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NEW VENTURE PERFORMANCE

Two Toolboxes for Starting New Ventures

There are at least two ways of building new ventures. Most textbooks and newspapers suggest the following method:

- Do market research and competitive analyses to figure out target market segments.
- Develop marketing strategies, calculate cost/price margins, and make financial projections.
- Write a business plan, raise resources, hire a team, and build your venture.

Expert entrepreneurs, on the other hand, appear to disagree with this approach. They prefer instead to do the following:

- Begin with who you are, what you know, and whom you know and begin *doing* the doable with as few resources invested as possible.
- In particular, begin interacting with a wide variety of potential stakeholders and negotiating actual commitments.
- Let the actual commitments reshape the specific goals of the venture.
- Repeat the process until the chain of stakeholders and commitments converges to a viable new venture.

The former is called causal or predictive, because it depends on accurate predictions and clear goals. The latter is effectual or nonpredictive, and it is extremely stakeholder-dependent and means-driven. It is very tempting to jump to the conclusion that the latter is the better way since it is overwhelmingly preferred by expert entrepreneurs. But it might be more useful to think through the pros and cons of each for the performance of new ventures.

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Causal/Effectual Logic and Success/Failure Factors

Both causal and effectual approaches require the entrepreneur to understand basic business skills such as sensible accounting practices, legal issues in the environment in which the business operates, and the daily mechanics of financial and people management. Both also require the entrepreneurial team to execute well on the commitments made by the new venture. Yet the primary drivers of enduring performance are different in each case.

In causal logic:

- Analysis precedes action
- Time and/or other resources are invested in upfront information-gathering
- Accuracy of prediction and clarity of goals drive the resource-acquisition process
- The likelihood of delivering on preselected targets dictates whom to bring on board
- Control over outcomes is achieved by being one step ahead of the trends and the competition
- Risk management involves the careful avoidance of failure at all costs.

In effectual logic, in contrast:

- Actions and interactions with others precede and drive the entire process
- Creative energies are focused on building the venture with virtually no resources invested—each stakeholder invests only what he or she can afford to or is willing to lose
- Unpredictability itself is seen as a resource—hence the emphasis on nonpredictive strategies
- The people who come on board help determine the goals and shape of the new venture and its market
- Control is achieved by doing the doable and continually transforming current realities into new and unforeseen possibilities
- Risk management involves keeping failures small and having them happen early, and then building upon them for future success.

Venture capitalists usually insist on a causal logic for building new ventures. Examples and advice abound on this topic. Among the potential factors leading to failure, according to venture capitalist Frederick Beste, venture capitalists usually include:

- Inadequate pricing
- Insufficient startup capital

- Failure to look at industry norms
- Lack of focus
- Inadequate market research
- Failure to segment market

And in pointing out the characteristics of successful entrepreneurs, Beste says, they usually list:

- A sound knowledge of their marketplace
- A sound knowledge of their competition
- A plan in mind that they actually execute

These are important points to keep in mind while building a new venture. But it is also critical to remember that less than a fraction of 1% of ventures actually get funded by venture capitalists. Even those do not get funded until the market has been somewhat opened up and the concept underlying the new venture proven to a considerable extent. Furthermore, whereas only a third of VC-backed ventures succeed and even fewer (one out of 10) are home runs, the survival rate for new firms in the larger population is substantially better. Econometric studies estimate that as many as 40% to 50% survive eight years. And as many non–VC-backed firms go public as VC-backed ones.

When we move from the success rate for new ventures to the success rates for *entrepreneurs,* the story gets even better. Basic probability theory shows that *merely by being willing to fail once or twice,* an entrepreneur can increase the probability of his or her success over any given success rate for firms. Serial entrepreneurs and experts in entrepreneurship, notwithstanding advice from VCs, appear to have learned a different set of lessons on new venture creation. According to Stephanie Clifford, writing in the March 2005 issue of *Inc.* magazine, they are more likely to list the following lessons learned:

- What You Learn From Company No. 1: When and How to Leave
- What You Learn From Owning More Than One Company: Don't Fall in Love With the Product
- What You Learn by the Third Company: How to Leverage Your Resources Creatively
- What You Learn by the Fourth or Fifth Company: It's Okay to Fail
- What You Learn by the Sixth or Seventh Company: Don't Hire People Like Yourself
- What You Finally Learn: It Does Get Easier

- What You Never Learn: When to Stop[1]

Expert Entrepreneurs on Failing

In this regard, it is illuminating to look at what expert entrepreneurs say about failing and not trying to predict and plan in the new venture creation process. Here are a few exemplary quotations. The first one is from Robert Reiss, a serial entrepreneur who has been involved in 14 startups, including a number of highly successful companies such as Reiss Games, R&R, Inc., and Valdawn, Inc., a division of R&R. (R&R/Valdawn was named to the *Inc.* 500 list of America's fastest growing companies in 1992, 1993, and 1994). The following quotation comes from an interview with Harvard Business School[2]:

> If you're about to start your own business, you've got to have a passion for whatever it is that you want to do. We can't teach passion; we can teach everything else. If you have passion and you do your homework, don't let fear of failure stop you from going into a new business. Fear of failure is the number one reason people don't go ahead in starting a business. They're just afraid to pull the trigger. They start analyzing what the fear means. There's the fear that the business won't succeed and the fear that their ego will be damaged. At least in your head, you've got to separate the two fears. Many people won't do things, like a sales call, because they're afraid they'll be turned down. Ego shouldn't be a concern. Every rejection is a learning experience. You deal with the fear of a business failing by doing all those things I spoke about to manage risk. There is risk in everything in life. Don't let fear of failure keep you from moving ahead.

The next one is from Scott Cook, founder of Intuit (maker of Quicken personal finance software), also in an interview with Harvard Business School[3]:

> …part of creating an entrepreneurial culture is to celebrate failure. It's very hard to be an entrepreneur inside a company if you feel you're going to get crucified for failing, because there's risk in being an entrepreneur. If you've tried ten things, five will fail. Besides, if you wait too long so that you can do enough research to be sure an idea will work, you're probably going to be too late. So you've got to create an environment where people know it's okay to fail and, that way, they'll try a lot more. They'll think outside the box. They're willing to think differently because they know that if it doesn't work, they won't be scorched and they'll still have a career.

[1] Stephanie Clifford, "They Just Can't Stop Themselves," *Inc.,* March 2005.
[2] http://www.hbs.edu/entrepreneurs/bobreiss.html (accessed 11 May 2006).
[3] http://www.hbs.edu/entrepreneurs/bobreiss.html (accessed 11 May 2006)

> At times, like when we've closed out a business, we've had something like a celebration of what we've learned. We celebrate what we now know that we did not know before because it will help us make much better decisions in the future. We celebrate those people who fail and everyone around them knows that they produced value. It wasn't the value we intended, but it's okay as long as we learn from it.
>
> In one of the businesses we launched last December, the marketing person was someone who had failed on her prior assignment. She had worked on a project where we were trying to set up a business for lending to small businesses on a very low-tech basis. We developed, launched, and got ten financial institutions to back it, but we couldn't get the volume to make the business fly. But then last December, working out of our Boston office, which is one of our most entrepreneurial operations, the same person and her team succeeded at launching a whole new business called QuickBase. It's a revolutionary product and is off to a huge start.

Finally, here is a quotation from Pierre Omidyar, founder of eBay, from his commencement address to Tufts University in 2002[4]:

> I can tell you, without the ability to prepare for the unexpected, there wouldn't be an eBay today. The key is recognizing that no matter how convinced you are in the power of your own ideas… Sometimes, ideas have ideas of their own. That's certainly true in terms of system design. Almost every industry analyst and business reporter I talk to observes that eBay's strength is that its system is self-sustaining—able to adapt to user needs, without any heavy intervention from a central authority of some sort. So people often say to me, "When you built the system, you must have known that making it self-sustainable was the only way eBay could grow to serve 40 million users a day."
>
> Well… nope. I made the system self-sustaining for one reason: Back when I launched eBay on Labor Day 1995, eBay wasn't my business—it was my hobby. I had to build a system that was self-sustaining… Because I had a real job to go to every morning. I was working as a software engineer from 10 to 7, and I wanted to have a life on the weekends. So I built a system that could keep working—catching complaints and capturing feedback—even when Pam and I were out mountain-biking, and the only one home was our cat . If I had had a blank check from a big VC, and a big staff running around— things might have gone much worse. I would have probably put together a very complex, elaborate system—something that justified all the investment. But because I had to operate on a tight budget—tight in terms of money and tight in terms of time—necessity focused me

[4] Pierre Omidyar (commencement address, Tufts University, Boston, Massachusetts, 19 May 2002).

> on simplicity: So I built a system simple enough to sustain itself. By building a simple system, with just a few guiding principles, eBay was open to organic growth—it could achieve a certain degree of self-organization.
>
> So I guess what I'm trying to tell you is, Whatever future you're building… Don't try to program everything. Five-year plans never worked for the Soviet Union—in fact, if anything, central planning contributed to its fall. Chances are, central planning won't work any better for any of us.

Causal/Effectual Logic: Key Relationships to New Venture Performance

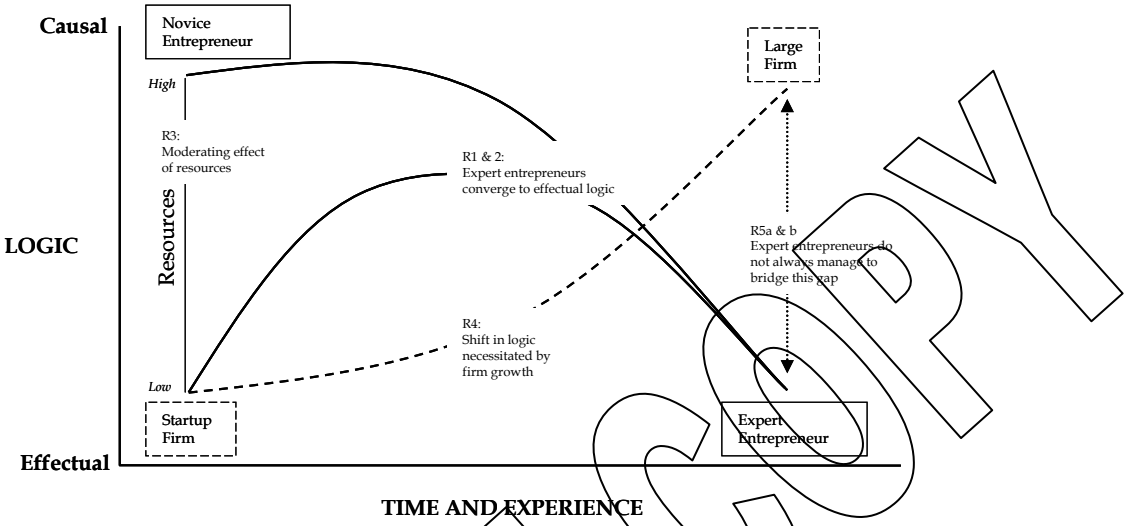
So, how can we begin to think about the pros and cons of causal and effectual logics in starting new ventures?

One way is to consider that there are stage effects in the relationship between action logic and venture performance. For example, whereas it may make better sense to use an effectual logic earlier in the startup of the new venture, it might be necessary to move to a more causal perspective as the venture comes into being and the new market gets opened up. Expert entrepreneurs do use rules of thumb to decide when this inflexion point happens. For example, they mention the following:

> When I walk into the building and cannot greet every employee by name, I know it is time to bring in the MBAs.
>
> OR
>
> When I reach $30 million in sales or the venture grows to a hundred employees, I start looking for a good COO so I can hand over the company to him or her and focus on new business units or quit and start the next venture.

Life histories of venture capital–backed firms provide strong evidence for that. When a firm obtains venture capital funding, there is a 50% chance that the founding CEO is fired by the VC and replaced by a more "causal" CEO who can make plans and deliver on predetermined goals. We can depict that changing relationship between the type of logic used in building the venture and the life cycles of firms and entrepreneurs through the following graphic:

Figure 1: Relationship between causal/effectual logic
and the life cycle of firms and entrepreneurs.



There are five relationships depicted in Figure 1:

Relationship 1: Although novice entrepreneurs may vary in their use of causal and effectual logics, their preferences for effectuation in the early stages of new ventures will increase as they become experts.

Relationship 2: Furthermore, both highly causal and highly effectual novices learn to balance causal and effectual approaches during the growth phase of new ventures, before developing a clear preference for highly effectual strategies as their expertise grows.

Relationship 3: The more resources available to novices, the more causal their actions are likely to be. In the case of expert entrepreneurs, availability of resources will not affect their use of highly effectual action.

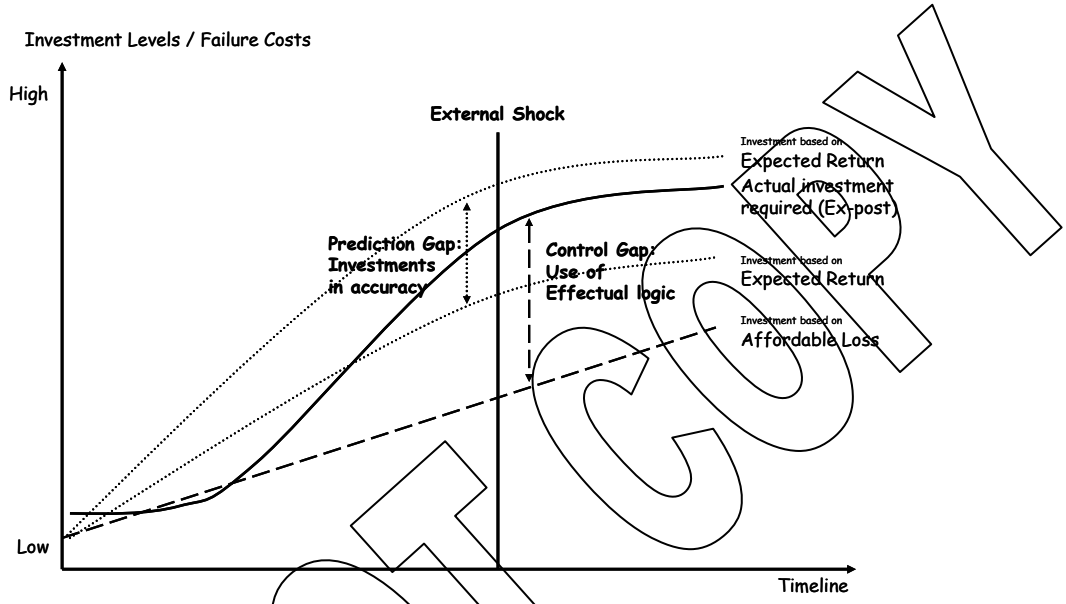
Relationship 4: Successful firms are more likely to have begun through an effectual logic and grown through causal approaches as they expand and endure over time.

Relationship 5a: Only a small subset of experienced entrepreneurs will successfully make the transition from an entrepreneurial firm to a large corporation.

Relationship 5b: Only a small subset of enduring firms will continue to be run by their founders.

Furthermore, it might be useful to separate out the probability of failure of new ventures from their *costs* of failure, which in turn can be related to causal and effectual logics as follows:

Figure 2: Relationship between causal/effectual logic and resources invested.



Let us now look more closely at the relationship between the use of an effectual logic and the use of resources in the entrepreneurial firm. The essence of effectuation is the use of nonpredictive strategies including the affordable loss principle. In contrast, a causal approach involves calculating the levels of investment required to achieve certain levels of expected return and predicating actual plans and implementation on those calculations.

In Figure 2, that causal approach is represented as the attempt to predict the shape of the curve showing the actual investment required (AI). As a broad generalization, we can use the S-shaped curve from the marketing literature on the diffusion of new products. The argument here is that actual investment has to be some function of how the firm's products get adopted in its market; hence, all other things being equal, the AI curve would look somewhat like the diffusion curve. Of course, all predictions are subject to Type I and Type II errors. So the predicted investment (PI) curve for a causal approach can either overshoot or underestimate the AI curve. That is represented as the prediction gap in Figure 2.

The effectual entrepreneur, however, does not try to predict the AI curve. Instead, he or she invests only what he or she and his or her stakeholders can afford to lose. Therefore the level of affordable loss grows as the firm grows. Hence, the level of investment in the effectual firm is a linear function of time. But that level of investment is unlikely to allow the venture to achieve its potential. The effectual entrepreneur, therefore, faces a control gap—and he or she and his or her stakeholders need to make up this gap in investment required through nonpredictive strategies that provide direct control of means and outcomes in the new market.

Distinguishing Characteristic: Imagining possible new ends using a given set of means.

In other words, when a causal logic is used in building a firm, the level of performance the firm achieves is directly proportional to the predictability of the market for the firm's products and services. And when an effectual logic is used in building a firm, the level of performance the firm achieves is inversely proportional to the predictability of its market and directly proportional to the number and quality of its alliances.

Furthermore, it is easy to see, given the assumptions of the argument, that at any given point in time, should failure occur, the effectuator is likely to lose less in terms of investment than the entrepreneur who invests using a causal logic. The corollary to this, of course, is that the effectuator may not make adequate investments in time to exploit a really large or extremely fast-growing opportunity, and therefore may lose out on the upside, either to other stakeholders or to competitors. But in general, whereas the causal entrepreneur seeks to find a big market and then strives to capture a large piece of that big market, the effectual entrepreneur seeks to own entire or large pieces of small markets that he or she stitches together into a large market down the road.