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Higher or Fire

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One of the less palatable truths about private equity in general, and venture capital specifically, is its poor record of keeping hold of management teams, particularly founders. To paraphrase Oscar Wilde, losing one CEO is unfortunate; losing two smacks of carelessness, but losing three or more?. As an industry we have cultivated a no nonsense, hire-or-fire approach to founder management, but far from improving things it is often profoundly counter-productive.

A number of academic studies and anecdotal evidence indicates that the attrition rate for founder management teams in venture backed companies could run as high as 50%. Never mind Oscar Wilde; this makes the position of junior officers in the trenches of the First World War look positively secure.

The cost of this profligacy is truly shocking.

- Step 1 - Removing a CEO is not cheap, and includes redundancy, option issues, legals, and most critically lost time.
- Step 2 - Finding a replacement carries almost exactly the same costs, but will also take at least 3 to 6 months to find and then get a new CEO up to speed and another 6 months (minimum) to establish whether they are any good.
- Step 3 - Over a year can pass before you realise that this might be another mistake; return to Step 1.

In a small, young start-up business this can consume a significant proportion of the original investment. Therefore imagine the benefit to be derived from retaining and successfully developing just one CEO in your portfolio who otherwise would have been fired.

So why is the loss rate so high and, more importantly, what's to be done about it?

A key reason for the high level of loss of management teams lies at the heart of the deal that is transacted between a CEO - often the founder entrepreneur - and his investors. Raising investment in a young company is fundamentally a selling process. The entrepreneur and his team are selling themselves to their investor, while the individual investment manager is also selling the deal to his own partners. For everybody in this selling process, this often becomes the triumph of hope over experience.

Every investor believes that every new deal is capable of being the new Google or Autonomy, and management encourage this belief by portraying themselves as Masters of their technology universe. All the investor has to do is light the blue touch paper with rolled £50 notes and take-off will inevitably follow.

Investors themselves are not free of some self delusion in this process. Behind all the due diligence and evaluation of the market, technology, finances and people that investors undertake, there is a gut feeling about the deal. Again, this isn't particularly surprising. Investing in young, high-growth potential companies can be as much about intuition as perspiration. If finding the next Sage, Autonomy or Facebook was just a matter of analysis, investing would be easy, and clearly it isn't. As an aside, it's worth noting that many super successful start-ups were carried by their founder CEO - or equivalent- from start-up through to becoming billion-dollar businesses .

A consequence of this delusion on both sides of an investment is that we have the seeds of failure, or rather an adverse response to failure, already planted. So when reality bites, the relationship begins to founder because it's not based on realistic expectations or trust on either side.

A further delusion that investors are prone to is the planned replacement of the CEO as the company grows. It is now almost an article of faith among private equity investors that the management team you start with will not be the same team that exits the deal. This is somewhat patronisingly referred to as "bringing in the grown ups" within 18 months or two years of original investment.

One of the ironies of this approach is that many of the greatest tech start-ups were made by people who probably would never have made it onto an IBM graduate training programme. Consider the list:-

- Bill Gates (Microsoft)

- Larry Page and Sergey Brin (Google)
- Larry Ellison (Oracle)
- Mike Lynch (Autonomy)
- David Goldman, Graham Wylie and Paul Walker (Sage)
- Steve Jobs and Steve Wozniak (Apple).

The list could go on. In fact, the final example of Apple makes the point even more explicitly. In the late 80s, a classic 'grown-up/hired-hand' (John Sculley) was brought in to bring some level of experienced management to the Apple business. The result: a complete disaster. In fact, the company turned back to Jobs to rescue Apple and, as they say, the rest is history.

All high growth companies experience problems. In twenty five years of investing in young technology companies I only ever saw two deals which went exactly to plan from day one. Changed circumstances are the norm, and the best investor- investee relationships recognise this from the beginning. Indeed, it is often the adverse events which prove the making of many young management teams.

Start-up founder CEOs are not stupid, although they sometimes do stupid things. The majority are well-educated, driven individuals who probably know more about their business than any of their investors. What they sometimes lack is experience and some general business expertise. But this is as it should be. Give me the enthused, driven entrepreneur over the 'MBA hired hand' generalist every time. This is for the simple reason that when the going gets tough, as it always will at some point, the hired hands start dusting off their CVs whereas the founder entrepreneurs will get ready to die in a ditch to make their business - and the VCs investment- work.

A final, critical element in this collective delusion of expectations is that entrepreneurs actually believe that VCs know about business, and particularly their business. This may or may not be true, but the perception of knowledge is dangerously skewed by the fact that it's the VCs who write the cheques. So even if the entire management team feel that the VC is talking through his rear end, they are unlikely to say so. This often reinforces the high opinion that VCs have of themselves and accentuates their view of founders as 'enthusiastic amateurs'.

So what can be done to address this problem, so as to reduce costs and improve the prospects for first time CEO entrepreneurs and their venture backed businesses? I would suggest the following:

1. Training, training, training – CEOs do not come to a start-up fully formed. They need help and advice. A programme for developing start-up CEOs (and their teams) post investment should be regarded as every bit as important as due diligence pre-investment. They are some good examples of this currently in place, such as the MBO training programme operated by Albion Ventures. In addition the BVCA have now started training programmes aimed at investee companies.
2. Understand the politics – The VC-entrepreneur relationship is often too much about power and "who really runs this business". This is a sterile debate, generally leading to poor outcomes for everybody.
3. Trust and realistic expectations – This is easy to say, but in many of the best venture-backed businesses both sides work on the basis of brutal honesty. Use it yourself and insist on it from your colleagues.

An investment in time, resource and appreciation of the dynamics of entrepreneur-VC relations will help reduce the waste of resources and aspirations and help to develop a new generation of super successful entrepreneurs.

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