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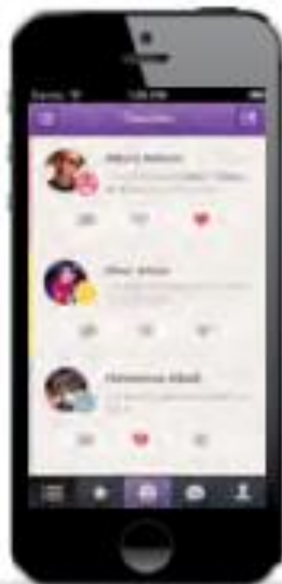


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# IT'S TIME TO REEVALUATE THE "FACTS"

## SECOND THOUGHTS ON VENTURE CAPITAL

*By John Mullins*

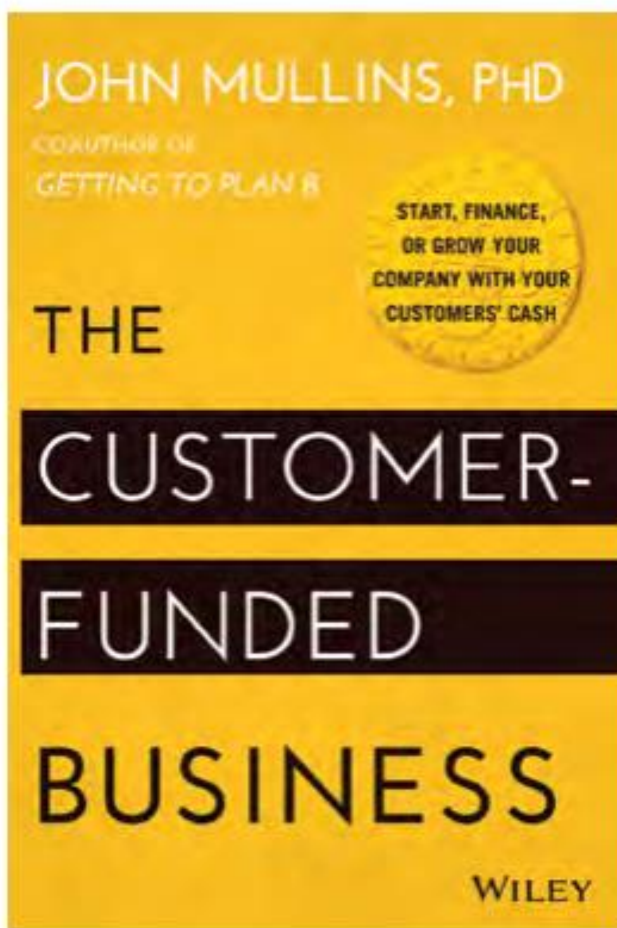
More than two generations ago, the venture capital community –VCs, business angels, incubators, and others– convinced the entrepreneurial world that writing business plans and raising venture capital constituted the twin centerpieces of entrepreneurial endeavor. They did so for good reasons: the sometimes astonishing returns they've delivered to their investors, and the incredibly large and valuable companies that their ecosystem has created. But the vast majority of fast growing companies never take any venture capital.

Consider Claus Moseholm, co-founder of GoViral, a Danish company created in 2003 to harness the then-emerging power of the internet to deliver advertisers' video content in viral fashion, saw no need for external investment. Funding his company's steady growth with the proceeds of one successful viral video campaign after another, Moseholm and his partners built GoViral into a leading digital platform to host and distribute such content. In 2011, GoViral was sold for US$97 million, having never taken a single krone or dollar of investment capital. The business had been funded and grown entirely by its customers' cash.

PUTTING YOUR CUSTOMERS AT THE FOREFRONT OF YOUR THINKING CAN ONLY PAY DIVIDENDS.

### WHY RAISING EARLY VC IS A BAD IDEA

Too many of today's entrepreneurs have come to the belief that the best way to start and grow a thriving business is to come up with a great "idea", write a great business plan, raise capital from angels or VCs, flawlessly execute the plan, and (Voila!) get rich! But it hardly ever happens this way, and the vast majority of successful businesses don't ever raise venture capital. Instead, at least at the outset, and sometimes for the entire journey, they get the cash they need, just as Moseholm did, from their customers.



# THE DRAWBACKS OF ATTEMPTING TO RAISE CAPITAL TOO EARLY

| Lifecycle stages | Key Drawbacks | Details |
|---|---|---|
| RAISING FUNDING | A distraction | Raising capital often requires full-time concentration, but so does starting an entrepreneurial business. One or the other will suffer when investment capital is sought. Why not raise money later when the business is less fragile? |
| | Pitching vs. proving merit | Nascent entrepreneurial ideas, however promising, always raise numerous questions. *Proving* the merit of your idea (to yourself and to others), based on accumulated evidence and customer traction, is much more convincing than using your own wisdom and charm to *pitch* its merit. |
| | The term sheet giveth; the shareholders' agreement taketh away | The terms and conditions attached to venture capital are (for good reason) somewhat onerous, as investors seek to protect themselves from downside risk. The further along the path, the less onerous the terms. |
| BUILDING THE BUSINESS | Advice and support | Just how good is the "value-added" advice and support that investors provide? |
| OUTCOMES | The stake you and your team get to keep | The further you progress in developing your business before you raise funding, the lower the risk, as early uncertainties become more certain. Less risk translates into a higher valuation and a higher stake for the founding team. |
| | Bad odds | VC today is an all-or-nothing game. Is that the game you want to play? |

They don't do so because it's easier, though. It's not. They do it in large part because of the unwelcome drawbacks entailed in raising capital too early.

But is there an alternative? Yes, five of them!

What do Michael Dell, Bill Gates, and Mel and Patricia Ziegler have in common? Each of them, like Moseholm, started and grew their companies largely with their customers' funds. Here are the five customer-funded models through which they and many others have done it:

› Matchmaker models (for example, the U.S. companies Airbnb and DogVacay)
› Pay-in-advance models (the USA's Threadless, India's Via and Loot)

THE VAST MAJORITY OF SUCCESSFUL BUSINESSES DON'T EVER RAISE VENTURE CAPITAL.

› Subscription models (India's TutorVista, the USA's H.Bloom)
› Scarcity models (Spain's Zara, France's vente-privee, the USA's Gilt Groupe)
› Service-to-product models (Denmark's GoViral, Puerto Rico's Rock Solid Technologies).

In fact, for most successful companies –today and always– whether fast-growing or otherwise, the early funding comes from a much more agreeable and hospitable source, their customers. Your funding can too.

**THE WAY FORWARD**

Thus far, I've focused largely on the drawbacks of taking early VC, but there are material benefits to not doing so, too. Perhaps the most important of these to an aspiring entrepreneur is freedom. According to Hussein Kanji, founding partner of Hoxton Ventures, "I wish more entrepreneurs ›››

understood the significance and freedom that cash generation can bring to young, fledging businesses. It puts an entrepreneur in the driver's seat. As a venture capitalist, I dream of entrepreneurs that are able to independently validate their product or service with the market, lay down early traction and are constrained only by capital to take their companies to the next level."

A second benefit is the consequence of directing your attention to customers, rather than to investors. In the words of The Darden School's Saras Sarasvathy, "Treat your first customers as your partners – they are your earliest investors and your best salespeople." Putting your customers at the forefront of your thinking can only pay dividends.

Third, and importantly, with the cost of building many kinds of businesses –including software and Internet businesses that are on so many entrepreneurial agendas today– lower today than ever, you may not need very much cash –your customers' cash– to cover your costs. One or more of the five customer-funded models may work for you.

Whether you're an aspiring entrepreneur lacking the startup capital you need, an early-stage entrepreneur trying to get your cash-starved venture into take-off mode, a corporate leader seeking to grow an established company, or an angel investor, mentor, or business accelerator or incubator professional who supports high-potential entrepreneurial ventures, a customer-funded approach offers the most sure-footed path to starting, financing, or growing your business or those you support. In the words of Shanghai's entrepreneur and angel investor Bernard Auyang, "The customer is not just king, he can be your VC too!"

YOU MAY NOT NEED VERY MUCH CASH –YOUR CUSTOMERS' CASH– TO COVER YOUR COSTS. ONE OR MORE OF THE FIVE CUSTOMER-FUNDED MODELS MAY WORK FOR YOU

John Mullins is Associate Professor of Management Practice in Marketing and Entrepreneurship at London Business School. His latest book is *The Customer-Funded Business: Start, Finance, or Grow Your Company with Your Customers' Cash* (Wiley, August 2014), from which this article has been adapted.

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