Dean's Executive Leadership Series - 2010-2011

Transcript of Presentation with Kate Mitchell, Managing Director, Scale Venture Partners

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Dean Linda Livingstone: To kind of continue that theme we have with us tonight Kate Mitchell. We're really thrilled that she came down from San Francisco and Silicon Valley to join us. Kate is the co-founder and managing partner of Scale Venture Partners. She also serves as the chair of the National Venture Capital Association. She has a really interesting background—went to Stanford with a degree in, I think, political science and then went to work for Bank of America. She was there at a very interesting time and had the opportunity to roll out their online banking component before anybody else was really doing that. So she was an entrepreneur within a large corporate setting. Went on from there to start Scale Venture Partners and has been doing that for about 15 years. We did our podcast a little bit earlier. And, I think, you will find, as I did, that she is a lot of fun and full of energy, passionate about what she does, really smart. You're going to really enjoy what she brings to you today. So I'm going to bring up Kate Mitchell.

Kate Mitchell: Well, it's great to be here and thank you for spending your St. Patrick's Day. I didn't even wear green, but I am in spirit. My mother was Sheila Jane O'Kelly, so you have a little blessing of the Irish here. But it really is nice to be here. It's so exciting. It's great to get out of the office. It's great, you know, speaking tonight to students, people who are very sophisticated in the industry, curious of mind and in particular entrepreneurs. So, I love getting out of the office because this is where it all happens. It's a lot of fun. I thought I'd give you just a brief bit of my background. You got a bit of my bio, but sort of how I got—particularly for students, we were talking a couple of us earlier sort of how I came to be where I am because there's never a direct route particularly into something like I'm doing. There aren't job applications for venture. You have to sort of find your way into it. Alex and I were talking about that earlier. I started out—actually, I come from—despite having a political science degree—I come from a family of engineers. My father was a civil engineer. My grandfather was an aeronautical engineer and founded Ames Research Center at Moffett Field, so early Silicon Valley when it was jet engines and that kind of thing. But, sort of had me growing up with this idea of change and my dad ran a small company

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and the idea of risk. Then went to Stanford and Jim Clark who founded SGI and Netscape was my professor when he still had patches on his elbows. It was all about figuring out how to use technology. It was even in a trailer. I mean now the campus because of the success of companies like Google is very different than when I went to school there. I lived in a trailer and I was taught in a trailer because there were constrained resources at the time. But it was when I first sort of got—you know, that was my first touch point with technology. I did start in banking, ended up using technology through various parts of my career and ended up in Internet banking when it was still a private business. I ended up with Mark Andreessen. Netscape was still a small company at that time and private. He brought big bars of chocolate to our meetings. He was a big guy and he liked big bars of chocolate. Then one of my staff members, he wasn't an employee, because he had his own little start up on the side was Craig Newmark of Craigslist. So it was kind of cool and I've stayed in touch with both of those guys over time. It was sort of like the wild, wild west at that time. You know, is this all going to work out? If I put online banking do any of our customers care? We blew through every projection we had for the numbers. So it was fun to be there in the early days. You know that a lot of this is experimentation. You're not always sure how things are going to end up and you just have to kind of keep your wits about you. So that's how I come to be here today and it's one of the most exciting things. It's a lot like being back in school. Most of my day is spent hearing pitches from smart passionate people and I get to learn about something new every day. It's like being in school. It's, I think, the ultimate luxury. So I thought I'd give you some background on what venture is. There's a wide range of knowledge in this room, so I apologize if I'm being overly simple or if I'm being overly complex. I'm trying to hit the middle. But I'll give you a quick interview of venture, its impact, but I'm going to end up really talking about entrepreneurship. So I may go through some of these quickly, but hopefully we'll have a chance to ask questions. I'm going to keep an eye on the time because that's really where, I think, the interesting stuff happens. So with that, let's see if this works.

So just a quick, what is venture capital? You know we focus—and this is always one of the questions because when you're in this business, you get 7,000 to 10,000 plans a year in our office and we invest in 10. So it's a high ratio. I vividly recall the toilet seat company and the ball bearing company—both of which were probably really cool ideas but not really venture fundable. I mean in that, we're really looking for high growth industries that are at an infliction point. That's why IT, healthcare, clean tech are so interesting because they're industries that have, you know, a higher rate of growth than the average in the economy. The other thing that finally became clear to me after a few years in venture that as a venture capitalist I'm not investing—I do invest my own money alongside my limited partners but most of the capital I invest is institutional capital. My mom is in a nursing union and she needs to have good return in her retirement, which she's drawing. And really, my job is to take the pension money of hers and to be the best conduit to the best entrepreneur. That's really my job. And then to hopefully nurture and help that entrepreneur be as successful as I can. It all really is about connecting up my mom with a great entrepreneur. When you think about the ecosystem it really kind of puts venture capitalists in the right

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place. Then, what we do in the economy is take a piece of knowledge and IP and fund it through the days when it is not profitable—when it can't get any other resources and get it to the point. In venture, we think of it as an exit, but really it's the beginning of the company. It's to the point where it can stand on its own become a big public company like an Apple, like a Cisco, like a Google.

We're kind of the kindergarten for the company because 92% of the company's growth happens after it goes public. Our goal is to get it to that point. That's really kind of what we do. You know, there are various ways to fund a company. At the high-risk phase of it is venture, as it grows it can get public, a company—can get public equity. It can get debt and other things. We're closer to the seed investors where it's risky. Because it's risky, we invest in a portfolio of companies to obviously diversify ourselves over time. And we do this, over a portfolio over a period of time. So we take R&D. We invest initially capital to get it to a first milestone and invest over time. When you think about a big company going public, there's really sort of one big investment. When you think about a private equity transaction, it's usually one big investment. We have a couple of companies that are on Series J to, whatever, Z. We had one that went right to double A, but where you're kind of meeting out the capital to say do you think we're going to get further? How's it going through the lab? Now, we've started selling, now can we scale it? Now, can we go overseas? Now, can we launch our next product? So it goes over a long period of time, and that's taking a lot more time than it used to. And, again, towards an exit which is really the beginning of the company's independence. Obviously, we built a lot of huge companies, and I'm now speaking of the industry from scratch. It is a successful model that we all, when you look at this, even Starbucks and FedEx, names that you didn't know, were venture-backed. But, they were very new ideas at that time and really needed somebody that was willing to take pure risk capital and invest it. We do it all over the United States and there's always the misnomer. Certainly during difficult times, a higher ratio of venture happens in Silicon Valley than elsewhere, and we can talk about why that might be later, but it is a national phenomenon.

Our two best companies are in Provo, Utah and Indianapolis. It doesn't have to be in Silicon Valley. It certainly can be in Southern California. We have some successful investments here down through San Diego. So it is a national phenomenon and something that we want to encourage, I think as Americans, to be happening everywhere in the country. The thing is, and this is probably the one takeaway about venture, the question of: is this really for you? For anybody who's associated with venture, venture has a high failure rate. If you can't embrace failure and if you can't embrace no—I mean 7,000 to 10,000 business plans for 10 investments—you aren't cut out for this and maybe you should do something else for a period of time until you get to that phase in your career, in your life. That's a very normal process. You know 40%—in a normal environment—of venture deals don't return capital. I mean bad thing. Second, 40% returns capital. That's not why you invested in venture, to simply to be right where you were when you began. You can do better in a savings account. That's been the challenge in the last couple of years with the dearth of IPOs; we look like the first two categories. The reason you do venture is the 20% at the end. Those are the companies. Those are the Googles, the Ciscos, et cetera, that really drive return in the funds. Our job as venture capitalists is to cut the first two categories off early so that most of the capital goes into the 20% that win.

When I look at partners like Silicon Valley Bank and others that participate in this ecosystem alongside us, that is, one of the challenges is as these companies grow, they winnow out over time. It's the few left standing that really become the winners. This is something that if you decide this is something you, like you have to get really comfortable with this and sort of internalize that. The reason it makes sense is because we have a high impact in the economy even though we're a tiny amount of the economy. We invest in venture companies 0.1% of GDP every year even compared to buy outs and certainly hedge funds, which are all private capital. We're such a small amount of what gets invested every year. We're really kind of the early seeds that get planted, but for great return. Ventured-backed companies employ 11% of the workforce. The companies generate 21% of GDP and they grow at twice the rate of non-venture backed companies. These are the gazelles that really, we're all interested in today as Americans that we want to help kind of bring us out of the recession. So there are great rewards out of it. We've created entire sectors: biotech, clean tech, semi-conductors, et cetera. And there'll be something we'll be sitting here hopefully 10 years from now, and there will be something new on this slide that we hadn't even anticipated. So it's an exciting industry to be in because it is really at the cutting edge. And something that is now, not only a phenomenon in the U.S., it is now a global phenomenon and is something that as Americans we have to be careful we keep here. And we can talk about that a little bit when we get to break.

So, where is venture today? Well, I call this slide "The Great Exit Slide" and I think a couple of you have heard me say this before. Venture capitalists love exits—we just don't want them to be our own. And what happened here, it's a very cyclical business. You can see in the early '80s, it was a much smaller magnet. This was a mini-tsunami versus our 2000 tsunami that we had a recession. A lot of interesting companies typically are formed in recessions because there are not too many technology companies. Often, when you come out of a recession like we are now, technology is flourishing. It is a jobless recovery partly because of that. What happened in the early '80s? Great technology. Everybody decided "whoo" you can make in that, then "swoosh" in comes a lot of capital—kills the returns. Of course, the same thing happened in 2000. When you look at the slope of that curve, any of us who is using technology and any of us—I was operating at that time in venture, but certainly was using technology myself, obviously, the Internet. If you look at e-commerce through that period, it was growing really steadily and nicely. It did not do this [motions up and down, up and down]. Everybody thought the Internet and Y2K was just going to be a huge boom and then, of course, we had a big bust. We often talk about in our industry, when is it going to be back to a level where we think it will be successful again? So this is the exit side. And I

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always say, by the way, it's not just that there were too many people that looked like me as a venture capitalist. The real issue is that we created too many companies. There were too many CEOs fighting each other to get in the customer's doors and slashing their prices for free. I actually think it's one of the challenges of journalism. Everybody had to give away stuff for free. Quality journalism, people should pay for it. The New York Times is trying to do that this week, and I applaud them for it because I care and I really miss the fact that there aren't as many qualified journalists. I'm talking to a former journalist in the audience here—a recovering journalist—but that's a real challenge. We can destroy. We can have great technology, but if we create too many companies, we're destroying business models.

So that's the real problem with the peak overall, and you see it in the returns. The bright green is venture, the blue, all of the variations of blue and purple are all of the various public indices, and in the far right is 20 year numbers. Venture was really good when there was a right amount of capital relative to the opportunity and you can see what it's been like the last 10 years. We've just swamped all of these great ideas with too much money and created too many companies. You are starting to see a slow rebound in IPOs. The purple are M&A and the green are IPOs. You start to see that turn up now. We're, you know, having conversations with a lot of people in the ecosystem about how we can improve the path for IPOs. But directionally we're going in the right place now, so I think things are certainly getting better. Acquisitions have really gone up and what you don't see in this are the values of those acquisitions have gone up, so that's a good thing as well. The thing for entrepreneurs to remember, though, is this is an end for investors. This is not a sprint. Everybody at the top thought, "I'll start a company and it will be public in two years. I'll have my island off in the Caribbean any time soon." It does not work that well, that quickly. It's a 10-year plus slog. It doesn't have the feedback cycle as an entrepreneur or as a venture capitalist that you get either grades every quarter or you get a review from your boss every year. You really have to decide that you're in it for the long run and that you are ready to give up that much of your career for that time period to grow that company that might not be one of the 20% winners. It's a calculus you really need to think about when you decide to be an entrepreneur. Patience is rewarded but you have to be patient.

This is something a couple of us were talking about at the break. This is an analysis that we did in our group for our limited partners because they're all saying, "Well, we think it's good that there's capital leaving the industry, then the opportunity is probably better suited to the amount of capital. How do we know when we're there yet?" Well, without going into a lot of detail, that green thin line is the amount of venture every year as a percentage of GDP—the amount invested. The purple lines are the returns in venture. And what you see the lower percentage of GDP the higher, the returns and when you have too much capital the returns plummet. You have in what I think of as the "golden years," sort of the '85-'94 before any bubble occurred. We were 0.1% of GDP being invested every year and we returned five times the money of our investors, on average, that includes all of those failures. That's when Silicon Valley—I was working there at the time—there were see through buildings and it was really hard to build companies. They had to be profitable when they went public. It sounds like today. That was when we had some great returns. Then Netscape went public and everybody paid for companies for futures and returns went up and then there's wall of money in 2000 and, of course, returns absolutely plummeted. We were happy post-2000, when the capital was leaving the market and we directionally thought this was good. But interesting that even in that '01 to '08 timeframe, we were investing 0.2% of GDP. Sounds like a small number. It was twice the level, though, that we had in the "golden years." It's only the last year-and-a-half that we've been down to the level that we had in the "golden years." Actually, it was slightly less than 0.1% of GDP.

I think that's good news. I think it's a better time for entrepreneurs to build companies. I think it's a better time to get returns. I don't think it will feel that way very quickly because it takes that five to ten years to build a company, but it is a healthy time. It feels better. We have our CEOs come and speak to our limited partners, the pension fund managers, et cetera, endowments and foundations, at our annual meeting, much in a room like this. And, again, I'm the conduit. We took us out of the mix and we have the entrepreneurs speak directly to our investors about how they felt as CEOs, how they felt about hiring, how they felt about their pipeline, how they felt about how long it took to close a customer. We do that every year and it's interesting—in the last three years, they've gotten more optimistic every year. They really feel good now. They really feel like they can dominate and differentiate themselves in a way that they couldn't a couple of years ago. So, I think, personally this is my thesis, at least, that we're in a better place. You see part of it because early stage investing is also up. So we're planting seeds for the future, albeit at a lower level than we did at the peak, but we're planting new seeds. We're starting new companies. At the beginning of the slide, which was the beginning of '07, it was less than 21% of the dollars and venture went to early stage companies. We were still trying to get the later stage companies sort of over the finish line. It's over 30% now. And directionally, you add that to all of the angel and seed money really increase nicely because we need to generate a new crop of startups to be successful. So all of this, I think, is great.

Often when I come to groups outside of Silicon Valley, they want to talk a little bit about how it is regionally. And, of course, we've done a lot of investing in Southern California. I think you have all of the right recipes for success here. It's interesting when you look at '96 to 2010, unlike other sectors of the country, Southern California has actually held its own. You do see that Silicon Valley has grown as a percentage partly because other parts of the country, the southeast, some of the northeast, et cetera, have a Midwest, have suffered slightly. But Southern California is holding its own and, I think, it's building a really nice DNA. It's programs like Pepperdine is running their wave accelerator, their 15X et cetera. Doing those kinds of things in your community, I think, really make a huge difference going forward.

So now I'm going to start, hopefully, to give you some ideas that Linda and I can talk about a little bit more and hopefully interact a little bit in the audience sort of conversations about for entrepreneurs, sort of how do you think about going about building a company? How do you get funded? And these are honest advice that I would give any entrepreneur. The first thing you need to look at is ask yourself, "Is the idea that you want to get funded a venture deal, if it is, is it in a large market? Is it capital efficient enough?" Look at the ball bearing company. But also we see companies, Linda and I were talking about this earlier, that really aren't companies and they really aren't even products. They're features. They're cool technology and they're really different than what was done before, but when you try to think of it as a logo next to all of those logos on a page before, it doesn't really stack up. So you really do need to ask yourself that hard question. Then you need to think about the VC that you're pitching. We get 7,000 to 10,000 plans a year, and 10 get funded out of our fund. There are a lot of ideas out there and a lot of them don't get funded and that's probably good because the entrepreneurs learn. We have entrepreneurs that I've seen three or four times and sometimes it's the fourth or fifth company that you say, "Yes, do it! That's the right idea!" And some start small and grow their way into bigger companies. But do your homework on that VC that you're pitching to. We get so many plans for sectors that we don't invest in.

Our group, as an example, hasn't done a lot in clean tech partly because we think it's over funded and partly because of the regulatory issues that we're concerned about with some of the deals. We actually have had a couple of deals in clean tech historically, but as clean tech became its own industry, it's not an area we focus on. But there are people that come to me assuming that I must have 15 clean tech companies in my portfolio. Come and look at our website, we have the portfolio. Now, we do semiconductor software. If your clean tech company is an adjunct on that, you'll see that you are a logical fit for us because it's software—semiconductors that point towards the clean tech market, which we think is interesting. But do your homework to see. I know friends that are tech investors that get pitches for half their companies that I know nothing about. So do your homework, think about the stage. If you have an early stage company that you're pitching a late stage investor about your brand, it's just not going to fit. So do your homework. Ask other people in the ecosystem what they know because once you get closer you're going to have a better hit rate. Then you have to network and warm the firm, I regret to say that. Because when I think about 7,000 to 10,000 plans, my guess is there maybe some of those that are good. If it doesn't come as a warm introduction, we don't have the time to process all of those. There are eight partners in the firm and we do spend time on the portfolio in addition to the new companies. So warm referral, somebody I know, accounting firm, a bank, a friend, a neighbor, somebody else who's in the industry, somebody who works in one of our portfolio companies. It doesn't need to be any given doorway, but a known introduction to any firm is so much better. Go to events like this, network with people. Go to your peers. Do everything you can to build up a network that starts to lead you that way. And sometimes it's the doors that you wouldn't think necessarily can be opened. But spend the time doing that. Work a lot on your presentation because, unfortunately, seeing so many plans we have the

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benefit of pattern matching. It doesn't need to be spiffy so much. I don't care that it's a long written thing, actually Power Points or short little presentations, quick demos are fine. It doesn't need to be long, but it needs to answer some basic questions that I'll talk about in another slide. But when you're thinking about pitching somebody, talk to your peers, try it with people who aren't going to invest in you but have heard a lot of pitches.

Go to your accounting firm, go to your bank, go to your peer entrepreneur who's already pitched quite a bit. Do, if you have a friend, and I've done this quite a bit. We don't do really early stage investing. We like investing after the technology is done. But when I have a good friend who introduces me to somebody who is in a sector that I'm kind of interested in learning more about because I might want to invest in them later in their lives. And if it's somebody I know, then I say to these guys hey, give me your pitch. I'm not going to be your first stage investor because I want the technology to be done, but pitch me because I see so many, I'd be happy to give you advice in what I normally see in pitches. And so it's great. You're not worried about failing because you're not going to. I can give you some advice and you can go on. So look to hone how you pitch and the questions you're asking and getting that done before the first meeting really is a great investment. Silicon Valley Bank runs boot camps and things like that, that really help entrepreneurs figure out how to access capital. Get in those kinds of programs because they're just hugely invaluable. And then, you know, you manage the process. And this is so difficult because it's a tunnel issue. You don't want to be apologetic and kind of "Oh, I think this will work," because if you're not optimistic, it's hard for me to believe in it if you're not enthusiastic about it. On the other hand, if you're completely unrealistic and overly enthusiastic or think you're just like, you know, and have your head up in the clouds. So finding that right balance and listen to feedback that you're getting. It's a high-risk business, so we don't expect anything to be riskless. Tell us the risks. Because the good news is, if you can describe to me and you have optimism around the opportunity and also tell me what the risks are – because again, I'm not going to return the kind of capital, the money investors are expecting—I expect that there's risks. The fact that you can identify if you have a plan to reduce that risk over time and that's what the funding is for. That's cool. So you don't have to be perfect. You need to be optimistic and realistic. And this is kind of what we look for. We want a high growth really large market. And really think about whether or not what you're pitching really is. Does it really fit that? We do want a winning team, and by that it doesn't mean that you had to have prior successes. Two of our most successful CEOs' prior jobs were being students, but your background needs to be relevant. And then putting together a team that complements all of the skills and, again, it might be three of you, five of you in the beginning. But thinking about a positive team, a winning team, and a relevant team is really important because half of everything we do is all about the people. And then really do a lot of homework on the competition, and your competition is global now. You really need to think about substitutes and other things. That is often what the problem is within investing in companies—maybe not a big enough idea. Do we like the team?

But really how does it stack up? It has to be not just iteratively better, evolutionarily better. It needs to be revolutionarily better. Those are the really big ideas.

I love the quote from Steve Jobs, "I don't do customer focus groups. My customers wouldn't know what they want." I mean what he's looking at is so revolutionary. It's like Henry Ford said, "If I asked my customers it wouldn't have been a car, it would have been a faster horse." It is really that idea of a real leap, and that was a real leap. It's the same idea. So looking at substitutes, competition, and is this really differentiated enough and just marginally being different on costs, marginally different on performance. When your big competitor is Motorola and their next gen is already in the pipeline and they have a lot more money than you do, it is a tough case to make. So we really have to understand why that product is compelling. And then a strategy for financing it that's realistic on terms that make sense for everybody because we need to be aligned with you. It's not a transaction that we're doing, although, there's a transaction element to that first investment. We're actually becoming partners. If I take too much of the company you're not going to be aligned and interested and motivated to work hard. But if you try to charge too much for it, I have to buy, right. I can't buy high and hope to sell higher. I have to buy right. I can't buy low. But, if I buy right, then I'm doing fine by my investors. So being aligned in financial terms, I think, is really important. And overall when you meet with an investor the first time, it's why now, why the solution, and why you? That's really kind of the key questions you're trying to answer. And then if I haven't dissuaded you already to be an entrepreneur and I think entrepreneurs are the best beings on the planet, so I love them because they're so optimistic. Build a composite board or mentor. Some people look for the person that can answer all of the questions. It's going to be the three entrepreneurs you met at that working event a while ago. You're going to put a composite group of people together that you should be thinking of as your network. Always, as I said about a pitch, get a safe reality check. You really want to get honest feedback about what you're doing—whether it's a pitch, whether it's the idea – because, often, you can get those really good entrepreneurs to iterate those first ideas. It isn't their first idea out of the box that actually becomes a successful idea. It iterated their way to it. So have people that you trust, that you feel safe, that you don't feel like, you know, maybe it's not your board member investor, maybe it's somebody else who you kind of need to ask "is this a crazy idea?" The person can say it probably needs a little fine-tuning. You need to get that feedback.

Then I have this whole idea of make deposits in the karma bank. I get so many wonderful plans, and so many appeals for advice that I'd love to give every person advice and I just don't, as a single person, don't have the bandwidth to give it. I just wouldn't have the hours in the day and it's a disappointment because I enjoy that aspect of what I do. So what I find is often, in addition to warm introductions, people that I end up working on projects with are people that I end up giving advice too and helping. I do work with different women in private equity, and women entrepreneur organizations. So we end up working on an event like this together. We're not even talking about business. We're talking about "is the food going

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to be here on time?" and guess what you end up knowing people and you really helped me get a bunch of people to that event and now we know each other. So when you make those deposits into the karma bank people, you know, so offer to help somebody on something if you want them to be part of your network, rather than saying please help me. I think that's often a better way to do it. If you want to help a venture capitalist, send them a good deal and they'll love you forever. Hard work is necessary but not enough. I mean you really do have to have all of those things I talked about in the former page. You need to get feedback.

So sometimes I get people who are just so earnest but you really do, you know, and frankly, unfortunately a little luck and obviously you can't manufacture that. But know that that's part of the reality. We've talked about the fact that losing is part of the business. It is hard. And by the way, as venture firms, you get turned down a lot too when you go to raise money. You just have to decide like any good salesperson. You'll get a lot of No's. Listen to the No's and why. If you're perseverant and you have a good idea, you will be successful. And so you need to get back on the horse. But as you get those turndowns, listen to that advice. There might be something in it. But even though you got the turndown and I actually think that this is a duty for me as a venture capitalist, although most of my peers don't and don't have time to do this is, is when I turn somebody down I tell them why. I always say, "You get what you paid for on this because you didn't—it was free." But take that advice and think about it. It was the competition. It was the price. I thought your team was weak. And take on that advice. I had one entrepreneur where I said, "It was really a horrible pitch." I was surprised because he had some venture investors, which I was surprised, had let his pitch go out. He was really smart, he said, "Do you have five minutes? Can you tell me why?" I went through his pitch with him and it was great. He brought his next deal back to me because he said you gave me advice my board didn't. So when people are telling you, "No," there's an opportunity in that too. And guess, what he and I created was a relationship. I really liked the guy and I thought it was really gutsy of him to want to listen to me to say something really difficult and painful. His next presentation was a heck of a lot better and he said thank you because I had 100 more of those pitches to do and he made it better every time.

There are lots of resources, by the way. Pepperdine, obviously, has a huge amount that you should take advantage of. These are beyond kind of national resources. And do go to a lot of VCs websites. There's advice on pitches. There are advice on how to put together cap table, on term sheets, all of kinds of things that you need to know if you haven't already gotten it in classes and places like Pepperdine that are a huge help to you over time. And with that, I think, Linda and I are going to have a conversation and hopefully get you guys in the conversation.

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