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Worse Before Better

Responsible venture-capital investors currently expend a great deal of energy diagnosing the lessons learned in the Internet boom and bust. As a result, we can expect that a more sophisticated understanding of the best practices for entrepreneurial finance will soon emerge. A more pressing need, however, may be a more refined understanding of a related challenge—that is, how to finance startups within existing corporations.

One of the most common observations about business is this: Corporations inevitably die. In fact, the average lifespan of a corporation is less than that of a human. Why? While the business environment is always in flux, organizations are naturally predisposed to maximizing the efficiency of the existing operation. Occasionally, there are periods of rapid and genuinely transformational change. During those periods, corporations find themselves engaged in a fight for their lives.

To survive, they must innovate. They must do more than simply expand product lines and service offerings. They must identify, finance, grow, and profit from completely new methods of doing business—methods that involve new skills, processes, and customers. They must combine an instinctive drive for operational excellence with a passion for entrepreneurship.

If only passion were enough. The corporation that attempts to operate simultaneously as a mature, efficient machine and a risk-taking, experimental startup faces a myriad of challenges. The most vexing of these challenges may be managing the investment community.

The fundamental conflict is clear. Investors reward smooth and predictable growth in earnings, but startups endure quarters or even years of losing money before turning a profit. CEOs are handcuffed. Survival demands internal new ventures that initially drag down earnings, but Wall Street does not tolerate "worse before better" performance.

This is hardly a new problem. Three decades ago the in-vogue conceptualization of the corporation was as a balanced portfolio of new, growing, and mature business units. As long as there was balance, earnings were steady. But the popularity of the portfolio approach declined as the diseconomies of excessively large organizations became abundantly clear.

With more focused organizations, there isn't balance because there is no need to continually be in the business of managing startups. Conditions will be ripe for a transformational internal new venture only periodically.

COMING SOON:
The Quest for Global Dominance, by Center Director Vijay Govindarajan and Anil Gupta, will be published this August. Given the current era of unprecedented change in both technology and the structure of the global marketplace, this book is a must-read for thoughtful executives worldwide.

The rise of the Internet created such a condition in many industries, but the best approach to managing investors remains in question. One possibility is a partially owned spin-off—a new organization with its own stock. But such a distinct separation minimizes the new company's ability to benefit from the brand, skills, and knowledge of the existing business. To allow for tighter integration, some especially creative minds on Wall Street created the tracking stock—a separate class of stock which theoretically tracks the performance of a single division within a corporation. But the approach is fraught with irresolvable accounting complications.

Both the spin-off and tracking-stock approaches risk exposing the startup to volatile investor expectations. This can result in frantic, reactive changes in the rate of investment in the startup instead of a desirable smooth growth trajectory. After a wild ride, NBC, Credit Suisse First Boston, and Staples soon will have repurchased their Internet shares at rock bottom prices. Although all intend to continue their investments in the Internet, they plan to do so in a steadier, more rational fashion (if they aren't too distracted by lawsuits coming from both the dotcom and parent shareholders).

The best approach to managing investors would insulate the market value of the existing business from the startup, insulate the startup from the risk of becoming overly responsive to mercurial investor sentiment, and allow the startup to take full advantage of the existing business's assets. Perhaps the solution is as simple as it is counterintuitive—volunteer more information to investors without creating new securities. If investors are able to understand management's approach to the startup, including the investment rationale, explicit performance expectations, and the expected synergies between the startup and the existing business, an overall package with a "worse before better" bottom line just might gain some acceptance. ■

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