Top Ten Reasons Why VC-Backed Companies Fail

In the summer of 2006, I started my first personal blog Breakout Performance. I'm going to revisit some of my most popular posts from year one over the coming weeks. The first, from August 2006, top reasons for why VC-backed companies fail.

In 2000, I became the 20th employee at VoiceGenie as VP of Strategy & BusDev – a VoiceXML platform software company based in a dingy corner of suburban Toronto. Did I mention we had no revenues in 99? Over the course of the next 4 years, it was quite a ride. We tripled revenues each year for 3 years and grew to 110 employees by the time I left. We also did 2 rounds of VC funding – raising $25MM. A few months ago, VG was acquired by Alcatel.

From that experience, plus through watching my friends at other VC-backed firms which failed (and succeeded), plus my Ph.D. dissertation which studied what factors drive VC-backed firms to succeed at IPO and post-IPO, I have compiled the definitive list of the Top Ten Reasons why (some, although not all) VC-Backed Firms Fail:

10. **The Founders Have Never Failed Before.** Failing is a good thing. It's only through failing that we learn and really grow as leaders. I found it frightening how many founding management teams is the 00 – 03 era had never experienced any kind of failure — or even a down cycle in the market. This bred enormous over-confidence and even arrogance among some.

The ideal founders are ones who've failed once for every 2 times they've succeeded. My experience is that those who have two good failures in the first 1/3 of their careers tend to succeed the most in the last 2/3.

9. **Too many cooks in the kitchen.** When things are going well, everyone's a hero on a management team. When things go south, everyone points fingers. We go back to Maslow's lowest-order on the hierarchy of needs: self-preservation. However, whether in good times or bad, having multiple opinionated people around the decision table (who don't really listen well to each other) is always a bad thing. You're much better off with one or two key people who have a clear sense of where the business is going.

Co-CEOs accentuate this problem. I can only think of RIM as an example of a successful company where this has worked (to date). The more founders on the same management team, the greater chances of a falling-out down the line (which becomes a big distraction to the business). And, then there's the board, which — let's be clear — for VC-Backed firms, means the VCs. Boards are there for advice, but you can't have 5 board members sharing CEO responsibilities with the CEO. Which leads me to #8….

8. **90% of VCs do not add value.** I know some brilliant VCs and some not so brilliant ones (as in any profession). When I was at VoiceGenie, I pitched over 300 VCs before Insight Venture Partners did our Series B in 2003 (US$10MM). From Menlo Park to Waltham, from Virgina to Toronto, I got to meet a lot of VCs and see how they operate.

Conclusion #1: The best advice comes from the GPs — experience counts. Everyone else working at a VC is trying to curry favor with the GPs to become a semi-GP themselves. However, Conclusion #2: my 90% rule still applies to GPs. The problem facing VCs is that they are trying to cover too many spaces in their investment portfolios. They are spread a mile wide and an inch deep. Most don't really understand the way that technology is changing within any one space (although they will claim to). If they spent the time to get-to-know that space, they really couldn't do their job (looking at other investment opportunities).

Conclusion #3: Most VCs serve on way too many boards to really provide meaningful value to yours. Where are the corporate governance gadflies to comment on a GP's ability to be a good board member if he's serving on 8 other boards, looking at new investments, closing down problem investments, communicating with past fund investors, and trying to raise his next fund?

Conclusion #4: If you expect your VC to help you run your business, you already have a foot in the grave; don't expect much from your VC and you will be pleasantly surprised. Pick your VCs as carefully as you would your spouse.

7. **Too niche a focus.** VCs are fond of getting a start-up to focus. I think this is the first platitude their analysts learn (on their own) to tell prospective investee management team members. And, of course, who can argue with that? You don't have infinite resources to go after too large a market. Yet, too many companies think too niche. Being the biggest fish in the pond doesn't matter if your pond doesn't grow any larger than it currently is. (See next point below.)

I would love (and will pay) an academic to do a study on what percentage of start-up business plans that quote Gartner/Forrester/some other industry analyst saying that the total market size for X in 5 years time is going to be $Y billion actually turned out to be true. In my experience, they are always off several billions of dollars. Where does that leave you?

6. **They focus on revenues instead of profits.** Revenues don't matter — profits do. However, most VC-backed firms still focus on building instead of harvesting. The argument is that these firms have some cash in the bank from the VCs, so get sales now and sell later (i.e., soon) for a multiple of sales. YouTube, MySpace, and Google are supposedly all examples of companies that followed this strategy and (at least Google) are now harvesting because they focused on revenues first, profits (ads) later.
Not true. Google always focused on profits.

I remember at Columbia B-School that Joel Stern (of Stern Stewart… creator of EVA) always said that equity was a soft pillow and debt was a razor. Management pays attention to the razor — never forgets about it.

Profits are always an appropriate discipline for any management team. If you're not creating profits, what value is your business? Focus on profits and revenues will take care of themselves.

5. **Founder CEOs who have all the answers.** Anyone who thinks they have all the answers is not someone I want to invest my money with. However, a founder CEO with all the answers is a huge red-flag that problems lie ahead. No one is right all the time — even Bill, Steve, Sergey, and Larry. (See point 10 about the importance of failure.)

Self-confidence is good, but over-confidence is usually behind the most spectacular of failures. A sub-set of this problem is listed next….

4. **Midas-touch-syndrome.** Most people in life stick to their knitting and stay working in a field that they understand deeply. If you're an advertiser, you stay in advertising. I love watching the people who are highly successful and then decide to branch out into a completely different area: what I call Midas-touch-syndrome. It's usually very entertaining — in a rubber-necking or, I suppose, Schadenfreude way.
Even the legendary Jim Clark, of Netscape fame (and several other successful start-ups), suffered from the Midas-touch-syndrome when he launched MyCFO — a financial services firm with a website.
If we only knew what we didn't know, we'd never make any mistakes. Always keep a healthy dose of humility — no matter how many *Business 2.0*and *Red Herring* writers laud you as the Second Coming.

3. **Groupthink.** Most people like people who remind them of themselves. Ever notice how people from your alma mater light up when they learn that you went there too? Start-up management teams are generally made up of longtime friends and buddies who have worked together before.

Truth is that the VC-backed world (VCs, as well as entrepreneurs who get their money) is very small and, therefore, clubby. This lends itself to a "way" of seeing the space that you operate in and how it will develop.

And, what happens at most start-ups if there are differences in opinion on the direction of the firm? The top dog's opinion carries the day (whether the CEO or the VC) and the other person gets in line or gets off the bus. So, over time (and multiple decisions like this), you're left with a very one-sided way of looking at the world – or groupthink on the management team. The best management teams are the ones which can actively debate issues — and may the best logic carry the day.

Do you remember what it was like in your high school debating society? It wasn't the quarterback who won the argument, it was the best debater. All management teams should aspire to keep a healthy spirit of debate and devil's advocacy.

2. **Obsession with the wrong enemy.** Who are we against? Microsoft thought it was IBM/Apple and others, not the Internet. Sun thought it was HP/Dell/IBM, not Linux. Friendster thought it was dating sites, not MySpace. An enemy can focus the mind and put horse-blinders on you. So, while leading a start-up is a lot of hand-to-hand combat, the most successful leaders keep an open mind to where their next challenger will come from.

It's fun parlor-talk to imagine where the titans of today (Google, YouTube) will be blind-sided in the future. I hope, for their sake and their investors', they avoid this fate.
It is very difficult to stay vigilant against your future enemies — especially when you consistently hear how smart and successful you are.
and

1. **Not learning from your mistakes.** I think God is a benevolent man (or woman). He wants us to be successful. Before we make any "blow-the-company-to-smitherines" decisions, I find he usually gives us a couple of warnings that this probably is a bad idea. However, most of the time, we ignore these. We poo-poo earlier failures or mistakes. We pump ourselves (and our employees) up with postive self-talk ("I will not make that same mistake again; I will do better next time…).

If we only did a better job at fully grasping why we previously were unsuccessful, we could adequately insulate ourselves from future repeat stumbles.

You don't have to be a VC-backed company to commit this last sin; this seems to be part of the human condition. However, we can learn to better learn.

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