

The Changing VC Process and Next-Generation Incubators

Work in Progress

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Introduction:

In a unique twist of irony, the disruptive nature of the Internet, which underlies the changes in so many industries, is in the process of fundamentally changing the very industry that has been so instrumental in forging its considerable success; that industry is the Venture Capital industry. As one industry sector after another falls prey to the Internet's assault on its entrenched business models, supply chains, and value chains, the VC industry itself may be in the early stages of just as significant a process of reinvention.

There are a number of contenders competing to become suppliers of superior value to entrepreneurs and early-stage startups by redefining the historical VC process [Gladstone]. One of the leading candidates is the set of so-called "next-generation" business incubators. Business incubators have been around for many years (decades, in fact), and the term "business incubator" has taken on a fairly stringent set of both denotational and connotational aspects during that time. However, "next-generation" business incubator models have diverged, often greatly, from the traditional incubator model, at least within the Internet arena. Not only are there significant differences between the traditional and the new models of incubators, but there are even more significant differences among the various types of "new" incubators, both in their business models and in their value propositions to entrepreneurs and Internet startup companies.

Along with these changes have come additional changes in the typical stake-holders and players, including the financiers, investors, managers, participants, and service providers of these next-generation incubators. The roles played by these participants and the values offered to the entrepreneurs have often changed so significantly that it is difficult, in some cases, to consider these incubators as, in fact, "incubators", at least given the traditional understanding of this term.

Unfortunately, the use of the term "incubator" is both misleading and obfuscatory, even when the prefix "next-generation" is applied. Accordingly, as incubators have changed to accommodate the rapid pace of disruption and opportunity within the Internet arena, a range of new names has arisen to designate the new incubator models; examples include "hatchery", "greenhouse", "accelerator", "e-accelerator", "venture catalyst", "Internet incubator", "EcoNets", and others. Unfortunately, these names yield little insight into the differences between the various business models and value propositions.

Traditionally, incubators have held a symbiotic relationship with the VC industry participants; the roles, purposes, and values provided by each were well understood by the other. Next-generation incubators, however, are poised to offer more of a competitive relationship than the historical symbiotic one, especially for early stage venture capital firms. Whether they will evolve to the point of constituting serious competition, or even significant threats, to the traditional VC business model remains to be seen; there are, however, several marks already appearing on the wall.

Changes to the VC Process

The VC industry has undergone significant changes in the past decade — particularly within the last five years; and even though the pace of these changes has slowed, the significance and nature of these changes seem unlikely to lessen anytime soon. Many of the changes are simply changes in scale; others are the result of technological advances in information and communication technologies as business enablers — these are often welcome; but others are more fundamentally systemic to the nature of the VC process itself. These latter changes are the ones being exploited by the newer business incubator models and thus pose the largest potential competition to the VC industry.

Changes of Scale: Some of the more fundamental changes are widely reported. These include: stupefying increases in funding levels, both for the VC funds and also for Internet company financing rounds; dizzying numbers of business plans being submitted to VC firms; much shorter life times before a liquidity event (such as an IPO); and larger investment portfolios (with consequent demands on time commitments to sit on the boards of the portfolio companies). These changes, however, and others like them, are essentially changes in the scale — more, faster, larger, etc. — of otherwise entrenched and well-understood processes and so do not affect the fundamental nature of the VC business.

Business Method Changes: Advances in computing and communication technologies are also introducing changes into the VC business processes; these are usually welcome, although some have yet to prove themselves. Included in these changes are: the use of email, firm promotion through a web site, the acceptance of business plans submitted over the net through the firm's web site, and enterprise management through ASP-delivered software tools, for example.

Some smaller, newer firms with new players are attempting to enter the VC arena by not only using the Internet to promote their firms but also to raise investment funds and to create deal-flow. Some of these are also exploiting various Internet technologies to gain an edge in operational aspects of their businesses over more traditional firms; examples include: Internet telephony and video telephony to establish regular and frequent communication, including virtual attendance at board meetings; the use of these same technologies to hold electronic road shows for investment bankers; investor relationship management tools and processes that exploit the web, email, and collaborative discussion software; Web-based recruiting systems; etc.

Systemic Changes to the VC Process

There are other changes, however, that are affecting central, fundamental aspects of the VC process, particularly in the value propositions and supply chain. These changes are likely to have more far-reaching affects than the changes of scale or business methods, opening up the traditional venture financing process to potential long-term competitors.

■ For example, even in the aftermath of the “bubble bursting” of the Internet stock markets, the average age of a typical Internet startup that goes public is significantly younger than historical high-tech IPO companies. This has placed significant

portions of some VC holdings in the publicly traded equity markets; this in turn is forcing VCs to understand the stock market and to actively participate in aftermarket activities for their portfolio companies. While anathema for some, others, such as Technology Crossover Ventures (TCV), actively embraced this fundamental change and integrated it into their business model, value proposition, and even into their term sheets! [Fox]

■ The changes in scale of the larger VC firms — more plans, more deals, more and bigger funds, more partners and more limited partners — are all imposing significantly more administrative responsibilities on a VC firms partners, taking them further and further away from their ability to impact their companies with their mentoring and other “value added” services. This has forced several larger firms to bring in Chief Operating Officers as partners. Typical responsibilities for this new class of partner include deploying cutting-edge business practices, figuring out when the firm should raise its next vehicle, and planning how many investors and support staff will be required for growth [Leibowitz].

■ Along with the significant increases in infusion of capital into venture financing has come a significant change in the number and type of investors who join as limited partners in a typical fund. Previously, these have consisted of mixtures of affluent individuals, retired senior-level executive managers, pension funds, and the like. More recently, huge funds are being put together in which the limited partners consist mostly or even only of pension funds, as these funds are increasing the traditional limits on the percentages of their funds that can be allocated to venture financing. While this reduces the number of partners to whom the VC firm must report and consult to a small number of very passive investors, thereby simplifying certain operational aspects of the VC firms, the number of vested-interest “experts” to draw on for assistance and advice with placing a given fund has diminished.

This is occurring at a time when it is arguably more challenging for many VC fund managers to add any significant value through mentoring, refining of business models, advising on marketing strategies, or even providing due diligence support on potential strategic partners, alliances, or acquisition candidates in the Internet arena.

■ The historical role filled by the broker (or match-maker) has also been significantly moved onto the Internet, making it possible to bring large groups of aspiring entrepreneurs into direct (or indirect) contact with large numbers of potential investors, including angels, angel clubs, and smaller investment firms (see Vfinance.com, for example).

■ With the rash of "quick flips", the newly reinforced irony of the industry "tombstones", the forced focus on LBOs and mergers, and companies eager to grow, survive, or enter the Internet arena through acquisition, many VC firms have moved away from building enterprises to more of a strategic "project" approach. That approach focuses on developing only particular markets and products and then sells or merges the companies, in a very short time frame. This is essentially financial engineering (transactions).

■ Typically, if a startup company is lucky enough to reach the point of an IPO, the VC firm works with one of its closely affiliated underwriters to "take the company public." What this amounts to in practice is that the lead investment bank agrees to buy all the offered shares of the startup company; it then resells them to institutional investors (e.g., mutual fund managers and very large brokerage firms) at a predetermined and agreed-upon price. Not only does this process fail to determine the market demand for the shares, and thus fails to garner the highest cash sale value for the company, but it also typically deprives the individual investor of participating in the first day of purchasing and trading. The firm of W.R. Hambrecht & Co., of Hambrecht & Quist fame, is developing an Internet-based system called OpenIPO that promises to democratize the whole IPO process, letting both individuals and financial institutions bid, over the Internet, on shares of the IPO. If successful, this move will demonstrably alter the VC industry's traditional distribution channels, and it will affect several of the larger institutions that have historically dominated those channels [Hambrecht].

Money is No Longer the Strange Attractor

The number and types of financing options available to entrepreneurs has certainly grown, and evidence points to their continuing growths [Stein].

■ First, more and more technology companies are themselves getting into venture investing; there are heavyweights among these (Adobe, Dell, Intel, and Lucent), but there are also smaller, less well-known corporate venturing arms being set up. While some of these are tasked fundamentally with technology spin-outs [Chesbrough], many are either pure ROI plays or strategic investment oriented, and thus external startups are their targets.

■ Many angel investors have found themselves excluded from participating in co-investing along with the VCs in traditional first round deals (due to the VCs' need to place larger amounts of financing with each deal). Because VC firms were pressed to place more funds more quickly, many

became eager to usurp the value-added role of the angels' higher-risk, earlier-stage financing. Many angels have as well found themselves shut out from pre-seed investment opportunities due to a declining level of Internet knowledge and domain expertise. To fight back, many angels have banded together to overcome these deficiencies, often engaging in "reverse mentoring" programs. Working in groups or clubs, they now actively promote themselves, make joint investment decisions, and solicit business plans over the Internet, making it easier for entrepreneurs to find them and vice versa.

■ As more and more individuals became shut out from being able to participate in traditional venture funds (due to the huge increases in institutional funds being allocated to VCs), web-marketed funds have arisen to not only allow these former investors back in but also to reach out to heretofore disenfranchised investors. New entrants to the VC field, having no black book of available, trusting investors, are nevertheless raising funds over the Internet. Eager investors are coming from far and wide, eager to participate in high-risk, venture-backed startups.

Thus, as has been widely reported for some time, the competition among potential venture capital investors — at least at the early stages of a startup — is no longer simply about who has money; it has shifted to a market determination of which sources of funds offer the greatest value [O'Brien]. VC firms have long competed on this basis, though, attempting to differentiate themselves through their business skills mentoring and access to legal and underwriting networks; underneath, their core competence was and remains "financial". But the value being sought by top Internet startups is defined in non-traditional terms. In consequence with other shifts in power [Toffler], it is not so much the shift from a focus on the money to a focus on the added value as it is a shift in the nature of the required added value that is at the root of the potential success of the new incubator models at the expense of the traditional VC firms.

Where Incubators Come In

During the heyday years of the Internet IPOs, incubators began to sprout up in seemingly innumerable measure. Many individuals, governments, countries, universities, and businesses were eager to join the rush, and forming an incubator became almost fashionable. In the California Bay Area, it was joked that almost anyone could start a VC fund, but if you were really good, you would start your own incubator.

Yet incubators have traditionally been maligned for teaching entrepreneurs little more than how to share a copier and a secretary. So why the rush? Historically, incubators have always had as their goal helping entrepreneurs grow their startups into strong, self-sustaining, venture-capital attracting companies. To do this, incubators offered office space, shared meeting rooms, secretaries, telephone systems, and often sophisticated computer network infrastructures. To this, they added informal networks of external mentors, legal counseling and services, basic training in business skills, and a network of interested investors, not the least of which were usually established VC firms. Finally, many added small amounts of seed-level funding themselves. Equity amounts, if they were taken, were usually small.

When incubators have been associated with government-sponsored efforts, the goal has often been job creation. When incubators have been associated with universities, the goal has often been technology transfer. Both have more often than not relied upon "tech push" models of innovation.

Internet Incubators: A New Breed

Along with the new economy, though, has come a new breed of incubators. Because these incubators have nearly always exclusively targeted the Internet arenas, they are usually called "Internet Incubators," not only to: 1) underscore their Internet business focus, but also to 2) differentiate them from the older incubator business model. Surprisingly, it is less their focus on the Internet than their differences in business models that differentiates them from traditional incubators.

■ Unlike traditional incubators, Internet incubators usually invest and invest heavily in their startup companies. The investment often comes in both time and seed-funds though, and equity participation by the Internet incubator is often very high. Internet incubators then are primarily investors rather than facilitators, and they view their suite of startup companies as a portfolio.

■ Further, most Internet incubators view themselves as long-term investors. VC firms typically exit at the time of a company's IPO or other liquidity event.

■ One of the most important sources of funding for many of these Internet Incubators has arisen from the rash of previously successful Internet entrepreneurs themselves. Having tasted glory once, they are eager to do so again; many have decided to form, invest in, or join Internet Incubators. Having wended their way through various Internet and new economy mine fields and escaped with

their lives, they offer Internet entrepreneurs significant role models; many VCs find it harder to serve in that role today. Thus the debate over who really supplies "smart money" intensifies.

■ The Rolodex of a VC firm and a classic incubator are likely to be similar; that of the Internet incubator usually differs substantially. Besides the usual service providers, which all typically include, the VC list is often heavy with those who can take over once the startup reaches the need for "continual improvement," "Six Sigma," or "operational excellence." The Internet incubators' list is more likely to include numerous key contacts for potential cofounders, radical thinkers, early-stage executives, programmers, web designers, and hackers. Given the shortage of highly skilled technical professionals, this list difference can be key in a startup company's success.

■ On top of this, these Internet-savvy entrepreneurs are often more than willing to roll up their shirt sleeves and jump right in, offering support services in web-design, web hosting, branding strategies, strategic alliances, and the like. In many cases, they willingly step into interim executive positions, thereby buying time for the startups to find and attract the right person but without having to do without that person's role in the venture. VC involvement is typically limited to serving on the board and to providing certain oversight functions, whereas Internet incubator executives often serve "on the team" and directly co-create value.

Unique Internet Startup Needs

Because Internet companies are often attempting to redefine existing markets and industries in the process of building one of their own, the need for deep, internalized domain knowledge is high, and not only at the market or industry level, but at the meta-level as well; this is particularly true when the company incorporates a disruptive technology or business [Hamel] [Christensen].

■ Serial Internet entrepreneurs associated with Internet incubators can add value not only with their money but also with their deep insights into the Internet economy and their highly relevant battle scars. Further, they generally possess significant domain value along with insights into the changing natures of new economy business models, online advertising techniques, economic webs, and the like. These are typically arenas in which most VCs have either little passion or little understanding.

■ Traditional VC firms have often competed in the marketplace by offering "full service" packages to entrepreneurs. What this has provided in practice to many startups is essentially "back office" serv-

ices — e.g., clerical, legal, accounting, and banking. More important to them are strategies, business models, web services, log file data mining and analysis services, experience engineering, branding, and online advertising, to name a few. And it is exactly these high valued services that many of the newly formed Internet incubators are capable of offering. Successfully doing so often requires a period of intense hands-on involvement in working with a startup, if these services are to be integrally incorporated into the fund's delivery of their chosen value proposition; monthly board meetings are insufficient. Further, simply allying with external, outsourced providers of these services, as some VC firms (as well as incubators) have tried to do, is also proving insufficient.

■ The new economic and business models are as challenging to many VCs as to anyone; a VC firm's wisdom gained through prior successes in industrial-age or "old economy" startups does not necessarily carry over to the more innovative, disruptive economic models.

■ Online methods of branding, customer relationship management, and advertising are rapidly and continually being reinvented; some firms have found it necessary to bring professional, experienced Internet marketing experts into the inner circle, and on occasion, even into the decision making process.

Will these Internet Incubators Survive?

Internet startups offer business challenges unique unto themselves. The nature and severity of these challenges pose significant problems to Internet incubator management. Incubating Internet-centric startups requires a special type of value-added support. Because of this, some people point to the disadvantages of the venture capital industry in the Internet arenas to contend that the new Internet Incubator industry is destined for a long, profitable life — perhaps even at the expense of the VC industry.

Even among these contenders, however, it should be apparent that not all models of Internet incubators are destined to such success; the differences in their approaches, their business models, their value propositions, their levels of funding and equity participation, their ability to pitch in and co-create value, and the like are simply too great. In fact, it is nearly impossible to make any *general* claims about either the likely successes or failures of Internet incubators due to these huge differences. Strangely, a great many new incubators bear more resemblance to the traditional incubator model than to the "next generation" Internet incubator models, but only in their value propositions

and not in their business models. Clearly an industry shakeout can be expected.

Some see the future even more bleakly, contending that the types of Internet incubators that will survive are few and far between [Hansen].

The shakeout may already be in progress. Internet incubators have fallen on hard times in the present market situation, and many prognosticators point to their demise. It is important, however, to factor out the effects of overall market corrections and performances from the current track records of the very young "next-generation" Internet incubators when assessing their business models; for just as the current situation is not an indictment on the venture capital model, it should not be overly generalized into an indictment of all Internet incubator business models.

Just as many VC firms are finding it harder and harder to add value above and beyond financial competencies, so to are many executives who have rushed to form one of these next-generation, Internet incubators without being serious, immersed participants in the wired world itself. Further, the overly simplistic belief that "speed to market" is the overarching need of Internet companies has made the task of running an incubator seem deceptively "old school." But the "need for speed" is so fundamentally different from simply doing what you know faster, that keeping abreast of the required skills and knowledge is nearly a full-time job in itself [Eisenhardt]. In historical models of incubators, the network of associated mentors and office managers often head for the golf course come 5:00; aggressive Internet incubator founders more often than not take your problems home with them and can be found solving them while they shower.

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