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The Role of the Venture Capital Company in Innovation

Leslie Barton*

Both business and government rely on innovation to a great degree to maintain the competitiveness of their products, processes and services. However, established organizations, by their very design, must be highly selective in their support of innovation. Thus, even the most meritorious innovation may fail to obtain support if the context of its origin is inappropriate, or if its predicted results are based more on vision than fact.

The corporation, for example, may find itself unable to exploit and support a proposed innovation for internally consistent reasons. In contrast, the investment decision process of a financial institution hinges on the opportunities presented by the innovation rather than the innovation itself.

The venture capital industry has evolved to provide a support base for innovation that is relatively free of the impediments of the other two potential supporters. This discussion will explore the contrasting universes of these three sources of support: venture capital firms, corporations and financial institutions. I will also give you some observations on the care and feeding of innovators, as they are a breed unto themselves and require the kind of treatment that is often not available outside a venture capital setting. In conclusion, I will summarize how venture capitalists manage the innovator and the innovation process.

First, I would like to define innovation. Innovation involves introducing something new. For example, OPEC was an innovation. The Sony Walkman was an innovation. Apparently the marketing department of Sony did not believe that there was a market for the product, but the chairman of Sony was the Walkman's champion; he insisted that the product be developed and marketed. Its success exceeded his wildest expectations by 300% in its first year on the market.

In any event, change brings benefits in some places, but often at the expense of benefits elsewhere. That is the risk that the innovator wants to take, if he or she perceives it as a risk at all. In the corporate world, change equals risk, and risk perturbs a corporation's established business directions. An established company has products and services accepted by its customers and these customers may not be ready to accept changes to an existing product. Similarly, a new product may require new customers, or at least a change in marketing strategy.

The corporation is a big ship with the attendant inertia of status

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An innovation must be lucky to be embraced by a corporation. Once a development program for a new product is under way, it is extremely difficult to deviate from the program. The marketing programs and product definitions will have been set and much investment will have been made in those areas. In summary, the history of prior decisions and investments that have been made in the status quo could cause an innovation to be rejected because the value of an innovation is seen in relation to the larger corporate agenda.

Every innovation needs a champion to carry it through from inception to fruition. Corporate managers with the necessary talent to do this tend to move on, up, or out of their positions too early in the process to be effective champions. The durability and stability of the commitment to the innovation depends on the champion. He may not be there long enough to follow through. Consequently, unless the corporation can immediately draw out benefits from the implementation of the innovation, there is a low probability that an innovation will be accepted.

While a corporation may have too much of its own history, a potential institutional supporter may not see enough history. Necessarily, financial institutions rely on track records, histories of industries, products and companies in order to assess the risk before making an investment. So they are later-stage supporters of innovation. They do not enter at the inception stage.

Institutions do not have the operational infrastructure to manage the innovative process. In order to help an innovation to fruition an assessment of the people, technology and market as the visionary sees them developing is required. Institutions do not deal at that level. So there is a low probability of support from a financial institution.

Venture capitalists, on the other hand, thrive on innovation. Venture capitalists are small multi-businessmen. Each opportunity can be evaluated "objectively," because the venture capitalist is outside of the context of a large corporate agenda and has fewer variables to worry about. The two key variables for a venture capitalist are the people who want to implement the vision and the market at which they want to direct the vision. Venture capital companies are organized and staffed to assess and manage risk. They have the people in place, the time available to the people in place and the structure to go through a micro-assessment. Also, venture capitalists have long time horizons and are organized to manage and contain failure on a small scale.

Some characteristics of attractive innovation opportunities are generally in the niche market area. Venture capitalists have great appetites for niche markets, where small gets big, and where timing of entry is the key to success. An example of bad timing is the "smart cards," plastic credit cards embedded with microcircuitry containing your entire medical, banking, or financial history. The technology and means of production have been around for years, but there are immense institutional impediments. An example of a good idea is a spreadsheet program such
as *Lotus 1-2-3*, which made it easier to operate a personal computer than in the past. As a result, venture capitalists now see exquisitely detailed business plans that are inaccurate to at least three decimal places.

A niche market, of course, must have some kind of defensible or proprietary attribute, whether it be in its technology, its products or its services. The defensibility can come from patents or know-how. The defensibility can come from speed of implementation of a perceived market opportunity. The technology may not be particularly new and the idea may be a very simple one, you just get it to market very quickly. I think the Sony *Walkman* would fall in that class.

Venture capitalists obviously have to look for high value-added products or services to fund the kind of growth that one looks for in a venture capital situation. Whatever it is, it has to provide quantum benefits and solve very big problems. We might be in the business of cultivating asparagus, but we are not in the business of growing oak trees.

On the other hand, niche markets are small, and in a corporate setting, because of the way corporations are organized, the same senior management team rules on billion dollar decisions as on million dollar decisions. That really slows the decision process. Evaluated in the context of the business thrust, niche opportunities are generally too small to help a large company grow 10% or 25% per annum, whatever its objectives. Corporations tend to look for home runs, the $100 million plus business. There aren’t many of those around; it might be wise for corporations to look at other opportunities and find ways to take advantage of them.

The established corporation is generally motivated to increase market share for existing products. So an innovation is very often valued in terms of what it can do for the market share of these products. I have seen many innovations that stall because they could not bring any help to major product lines.

Corporations may prefer to acquire the results of innovation and pay a lot of money, rather than step up to creation of the business entity that results. So early support from inception goes through a very tough selection process in the corporate setting. As management generally sticks to its proven products, this can and does generate a lot of opportunities for venture capital to support innovation.

Institutions deal on an entirely different level with innovation. They are neither equipped with the historical knowledge required, nor the infrastructure to manage, and generally are focused on very large dollar opportunities. They have large amounts of funds to place, and a $1 million or $10 million investment is not a significant opportunity. On the other hand, most institutional investors will invest in venture capital limited partnerships to access such opportunities, and to gain an insight into what is coming. So corporations and institutions have difficulty with
niche opportunities of innovation. Venture capital has a durable agenda, while institutions may be too distant to provide support.

Another way of looking at innovations as opportunities is to compare the focus of the three potential supporters. Venture capitalists can rarely say we are not in that business, as a corporation often must say. We have to be broadly interested and have enough knowledge about any industry in the high-technology field to sort out the scams and the schemes from the visions, and we cannot afford to be too selective. Our interest is the same as most other technology-oriented capital funds. We span all kinds of telecommunications, computer systems and peripherals, manufacturing processes and services. These may include voice, data or video communications, new materials, intelligent databases, marketing information or intelligence gathering, and management services. Our focus is very general — whatever looks potentially profitable. So we cannot say we are not in a particular business.

An institution may say we will not enter that business yet. The corporation may say we do not choose to enter that business at all. But even the largest corporations have some high degree of focus. I was with IBM in the United Kingdom in the early 1970s, and I collaborated with two very brilliant designers who went on to develop what would now be called the personal computer. It was a crude but remarkable achievement. The project was taken all the way up to the president of IBM and after much deliberation the corporation rejected the opportunity on the grounds that IBM could not provide field support for 20 million or 30 million personal computers. Whether they were right or wrong, they sure changed their minds when somebody else did it.

Institutions have broad interests, but prefer established opportunities. Corporations provided necessarily self-serving support to innovation on a highly selective basis. Institutions prefer to wait for innovation to become significant enough for them to provide larger dollars, whereas venture capitalists have a desperate need for innovation in which to invest.

The human capital available today is extraordinarily well-equipped. It is in the best shape ever. Anybody who goes through graduate school today is extremely computer literate. The better ones are extremely technology literate; they know what is going on under the covers of the tools that they use. We are finding people who have crossed over from one discipline by mapping the technology they use while they were learning that discipline onto an application that really is very innovative. For example, two weeks ago, we invested in a small Canadian corporation. The CEO is a prizewinning neurosurgeon. During his research, he became very familiar with personal computers and the ability of technology to help him treat his patients better. Now he is managing a company which provides the world’s best 3-D imaging from 2-D CAT scan data. Moreover, he knows the market. He used to be in it, so he knows the problems. He has product ideas for the next five years. He is a prime
example of someone from one discipline using another discipline to create a whole new product class. We see more of those as the years pass.

Innovators are certainly risk-oriented mavericks. They demonstrate unreasonable conviction based on insufficient evidence, and are generally difficult to deal with, often bordering on the irrational. In such cases, venture capitalists' support is often the only means by which they can get their innovations even assessed. There is $3 billion in the venture capital industry this year for such support to be provided.

The corporation is clearly going to have difficulty with mavericks. The potential contribution of a maverick is evaluated in the context of the ever present larger corporate agenda. A brilliant person may be required or asked to do something perceived as more relevant to the corporation, but these mavericks will not be diverted. They will not go to a position which is deemed to be more worthwhile than the course on which they are set. Therefore, they are often deemed to be unmanageable and they leave. Then there are plenty of people like me who will listen to what they want to do and provide support.

Innovators have to be managed and supported in a particular way. A key skill of the venture capitalists in the industry as a whole, is the ability to be able to harness the innovator. By being a hands-on investor, one lives with the innovator. You spend 10-15% of your time with him and really get under his skin. You develop congruent motivations. Innovators are smart people, they know when you are with them. You have to be able to share the vision and accept the risk in order to become part of the team.

The fact that innovators are mavericks and that people tend to recruit in their own image can leave you a disastrous situation. A room full of innovators is a horrible sight. So a wise venture capitalist will go through a process of "founderproofing" the business, by helping in the recruiting process and building the team.

Also, no matter how much of the company the innovator retains ownership of, there is a golden rule in venture capital which says that he who has the gold rules. If the innovator does not have any money and I only own 1%, but I have the money, then he had better listen to what I have to tell him.

In practical terms, what kind of support does real working management by the venture capitalist provide in the early stages of an innovative company? The company doesn't need a chief financial officer, so one of the venture capitalists could take that role. The company does not need a high power marketing type, but there should be somebody in the venture group who can bring that kind of expertise and vision. The same is true for manufacturing.

A more fundamental piece of wisdom that venture capitalists bring to a project is the prior experience of a high-growth situation which has unique problems and opportunities. For a number of years, I was with a
company that doubled in size for seven straight years. It is not too difficult to grow from 100 employees to 200, but when you go from 4000 to 8000, it is tough. Half of your employees have been with you less than a year and you don’t have room for all of them. It is that kind of practical detail that can confound an innovator in the implementation of his vision.

The refinement of strategic directions is very important. In my experience, the first few days of discussion about new products or services involving any kind of technology will define almost the entire strategy, everything needed to achieve the end result. It defines the cost to design the product, the cost of production, the quality, the customer base and the manufacturing requirements. Those first few crucial days cost very little, but during the first few thousand dollars of actual money spent, you will find you have committed at least 90% of your total outlay. It is the most critical time in the entire innovation process.

A good venture capitalist will have many, many external contacts and networks, and these are always useful to an entrepreneur or innovator. These include access to customers’ complementary technologies and so on. We become strongly identified with the ventures — setting goals and having an interest in the investment helps.

Investments tend to be syndicated. There is no degree in venture capitalism, so venture capitalists have typically been successful managers in many different parts of different industries prior to becoming venture capitalists. This kind of a diverse knowledge base at the board of directors level is parallel to a strong external board of directors of a larger company, although probably at a more focused operating level than a large corporation. The chain of command impediments do not exist. It is one man, one vote on the board. It is a very small operation. One can act with dispatch, and one does. The important point is that there is an appropriate corporate management support team for each different venture, rather than the same people responsible for the large corporation, who can be expected to focus on things like market share and the business as it exists.

Since timing is of the essence, to conserve money and to get to the market quickly and preferably first, ventures have to react very quickly. We make sure that the decision-making process is rapid. Companies are losing money, not making it, in the early stages. There are decisions which must be made, but we do not have large agendas. Non-strategic decisions must be made very quickly.

We have great freedom to provide incentives and rewards. Corporations are often hampered by the fact that there are established compensation packages, and no matter how extraordinary the efforts, it is difficult to give one person a great reward and not upset everybody else. Innovators and the people they attract are capable of extraordinary effort, and you must have the ability to reward that.
As the venture progresses, venture capitalists have all possible exit strategies more readily available than other support organizations. We can take the venture public and make people wealthy and reward the extraordinary efforts already provided. Merger or sale is far less complicated for a stand-alone entity than for a spin-off. Spinning off a piece of an existing company brings several lawyers into rooms for many days trying to figure out what exactly it is the company wants to sell, what it can sell, what happens to the businesses that it has left behind, and so on and so forth. It is a very difficult situation. In addition, we can cut losses. We do not have public shareholders to worry about or Wall Street to pacify. We can conduct private euthanasia — no flowers, close family and friends only.

Venture capital is the business of nurturing innovation. The model that we have come up with is based on the ability to evaluate opportunities purely on the basis of merit outside of strategic concerns or larger corporate agendas. It is based on profit potential alone. We must have the ability to accept and manage high degrees of risk. Failure four times out of five is a record that the industry is proud to sustain. We have the ability to become integral to the innovation process by sharing the vision and hoping to realize it. Corporations and institutions provide immense support for innovation, but there is still plenty to go around.