.
- They attract talented people who want to help achieve that long-term goal.
- It is clear who will benefit from achieving the goal.
- The founders are likely to face a challenge as they attempt to maintain unswerving devotion to their long-term goals and generating sufficient cash flow to keep their organizations operating.

Solve Personal Pain

While the majority of start-ups I interviewed set their long-term goals based on a perceived market opportunity, some believed so strongly in the importance of addressing their personal pain that they went ahead with their companies without hard evidence of a significant market opportunity.

Here are some examples of the personal pain that spurred the creation of for-profit start-ups:

> I got the idea for AfterSteps after a grandparent died. My mother started calling me in periodic spurts with her estate plans, wishes for various personal items, and requests for how to handle her body. I decided there had to be a better way. So I started AfterSteps to bring organization, completeness, and knowledge to the end-of-life planning process.[40]
>
> — **Jesse Bloomgarden, founder and CEO of AfterSteps,** a service that helps people prepare their loved ones for their death.

> Before starting Huddle, I worked for a "big data" firm called Dunnhumby—it analyzed data for large retailers such as Procter & Gamble —where I led a business that grew to $60 million in revenues in three years. When the company was acquired, I left. I used some of the proceeds from the sale to finance Huddle's initial operations in 2008. I wanted to solve a problem I had at Dunnhumby—my 300-person staff could not work together on projects through a single, easy-to-use system. Huddle was started to remedy that problem.[41]
>
> — **Alastair Mitchell, founder and CEO of Huddle,** a service that enables big companies collaborate on projects.

> I attended an all-girls high school in India and was then admitted to one of its top engineering programs, IIT Kanpur, India. There, I was one of three girls in a class of fifty computer science majors. I was shy and studied alone while the more gregarious boys collaborated. As a result, the boys, working together, could get answers in ten minutes to questions that I spent four hours solving myself. Piazza is my way of letting the shy and the gregarious of both sexes collaborate online. I believe that Piazza works better than wikis and threaded discussion groups that are often used for student Q&A.[42]
>
> — **Pooja Nath Sankar, CEO of Piazza,** a service that helps students ask questions of peers and professors and get the best answers at the top.

These stories all share certain common characteristics that typify entrepreneurs seeking to solve personal pain:

- The start-up CEOs each had a compelling personal problem and wanted to develop a business dedicated to solving that problem.

- The CEOs were willing to invest their time and money in developing a solution to their problems and did not let the absence of a clear market opportunity stop them.
- The CEOs assumed that if they could solve the problem well, they would find plenty of other people who would pay them for the solution.

While the long-term success cannot yet be predicted for any of these ventures, their goals serve a useful purpose. By choosing long-term goals that relieve their pain, there is little doubt that these founders will have ample motivation to solve the problem effectively.

And in these cases, it does not take a precise market size estimate for the founders to apply some common sense and realize that their pain is widely shared—even if the precise size of the market is not of great interest to them in setting long-term goals for their companies.

Follow the Research

A few of the start-ups I interviewed were started by people with PhDs who decided to try to turn their doctoral research into a business. While this is a fairly risky business proposition, there is often a chance that their original research can be applied to an existing problem for which there is not a particularly good solution. It is also possible that their work can create a market where one has not previously existed.

Here are some examples of how following the research spurred the creation of two start-ups:

> Sifteo CEO Jeevan Kalanithi, a colleague from Stanford, and I were studying at MIT's Media Lab. He shared my interest in bringing physical objects such as dominoes back to interactive gaming. We wondered together why everything on our computers—email, files, and icons—were two-dimensional. We wanted to bring three-dimensionality to computing—to develop siftable computers that people could use their hands to manipulate—to sift and sort—like a pile of LEGOs. In the summer of 2009, we founded Sifteo to build products that would fulfill our vision for hands-on interaction.[43]
>
> — **Dave Merrill, co-founder and president, Sifteo,** which makes blocks with programmable screens that can interact wirelessly.

> I took a leave of absence from my Stanford master's degree program in computer science after earning a BS in the field—I have four classes left—to start Loki Studios. At Stanford, I met an engineer who shared

> my passion for the idea of starting a gaming company that would take advantage of mobile technologies.[44]
>
> —**Ivan Lee, CEO of Loki Studios,** a maker of mobile Pokemon-like games.

It's not very often that entrepreneurs start companies to follow the research; however, they:

- Each had a strong interest in applying new technologies to games.
- All came up with novel ways to apply existing technologies to their interest in games.
- Assumed that if they could solve the problem well, they would be able to create a market of people who would be willing to pay for their solution.

While these intellectual ventures both got started without substantial research into the market potential for the products that they were developing, it is clear from talking with the founders that they would be happy to develop their products and get them working well. If they happened to find sizable numbers of other people who shared their interest, they would be delighted.

So, if you are an entrepreneur who wants to follow the research, you should consider raising capital from investors who share your interest in the field.

Solve Personal Pain and Respond to Market Opportunity

As noted previously, about a quarter of the companies I interviewed started companies to relieve personal pain and because they believed that there would be a big market opportunity in so doing.

Here are some examples:

> I left my driveway at 9 a.m. for a doctor's appointment; I signed in, waited a few hours, and finally got in to see my doctor, who prescribed medication. I get back in the car, drove to the pharmacy, waited in a line for my prescription, and paid for it. By the time I returned to the driveway, it was 2:30 in the afternoon. A fine day, wasted. I was thinking about starting a new company targeting a big market and when I was returning from the pharmacy that day, I realized that health care would fit the bill. So I decided to start WhiteGlove Health.[45]
>
> —**Bob Fabbio, CEO of WhiteGlove Health,** which provides health care to corporate employees in their homes or offices.

> I like to take photographs. In 2003, I had what I thought was a great collection that I wanted to use for a book to give 35 friends and family members. One little problem—the price tag for doing that would be a jaw-dropping $10,000. I thought that given the technology available at the time, it should not be so hard to produce that book. I set up Blurb to solve that problem. I immediately set out to research whether there would be a big enough market to make a start-up worthwhile and discovered that the opportunity was worth pursuing."[46]
>
> —**Eileen Gittins, founder and CEO of Blurb,** a service that lets people self-publish, with an emphasis on books with digital images.

> I bought some security cameras to protect my business and noticed that their quality was terrible. Having expertise in high-quality camera hardware and software, I started a company focused on building much better surveillance systems. We're targeting the $10 billion market for surveillance systems—half of which is cameras and the other half video management software. The market is growing between 5 and 15 percent a year, and we are tapping the fastest-growing upgrade segment.[47]
>
> —**Alexander Fernandes, CEO of Avigilon,** which makes inexpensive, high-quality visual surveillance systems.

These stories share certain common characteristics that typify entrepreneurs seeking to solve personal pain and respond to market opportunity:

- The start-up CEOs each had a compelling personal problem and wanted to develop a business dedicated to solving that problem.
- They were not willing to bet their time and money on the opportunity unless they could be convinced that there would be enough other people who had the same problem and would be willing to pay to solve it.
- Their research gave them confidence that the market opportunity for solving that problem would more than offset the likely investment required to develop a solution and sell it to those potential customers.

This combination of reasons for setting a start-up's long-term goal is among the most compelling ones out there. The existence of a personal problem that the founder wants to solve is a powerful spur to invest time and money in solving it. And the ability to gather compelling evidence that the number of potential customers is big enough to justify that investment is likely to interest potential employees and investors.

Follow the Research and Respond to Market Opportunity

Some of the start-ups I interviewed combined their desire to follow the research with what I think is a sensible urge to find whether the demand for their product will justify the investment of their time and money.

Here are some examples of companies that followed the research and responded to a market opportunity:

> Company co-founder Marsha Moses and the late Judah Folkman of Boston's Children's Hospital invented a urine-based, noninvasive cancer detection technology that Predictive Biosciences has commercialized. Monitoring bladder cancer patients after their initial treatment is very expensive. Patients must submit to cystoscopy—threading a cystoscope through their urethra and into the bladder—every three months for the first two years, every six months for the next two years, and annually thereafter. Replacing this invasive test with one that detects biomarkers in the urine targets a $3 billion market for bladder cancer detection.[48]
>
> — **Peter Klemm, CEO of Predictive Biosciences,** which makes diagnostic tests for diseases like colon and prostate cancer.

> I started Locately in 2008 with the idea of applying location analysis to the then recently introduced Apple iPhone. To finance the company, I and fellow MIT PhD, Eric Weiss, saw success in the MIT $100K Entrepreneurship Competition. Our idea was to make use of valuable location data from mobile devices [that were] going unprocessed and unharnessed every single day. And we saw a business opportunity in packaging and analyzing that data for national brands, market researchers, and advertisers. Our goal was to provide new insights into consumers' location-relevant lifestyles while keeping individuals always in control of their data.[49]
>
> — **Dr. Thaddeus Fulford-Jones, CEO of Locately,** a service that helps retailers track consumers' shopping behavior as their locations change.

These stories share certain common characteristics that typify entrepreneurs seeking to pursue an intellectual interest coupled with a market opportunity:

- The start-up CEOs each had invested a significant amount of time developing the intellectual interest, and it took the form of a doctoral thesis or postdoctoral research.
- In some cases, the people who conducted the research had no interest in capitalizing on it themselves; however, they did want to license their

work to someone with a track record of successfully commercializing such intellectual property.

If the market opportunity for applying the research is sufficiently attractive, the combination of the unique, patented technology with a significant, unmet market need can set the stage for a successful venture with a clear long-term goal that galvanizes executives, capital providers, and workers.

As an investor, I find this combination of intellectual originality and market opportunity to be generally quite compelling. Potential employees would also be likely to find the goal of building such a start-up to be attractive.

There are many kinds of long-term goals that entrepreneurs can set for their start-ups. In general, hungry start-ups set these long-term goals with the idea that they will help shape the work environment that they want to create. So whether the long-term goal springs from personal pain, an intellectual interest, a market opportunity, or a combination of these, the most important thing for the company is that the founders firmly believe in their long-term goals.

Their belief in these long-term goals will motivate them to commit their time and capital, if necessary, to achieve them. That belief will also help them attract employees and capital to help achieve those goals.

THE REAL-OPTIONS APPROACH

Hungry Start-Up Approach to Short-Term Goals: A Series of Real Options

Hungry start-ups are so short on cash that what they choose to do in the short term can make the difference between surviving and running out of money. Rather than betting all their cash on one big goal, start-ups set shorter term goals—such as building a prototype of a product and getting customer feedback on it within six months.

Principles of Hungry Start-Up Approach to Short-Term Goals

Start-up CEOs think of those short-term goals as real options—inexpensive, time-limited bets. And these options will either generate a successful outcome or a failed one from which the start-up can learn and adapt. More formally, start-up CEOs think of short-term goals as a *sequence* of real options which give their holders the right, but not the obligation, to make future investments in the start-ups.[50]

Here start-ups conduct a series of frugal experiments[51] where they spend a relatively small amount of money to test a hypothesis about a potential opportunity. Through this hypothesis testing, start-ups get insight about the nature of the opportunity, which they can use to decide whether to buy another option—by making a new frugal experiment[52]—or to stop their experiment.

To set short-term goals through a real-options approach, entrepreneurs should follow three principles:

- *Use goals to limit risk and encourage learning.* The real-options approach to goal setting also forces managers to break up the very daunting challenge of building a company from scratch into more manageable bits. The art of this real-options approach is to sequence the goals so that if the first one is achieved, it will provide learning that helps to achieve the second one. The same logic applies to jumping from the second to the third goal in the sequence. Even if the company fails to achieve all the goals, if managers choose and sequence them properly, investors can limit their risk of loss.
- *Set goals that are ambitious, yet achievable.* One of the primary reasons to set goals is that they help communicate to employees why they are there—and in the case of start-ups, why they are working so many hours. Setting ambitious yet achievable goals can motivate people. With start-ups the term of those goals is measured in months, rather than years. To achieve such short-term goals demands a very high level of concentrated effort. And a larger firm with a slower cycle time may be vulnerable to the efforts of a start-up that targets the larger firm's customers.
- *Use goals to map the company's growth path.* Finally, the real-options approach to goal setting can put the company on a steep growth path. For instance, Adeptol, which offers a browser-based document reader, is owned by its founder and CEO, Prateek Kathpal. Adeptol had 2,000 customers when I talked with Kathpal after it had been in business for a mere two years.[53] And Apptio—which offers a service that helps companies' chief technology officers explain the costs and the value of their services to their corporate customers—has also exceeded ambitious short-term goals. For example, CEO Sunny Gupta set a year-two goal of 300 percent growth which Apptio surpassed by a factor of three.[54] Apptio's ability to exceed its goals highlights the motivational power of setting them and the appeal of its service to customers.

Hungry Start-Up Approach to Short-Term Goals: Defined

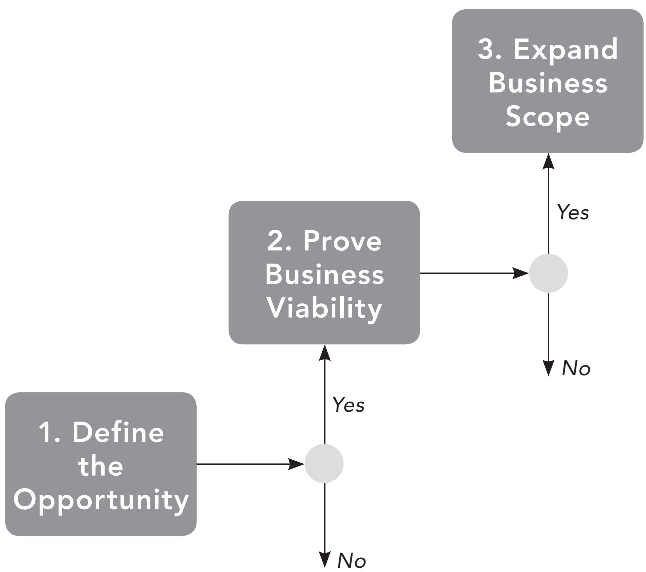
Goal setting—a firm's process of deciding what measurable outcomes it wants to achieve—is a critical starting point because it focuses all of its subsequent actions. Simply put, a company's strategy flows from its goals.

Start-ups' goals vary. Based on my research, if a company is largely controlled by external venture capitalists, then their goals will prevail. In general, VCs want to make an investment and sell it within a period of years at the highest price that another company or public investors are willing to pay.

Since start-up CEOs generally seek out VCs who share their goals and their industry expertise, their goals are naturally aligned. If a start-up is owned by its CEO, the CEO will determine its goal—which, in the cases I've researched, is to become a technology leader in the CEO's industry of choice.

- While each of the companies I interviewed applies this concept differently, there seems to be a common pattern they all share. As depicted in Figure 1.2, start-ups set goals according to the following sequence:
- *Real Option 1: Define the market opportunity.* While it is somewhat amazing to me, some VCs are willing to give a management team millions of dollars to take a vague idea about a particular problem facing a group of customers and let them try to figure out whether they can

FIGURE 1.2 Hungry Start-Up Approach to Short-Term Goals.



develop a version of their idea that attracts customers fast. Determining whether enough customers will use the start-up's prototype is the goal of the first real option.

- *Real Option 2: Prove business viability.* If the result of that first frugal experiment is positive, then the VC is likely to invest in another. The goal of the second investment is to try to sell the product resulting from the first experiment to enough customers to make a fact-based estimate of the likely size and potential profitability of the business. Deciding whether the business is viable is the goal of the second real option.
- *Real Option 3: Expand business scope.* If the result of that second frugal experiment is positive, then the business may have generated as much as a few million dollars in sales. This is not a big enough business to interest potential buyers and therefore it sets the stage for the final goal. The goal of the third investment is to try to scale the business to the point where the founder can sell shares to the public, to an acquirer, or to capital providers willing to pay a higher price for its privately held shares.[55] Getting the business to a size where investors can realize a return is the goal of the third real option.

Benefits of Real-Options Approach to Start-Up Goal Setting

There are three ways that start-ups benefit from the real-options approach to goal setting:

- *It bounds risk.* The real-options approach to goal setting puts a clear limit on how much risk investors will take and it makes clear what kinds of returns that risk could generate. At a minimum, real options are almost guaranteed to generate information that can be useful for decision making. If that information leads to a decision to invest again, real options can boost the odds that investors—including the CEO and top managers who own equity in the firm—will achieve an attractive return on their investment of capital and effort.
- *It focuses the company.* The real-options approach to goal setting helps to focus the efforts of a company's relatively small employee base. It forces to the top of employees' awareness that the money available to pay them will run out within a fairly short period of time. The CEO's job here is to make it clear to all employees what they need to do in order to contribute to the company's current goal. And that clear focus also boosts the odds that the company will succeed enough to persuade investors to grant it another round of capital.
- *It maps a growth path.* Finally, the real-options approach to goal setting helps the organization keep in mind the bigger picture as it becomes

focused on the start-up's day-to-day activities. Particularly during the first real option stage, the start-up can motivate people more effectively if they have a map of the longer-term trajectory of the start-up if it achieves all the goals needed to reach the ultimate outcome.

HUNGRY-START-UP GOAL-SETTING TACTICS

How can a start-up CEO turn these general guidelines into useful action? This section provides tactical advice on how to pick a compelling mission, how to choose long-term goals, and how to set short-term goals.

Effective start-up missions share the following characteristics:

- *Important to the founder.* Effective start-up missions are invariably extremely meaningful to their founder. That meaning springs most frequently from two sources, a strongly held belief that there is an untapped market opportunity and a personal passion that the founder believes he or she must pursue.
- *Relatable.* A corollary to the first characteristic is that an effective start-up mission is compelling not solely to the founder but also to other people that could help the start-up get off the ground. More specifically, missions that help a start-up hire talented people or get customers to try its product work best.
- *Spur value creation.* Finally, a mission that spurs people to create a competitively superior product for its target customers helps a start-up prevail. An example of this is BrewDog—whose focus on creating high-quality beer that its founders and employees prefer helps it take share from so-called corporate beer purveyors.

Effective long-term goals are specific, measurable, and time-linked. And such long-term goals should be measured in ways that people in the company can understand. For example, people can more easily understand goals for getting a specific number of new customers than they can more abstract market-share target. Similarly, it helps in recruiting for a start-up CEO to make it clear that he sees the company going public in some specified time period or remaining independent.

How Start-Ups Define Useful Short-Term Goals

Real Option 1: Define the Market Opportunity

How long should a start-up take to determine whether it can develop a viable business model? The answer depends on how much capital the firm has and how much capital it needs to test the business model ideas. A start-up's first real-option should make room for as many frugal experiments as it can execute given the rate at which it is burning through its scarce resources.

To know whether a venture has found a viable market opportunity, the entrepreneur must answer these four questions in the affirmative:

- Does a basic version of your product attract a small initial group of users that's passionate about your product?
- Do those initial users keep using the product after the first try?
- Do the users recommend the product to other people?
- Do initial users get more value from the product by recommending it?

Use the following approach to get yes answers to these questions:

- Listen to early adopter customers—the people who always like to be the first to try a new product—to uncover their unmet needs.
- Build and give them a simple version of the product to get feedback.
- If they like the initial version, ask them if they will recommend it to others.
- If they don't like it, find out what they don't like about it and what's missing, and try again.

Real Option 2: Prove Business Viability

If you can define the market opportunity, the next question is whether you can get people to pay for your product. If that effort is successful, then your business may be viable—particularly if the sales to those paying customers are greater than your costs.

One way to test a start-up's viability is to consider a freemium strategy. By getting a fraction of 1 percent of those customers to pay for a more fully featured version of the product, companies can use the freemium strategy to become a viable business.

Jason Lemkin is VP of Web business services at Adobe and he explained that his start-up EchoSign was acquired by the maker of Flash in July 2011. Lemkin started EchoSign in January 2006 to help people get contracts signed and filed electronically.[56]

EchoSign offered a way to integrate contract signing with customer relationship management systems and it gave its product to customers at no charge—with the idea that they would pay for a premium version. When Adobe came looking for a big player in the electronic contracting space, it knocked on EchoSign's door and bought the company.

In the four and a half months since that deal closed, Lemkin was thrilled to report that EchoSign's integration with Adobe Reader had given him more new users than he had prior to the acquisition—and it then had a total of five million people using the product.

But here's where the beauty of the freemium strategy comes in—even though a small fraction of those users were paying customers—that amounted to paying customers in the tens of thousands—including salespeople from Groupon and sales representatives from British Telecom.

By charging these more sophisticated users $100 a month for an advanced version of the product, EchoSign generated some pretty significant revenue from that small percent of users who paid—at that pay rate; EchoSign is a multimillion-dollar revenue business.

It hasn't always been smooth sailing for Lemkin's freemium strategy. Here are three lessons he's learned:

- *It takes time.* A company using a freemium strategy has to be patient and must make it extremely easy for users to sign up. In Lemkin's experience, it can take three months for a start-up company that signs up to use EchoSign extensively, and another three to five months before that user feels compelled to buy the premium version of the product. This means that it takes a long time for the business to reach $10 million in sales, less time to double to $20 million, and after that it starts growing virally.
- *Invest to make the free version very compelling.* Lemkin sees DropBox—a free service that lets users take their photos, documents, and videos anywhere and share them easily—as a compelling free utility that produces instant customer value. But if 20 percent of the users convert after, say, a month, then the service is not really freemium—it's a free trial for a short period of time.
- *Need millions of free users.* When Lemkin started EchoSign, he thought of eFax—then a $200 million service—as a good model of what his company could become. eFax had 10 million users and 10 percent of them paid. As it turned out, Lemkin was overly optimistic when he assumed that EchoSign would garner a similar 10 percent.

Nevertheless, with many of EchoSign's current customers paying, Lemkin was happy with how its freemium strategy was working once it became part of Adobe.

EchoSign's success with its freemium strategy illustrates the difference between finding a market opportunity and proving a start-up's business model. When customers used the free version of Lemkin's product, he proved to himself and his investors that he had found a market opportunity because people were using his product and recommending it to others.

However, it was not until EchoSign had gotten a critical mass of users and enough of them began to pay for the service that it began to generate sufficient revenues to become "cash-flow positive."

Real Option 3: Expand Business Scope

Once a business has proved its viability in one market, the next short-term milestone is expanding it to other markets. The new markets could be in different countries or they could be a new group of customers within the company's home market.

Here are some tests to decide whether the potential new market is likely to boost the start-up's profitability:

- Are the potential revenues and profits in the new market sufficient to offset the cost of serving it?
- Does the start-up have the products and business capabilities needed to offer customers in the new market a competitively superior value proposition?
- Are these competitive advantages enough for the start-up to gain a meaningful number of customers?

BrewDog's expansion into twenty-seven countries is a case in point. Its first customers were in Sweden because an influential blogger liked its product and let his readers know. This helped BrewDog ink a contract with a leading Swedish beer distributor. And since such distributors relieve suppliers of the cost of operating a local operation, they can generate significant profits for the supplier if the product is in high demand. Most likely, BrewDog repeated this successful pattern to add twenty-six more countries to its collection of markets.

GOALS: DO YOU HAVE THE RIGHT ONES?

The foregoing discussion of goals may be raising questions in your mind about whether your start-up has the right ones. To help think about this question, here are some more detailed questions that may help you reach a conclusion:

- Do you feel a connection between your passions or intellectual interests and your start-up's long-term goals?
- Have you considered whether pursuing those passions or intellectual interests will satisfy a widely shared human need?
- If not, are you willing to take the risk that your start-up may not be able to generate sufficient revenues?

- How confident are you that enough potential customers could benefit if your start-up achieves its long-term goal?
- Have you developed a sequence of short-term goals that build on one another?
- Do you have specific measures in mind that will help you determine objectively whether your start-up is on track to achieve the short-term goals?
- Are you prepared with a back-up plan in case your start-up does not achieve its short-term goals?

If you have solid answers to these questions, then your long- and short-term goals have been set in a way that will serve your venture well. And if not, these questions may help you rethink your long- and short-term goals until you do have solid answers.

SUMMARY

People respond to goals—particularly if they can benefit from their achievement. In order to get a venture off the ground, entrepreneurs must provide them with an initial puff of inspiration. The goal is to create a hunger for creating a new world—or at least to create a start-up with a long-term goal that attracts talented people and ultimately customers and capital for growth. Whether that long-term goal springs from responding to market opportunity, solving personal pain, following the research, or a combination, it is critical that the mission be meaningful to the founders. And while a start-up's long-term goal ought to remain constant, it is also important that entrepreneurs create a roadmap of sequential short-term goals the achievement of which will ultimately realize that long-term goal.

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