Exit

How Venture Capital Changes the Laws of Economics

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((U1))The Contours of Exit-Capitalism

“There are two times in a man's life when he should

not speculate: when he can't afford it and when he can.”

Mark Twain

The euphoric days of the stock market boom have vanished without a trace. Cleaning up the debris is a sobering task. Venture capitalists financed manifestly senseless business concepts, laments Gordon Moore, longstanding chairman of chip manufacturer Intel. Anything that moved received venture capital financing or headed straight for an initial public offering (IPO), criticizes Benjamin M. Rosen of venture capital firm Sevin Rosen Management. Summarizing the boom phase in retrospect, Rosen says that strictly speaking it was a horrible period. Don Valentine, one of the elder statesmen of the U.S. venture capital scene, observes that the crush of start-ups changed the venture capital business from the ground up. In earlier times, venture capitalists would finance one or two companies per business sector all told, and the companies’ only competitors were the larger, well-established corporations which were too sluggish to recognize the first signs of an emerging niche market. During the boom, however, each venture capitalist had one or two investments in every niche market. According to Valentine, these start-ups competed with each other so fiercely that even the best of them had difficulty turning a profit.

The consequences of such “over-financing” became clear when the mood changed on the stock market, share prices plummeted and companies encountered increasing difficulties obtaining additional financing for their activities. One company after the other missed projected targets. Top executives from established, profitable companies who had switched to young, unprofitable start-ups during the boom days had no alternative but to declare their companies bankrupt several months later. Suddenly, journalist John W. Wilson reports, an industry which had “burned” vast amounts of money only a year or two before found itself struggling with liquidity problems. In the hope of recouping their market losses at least partially through litigation, outraged shareholders began filing suit against the companies and the banks that had underwritten their IPOs.

Venture capitalists used the remaining resources in their funds to save the stagnant companies in their portfolios from bankruptcy. For new enterprises the prospects for obtaining financing were dismal, and, as Richard J. Matlack, president of consulting firm InfoCorp. tells it, anyone who was still intent on currying favor among venture capitalists had to promise a really fantastic deal.

Retrospectives of the stock market’s intoxicating upswing and its appalling collapse could go on indefinitely. But one important point needs to be made. The comments mentioned above do *not* stem from the aftermath of the Internet boom at the beginning of the 21st century, but rather from the mid-1980s. On the venture capital scene in those days the opinion gained sway that the PC-boom in the early part of the decade had led to uncontrolled hype.[1] Although several hundred personal computer makers had been financed with venture capital

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[1] This information is taken from Wilson 1985, 189ff. For Rosen’s comments see Schilit 1991, 127.

during that period, only a handful had survived. Several dozen venture capital-funded start-ups were active in the relatively limited hard drive market alone. Prior to the change in sentiment among financers, experts following the software sector actually counted over 3,000 companies.

The similarity of analyses drawn from the earlier period and observations made after the Internet bubble had burst suggests that the venture capital business is remarkably cyclical. The goal of the present book is to discuss the principles underpinning this sector, beyond the commotion of its up and downswings. Only knowledge of the sector's cyclicality will allow us to achieve one of the key insights; the venture capital business is based on "chain letter mechanisms." The companies – and financers – who come out on top are the ones who understand how to optimally exploit the capital market's hyperbolic flight.

This book uses the concept of "exit-capitalism" to portray an economic process which has emerged with the gradual institutionalization of the venture capital business since the Second World War. Granted, speculating on short-term gains was always part of capitalist economies, but only with the launching of venture capital funds, the formation of venture capital firms and the professionalization "venture capitalism" did the dynamics develop which make it necessary to view an exit orientation as a central element of economic life.

The term "exit-capitalism" applies because growth company founders, the venture capitalists who back them and small stock holders on the exchange are not interested primarily in receiving regular dividends on a capital investment. Rather, their main goal consists of selling the shares they hold for a high *exit profit*. The logic is not based on an investment made for the long haul, but is dictated by the orientation of venture capital investors whose earnings depend on the difference between the purchase price and the sale price of their shares. Since offering stock for sale implies selling a piece of the company itself, interest therefore focuses on a product behind the actual product.

Regardless of what is sold, be it a software package, a potency-enhancing pharmaceutical with astronomical development costs, the delivery of packages in downtown New York or company shares, the short-term effect is always the same; the sale puts money in the till. The strategies employed in sales, however, are subject to wide and sundry range of principles. In order to outline the contours of exit-capitalism clearly, the present book will elaborate those principles which are geared to the capital market and illustrate the relationships between capital market and product market orientation.

The term exit-capitalism is not limited to the business dealings of company founders, venture capital firms and investors in growth stock markets. The current book will also demonstrate how the logic of venture capitalism can influence wide segments of the economy. During hype phases venture capital-financed companies are cast as models in every respect, ranging from their strategic orientation to their capacity for innovation and their management techniques. The rise and fall of the major traditional corporations which compete with venture capital-funded enterprises can frequently be traced to the corporations adopting the capital market orientation of their venture capital-funded competitors.

This book is based on interviews with venture capitalists, entrepreneurs, managers and employees of venture capital-financed companies as well as on an examination of the research literature. Overstatements of the principles of exit-capitalism are intentional. The book’s main objective is to describe the new economic development lines that have emerged since the Second World War, using as examples the exit orientation of venture capitalists, the spread of this logic to entrepreneurs, managers and employees, the capital market orientation of venture capital-financed companies and their presumed exemplary nature, their creative accounting practices, and finally the failure and survival of the startups themselves.

The occasional reader might find some of the differentiations lacking in detail. Clearly, the differences between various types of venture capitalists could be elaborated in greater detail. Company founders with an interest in establishing an enterprise for the long term could be more clearly delineated from those whose horizons extend only to a quick exit. But the book avoids greater differentiation intentionally. Instead, its unusual perspective centers on using overstatement to depict the influence of the capital market on the economy in general and the structure of capital market-oriented enterprises in particular. For this purpose, the debate over venture capital – which is somewhat short-winded during both bull and bear markets – has been re-focused beyond the near-religious apotheosis of “venture capital culture” on the one hand and condemnations of “nitwits in pinstripes” and “stock market fraud” on the other.

((U1)) I

((U1))The Exit Concept and the Logic of Venture Capital Financing

" My ventures are not in one bottom trusted,

Nor to one place; nor is my whole estate

Upon the fortune of this present year:

Therefore my merchandise makes me not sad."

Antonio, William Shakespeare's Merchant of Venice

Venture capital is surrounded by an almost mystical aura. In the USA it evokes comparisons with the settling (or occupation) of America by white pioneers. The entrepreneurs from California's Silicon Valley or Route 128 in Massachusetts emerge as modern trailbreakers, overcoming all resistance to cross new industrial frontiers. According to Bob Zider, an observer of the U.S. venture capital scene, early U.S. venture capitalists such as Arthur Rock, Tom Perkins or Thomas Davis are cast as the entrepreneur's rich blood brothers, offering assistance in word, deed, and above all in the form of money, thereby making their contribution to fulfilling the American dream. There is good reason why the term “venture” capital brings to mind the “adventures” of the Wild West. [2]

Only the efforts of early venture capitalists and those who followed their example, the ever-repeated myth would have it, enabled Silicon Valley and its clones such as New York’s Silicon Alley, the Silicon Prairie around Dallas, England’s Silicon Fen or Scotland’s Silicon Glen to develop into what they are today. Just as the courage, the “venturous” spirit and work ethic of white settlers threw open the USA for “civilization,” the professional daring of venture capitalists enables us advance into new technological “territories.” The claim is advanced that without venture capital there would be no such high-tech territories and – as the myth is occasionally spun out with pathos – perhaps even no computers or microelectronics. According to such commonly held assumptions, even genetically engineered pharmaceuticals, computer workstations, Internet browsers and portals would never have come about without the initiative and especially the financial commitments of venture capitalists.[3]

Indeed, there may be merit to this Wild West mythology. Venture capital does make financing available to sectors with no alternate funding sources at their disposal. An entrepreneur with a product or service idea, a new technology or a novel variation on an existing technology, frequently does not have sufficient capital to found a business. Due to a lack of collateral, high default risk and the substantial testing costs associated particularly with new technologies, banks have little interest in individuals seeking to found such companies. If they have any prospect at all of obtaining credit, then it would be only if they

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[2] Cf. Zider 1998, 131f.

Gelöscht: Siehe zu den Assoziationen mit den Adventures auch Wilson 1985: 18ff. Für den Begriff des Venture Capital gibt es im Deutschen, Französischen oder Spanischen kein Äquivalent, weswegen entweder der englische Begriff genutzt wird oder die etwas ungenaueren Begriffe Risiko- bzw. Wagniskapital, capital de risque oder capital de riesgo.

[3] Cf. McSummit and Martin 1990, 429; see also Southwick 2001, 21; Kenney 2001, 1.

were willing to collateralize with their cars, their homes (or those of their parents or children), risks which many company founders are unwilling (or unable) to assume. Economists refer to this situation as a lack of equity capital.

A lack of equity is typical for “classical” company foundings. A company is called into existence by taking out a home mortgage or investing one’s savings and, following initial losses, steered to profitability with the utmost dispatch. Only then can the enterprise expand into other regional markets or other market sectors. The “classical” family business is founded in retail, a trade or some other service sector catering to the needs of daily life. It expands only very slowly, if at all, and contents itself with relatively modest earning potential. But even companies in the service and manufacturing sectors, which are oftentimes founded by experienced managers and concentrate on capturing a strong competitive position within a niche market, grow largely by reinvesting earnings from ongoing business operations.

Launching an innovative technology in the market using this method would entail a tedious process. Often an entrepreneur cannot produce a market-ready product quickly enough to face off established competitors who are already trying to capture the market. When product development costs run high, as in the case of complex software, technologically sophisticated machinery or pharmaceuticals, lead times until the product starts generating income are so protracted that a company founder can only launch the undertaking with the backing of a strong partner.

There is only one way to overcome such limitations: venture capital. Since the Second World War the emergence and continuous expansion of the market for venture capital has increasingly resulted in a company founding track which is geared to growth markets and to achieving competitive advantages quickly. Such so-called “growth companies” are financed with venture capital through business angels, venture capital firms or investors on high-tech stock exchanges. The founders use the capital to expand the company quickly – even at the cost of short-term profitability – and thereby capturing a dominant position in an emerging growth market.

This chapter explains the functioning of venture capital as a business, the role played by the exit orientation of venture capitalists, and the reasons why the emergence venture capital firms, the launching of large venture capital pools and the emergence of “venture capitalist” as a profession transformed “venture capitalism” into “exit-capitalism.”

((U2))1. Thinking of an Investment in Terms of Its “Outcome”

If a wealthy individual, a bank, or the mafia were to demand loan interest of 50, 100 percent or even higher annually, word of loan sharking would quickly make the rounds. In industrialized nations consumer protection organizations would even take the lender to court for usury, and with good chances of success. In many countries, a contract which held a borrower to such exorbitant interest payments would violate accepted practice and would be voided by the courts. This explains why lending under such terms of interest is generally relegated to red-light districts where traditional bank supervision no longer applies. When it comes to the enforcement of repayment obligations, loan sharks rely more on the muscle of their debt collectors than on the legal system.

But providing venture capital entails “interest rates” of precisely this magnitude. A venture capitalist wagers that his investment in a company will multiply in a few short years. How can this business model function without venture capitalists spending a major portion of their time in court fighting usurious interest law suits?

((U3))The Difference between Venture Capital Financing and Usury

Venture capital is primarily channeled to innovative growth companies through three institutions. The initial start-up phase frequently involves the direct participation of affluent individuals, so-called business angels, who purchase an interest in the company using their own capital. Next, during the growth phase, venture capital firms – which, in turn, raise funds from wealthy individuals, pension funds, banks, major corporations and other investor groups – acquire stakes in the company. Their support is not limited to providing financing but extends to management consulting, forging ties with suppliers and clients, and organizing further rounds of financing. And finally, in the later stages, the growth stock markets offer venture capital-financed companies a further opportunity to attract infusions of new capital.

The special feature of venture capital funding and the issuance of shares on a growth stock exchange is that the financers themselves provide the equity capital. Unlike assuming a loan, equity capital involves no repayment obligation for the company. In the event of bankruptcy, the company which received the financing is not required to pay interest charges on, nor is it liable for the capital invested by business angels, venture capital firms or private investors. This is the reason why, the lofty return rate expectations of investors notwithstanding, allegations of usurious interest miss their mark.

The risk assumed by venture capital investors consists of having to write off their entire investment in the event that a company fails. In contrast to lenders, who may expect at least partial satisfaction of their claims in the event of a bankruptcy, the venture capitalist’s claims are satisfied last. Meanwhile, the attraction is that an investment can only be lost once.

At the same time it holds out the promise of tenfold, hundredfold, or even thousand fold gains in those extremely rare, exceptional cases like the eBay deal financed by Benchmark Capital. Contrary to banks which derive their profits from interest on loans, the earnings of venture capitalists are based on the difference between the purchase price and the sale price of their stake in a company. Even if every single company in a venture capitalist's portfolio isn't a run-away success, substantial average returns are entirely within the realm of possibility.

Ideally, venture capital investments can yield annual returns in the 40 – 50 percent range or higher, even over the longer haul, surpassing by far the profits banks earn from interest income. Success stories circulate about venture capitalists who increased the total value of their investment tenfold in just a few years by getting in on the ground floor. In the 1960s venture capitalists Thomas Davis and Arthur Rock raised $5 million from wealthy private investors for their first pool. Among other companies, they invested $300,000 in Scientific Data Systems, a young company that manufactured mini-computers. When the company was sold to Xerox for just under $1 billion in 1968, $60 million alone wound up in Davis & Rock's fund. Not least due to this success, the fund was able to pay investors returns more than 20 times greater than their original investment. The first fund managed by Gene Kleiner and Tom Perkins consisted of $8 million. Seven of the 17 companies Kleiner and Perkins backed were flops, but two early investments in particular, computer manufacturer Tandem and bio-tech company Genentech, increased the fund's value to $400 million over ten years. Even after deducting management fees and the profits of the venture capitalists, investors earned an annual return of 47 percent.[4]

[4] Cf. Wilson 1985, 36ff and 69; Kaplan 1999, 198.

One thing must not be overlooked, however: annual returns of 40, 50 percent or more number among the great exceptions in the venture capital business. Venture capital pundits William D. Bygrave and Jeffry A. Timmons point out that annual return success stories à la Davis & Rock and Kleiner & Perkins have a rather folkloristic, anecdotal character, and that venture capital firms achieve annual returns of this magnitude only during runaway bull markets. Venture capital funds strive to achieve a minimum annual return on investment of 20 percent. Frequently, the effective annual return ranges only between 10 and 20 percent, which is still a substantially higher yield than long-term investors receive from certificates of deposit, fixed-interest bearing securities or equity mutual funds.[5]

((U3))The Exit Orientation

Venture capital is not an open-ended investment in terms of time. For a business angel, a venture capital firm or an investor on a growth stock exchange the idea is to invest in the growth of a young company and then to unload one's stake when the company achieves sufficient size and credibility. Venture capitalists "exit" either when the company is taken public, when its shares are sold to another company, or – in very rare cases – when the shares are sold back to the company's founders. In short, venture capitalists acquire a stake in a young company, or even just an idea for a company, support the undertaking for several years

[5] Cf. Bygrave and Timmons 1992, 20ff and 153ff; see also Sahlman 1990, 483; Barry 1994, 6; Bhidé 2000, 162. On annual returns on European venture capital funds see OECD 1996, 32.

with money and through word and deed, and then sell their shares for the highest possible exit-profit.

Consequently, venture capitalists plan an investment in a growth company with an eye on its outcome. From inception the “harvest concept” plays a key role in planning investments, because venture capitalists can only get their money’s worth if a lucrative exit opportunity presents itself. The earnings of venture capitalists are not based on dividends paid from a firm’s operating profit. Rather, they derive from the difference between the price of acquiring a stake in a company and the price others are later willing to pay to purchase that stake. Thus, venture capitalists have no alternative but to gear their investments to very early exit.

Venture capital firms make no secret of their exit-oriented calculations. In Silicon Valley venture capitalists claim that their relationships with the companies they finance generally last longer than the average California marriage – and are similarly intense and conflict-laden. But while marriages, even in California, have at least a theoretical chance of lasting several decades, the same does not apply to venture capitalists. They present themselves to their companies as a “live-in lover” who will indeed stand by “their” companies for several years, but have no intention of staying with the same partner “until death do them part.” Companies which sell shares to venture capital firms are informed that the shares will be unloaded once again as soon as a lucrative opportunity presents itself. This explains why contracts between venture capitalists and their companies often reserve the right of the financers to launch an IPO or put the company on the block even in the face of opposition from its founders.[6]

The length of time after which venture capitalists attempt to exit their positions in a company varies. Whereas they reckon with holding investments in high-tech companies, software developers and bio-tech firms for a period of three to seven years before they can cash out, two to three years seems (better said, seemed) realistic for Internet companies. Although the average life span of an investment may be several years, boom times repeatedly produce isolated “perfect examples” where venture capitalists can unload their shares after an extremely short length of time. The often-quoted, illustrious figures of the venture capital scene occasionally do land deals like computer maker Atari, e-mail service provider Hotmail or online auction house Alando. The venture capitalists who acquired a $2 million dollar stake in Atari in the summer of 1975, were able to pocket quadruple that amount from buyer Warner Communications only one year later. In 1996 the venture capital firm of Draper Fisher Jurvetson invested $300,000 for a 15 percent stake of then newly-founded Internet company Hotmail and quadrupled this sum just under three years later, when Microsoft acquired Hotmail for $425 million in its own stock. Only nine months after the Alando company was established, venture capitalists and company founders succeeded in selling it to competitor eBay for $48 million. According to Robert Bauer of Foodstep personnel

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[6] On the influence of venture capitalists on the exit see Lerner 1994; Gompers 1995; see Hellmann 2000, 280 for the marriage simile in venture capital financing.

consultants this translated to a nine-month return of just over 2,000 percent for Wellington Partner Venture Capital.[7]

It is virtually unthinkable that a venture capital firm would finance a company for longer than seven or eight years. After ten years at the most, the investors who back the venture capital fund want a balance drawn so they can evaluate the fund’s performance and take profits. Companies for which no promising outlook develops over this period are therefore cut off. The companies venture capitalists call “zombies,” the ones where performance has been only mediocre, are liquidated and any excess cash is distributed among shareholders.[8] In the final analysis, no company escapes the law of the exit.

((U3))Risk Diversification and Growth Pressure

To ensure the success of their exit-oriented strategies, venture capitalists rely on diversification. As a rule, a venture capital firm assumes that a mere 10-20 percent of the all the companies in which it acquires an early stake will yield a tenfold or hundredfold return on the dollar. Venture capitalists emphasize almost monotonously that of any ten companies, only one or two will turn out to be “high flyers” and lead to a highly lucrative IPO or a very profitable buy-out by another company. In the case of three, four, or perhaps even five of the

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[7] Concerning Atari see Wilson 1985, 63; for Hotmail see Harmon 1999, 27. Bauer is an anonymized interview partner.

[8] Cf. Gompers and Lerner 1999, 19; Bhidé 2000, 145; Tykvová 2001a:, 25; concerning the length of time between entry and exit see Fried and Hisrich 1994, 31.

companies one can hope to cash out with somewhat decent returns or at least to break even. And the remaining companies will have to be written off, because they wind up either merely treading water or failing. David Rosenstein of International Incubators observes that out of ten companies two or three will definitely fail, but generally one or two will really take off. The others are what venture capitalists call the "living dead," companies that aren't doing poorly but are simply difficult to unload. The "10-baggers" or "100-baggers," i.e. firms where venture capitalists achieve tenfold or hundredfold returns, compensate for the companies which are total losses.[9]

The history of venture capital financing is full of successful examples of this kind of risk diversification. An investment in Apple Computer during an early stage produced in excess of a hundredfold return for venture capital investors Venrock Associates, after Apple was taken public. This investment alone compensated for all of the losers in Venrock's portfolio. The IPO of bio-tech company Genentech brought venture capitalists Kleiner Perkins Caufield & Byers returns far exceeding a hundred to one, which allowed this venture capital fund to pay investors handsome dividends even after all of its other companies declared bankruptcy. But even the modest investment by California venture capital firm Sequoia Capital ($1 million for 25 percent of the company) in the start-up phase of

[9] Rosenstein is an anonymized interview partner. Concerning the early stages see, for example, Wilson 1985, 26f; Clark 1987, 9. A study dating from 1988 demonstrates, for example, that out of 383 investments made by 13 venture capitalists between 1969 and 1985, over 33 percent ended in a total loss of the investment. The 6.8 percent which were "10-Baggers" in the venture capitalists' portfolios accounted for nearly 50 percent of the total value of all companies. See Sahlmann 1990: 483.

Yahoo.com, peaked at nearly $10 billion and would have been capable of more than canceling out all the flops in the company's portfolio by itself.[10]

The calculations of venture capitalists resemble those of major Hollywood producers who follow the motto of James Tobin, Nobel Laureate in Economics; instead of "putting all of their eggs in one basket," they divide up the eggs among several baskets in order to diversify risk. Many films, such as the Kevin Costner "Waterworld" debacle, John Travolta's megaflop "Battlefield Earth" or the flop Western "Heaven's Gate," for example, disappear from the cinemas after only weeks. The producers are forced to post their million dollar investments as losses. But time and time again Hollywood producers turn out box office hits like "Titanic," "Star Wars," "Jurassic Park" or "Harry Potter." The earnings from these releases exceed production costs many times over and compensate for the losses incurred on the flops.

The sale of shares in one or two "star companies" is enough to achieve the desired overall return on investment of 25 – 30 percent. How does that compute? Venture capitalists invest only in companies they hope to be able to sell for a high multiple of their entry price. Here, too, the venture capitalist's arithmetic resembles that of film producers who – due to the high flop rate of cinema productions – must bank on every film they finance having at least the theoretical potential to gross ten times its production costs.

These calculations result in the high growth expectations placed on venture capital-financed companies. Venture capitalists strive not merely to double or triple their investments, but if possible to increase them tenfold. This puts their companies under pressure to grow so

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[10] Regarding Venrock see Malone 1985: 290 and Kunze 1990: 71; on Kleiner Perkins see Wilson 1985: 10; on Sequoia Capital see Ferris 2000: 63 and Kaplan 1999: 312.

rapidly and aggressively in only a few years that their value in the capital market, at least theoretically, could be ten times greater than the venture capitalists' entry price. From this perspective it is more important for a company to assume the risks of such rapid growth, rather than to trundle along as a profitable company with stagnant growth.

((U2))2. From Risk Capitalism to Exit Capitalism

There is nothing new about the logic behind venture capital financing. Only a short time after the Spanish throne had contributed substantially to underwriting the "discovery" of America by Christopher Columbus, a wide circle of private merchants had already become involved in financing expeditions to the New World. When Sebastian Cabot organized an America expedition in 1504, it was no longer primarily the Royal treasury that stepped in with "venture capital." Rather, backing was provided by merchants de Haro in Spain as well as the German houses of Fugger and Welser, who envisaged manifold returns on their investments. Even in the charter of the Hudson Bay Company, the world's oldest stock company, shareholders were already called "venturers." At the annual meeting of this Anglo-Canadian shareholder company founded in 1670, the president would traditionally open the proceedings with the words, "Gentlemen Adventurers."

The calculations of a British, Dutch, or Venetian investor who backed a ship for an expedition the Far East in the late 16th or early 17th century bore a strong resemblance to the calculations of a modern venture capitalist who finances companies in the computer industry, biotechnology or fiber optics. Innovations in sailing ships and navigation techniques enticed merchants in the 16th and 17th centuries to advance into new regions. Technical innovations notwithstanding, they did not assume that all of the ships they equipped would return home with holds brimming. But when a ship did accomplish its purchasing mission successfully and managed to return safely, the merchants expected that the nutmeg, peppercorns and cloves bought in Asia would return greater than tenfold profits. Only by investing in a multitude of expeditions could an investor sufficiently diversify his risk. It was in conjunction with intercontinental merchant shipping that the term “risk” first appeared. The loss of a ship was no longer viewed primarily as an act of God or an uncontrollable stroke of fate, but as a regrettable consequence of one’s own (risky) investment decisions.

During the construction of the U.S. railroad system in the 19th century a network of wealthy individuals also played an important role. They backed such high-risk projects as laying track between two cities, which virtually no bank was willing to finance. Like modern venture capitalists, the “Yankee Financiers” speculated that they would be able to cash out of the company shares they held with a high exit profit on the stock exchanges.[11]

This “mythical” lore often plays an important role in lectures, articles and books by venture capitalists, but we must not allow it to divert our attention from recognizing that only the emergence of venture capital financing as a “field of its own” after the Second World War led to exit-capitalism.

((U3))The Momentous Difference between Wealthy Private Investors and Venture Capital Firms

[11] Cf. Chandler 1954; Porter and Livesay 1971.

General Georges F. Doriot, a professor at Harvard Business School, is generally recognized as the “father of the modern venture capital industry.” After the end of the Second World War, Doriot, together with Karl Copton, president of the Massachusetts Institute of Technology, and several other Boston businessmen founded the American Research & Development Corporation. The company’s goal was the commercial exploitation of technologies developed during the War. Well-nigh half of the profits in the 26-year history of this early venture capital firm stemmed from a 1957 investment of $70,000 in the Digital Equipment Corporation. By 1971 the value of the company had risen to $355 million.[12]

If Doriot was the “father” of the modern venture capital industry, then New York investment banker Arthur Rock was probably the “co-progenitor” who spread the venture capital concept to the western United States. In 1957 Arthur Rock, who had just turned 31, arranged the venture capital necessary for a group of eight engineers to leave the Shockley Semiconductor Laboratory and start their own company. The $1.5 million in start-up financing were provided by Shermann Fairchild, who had made a fortune in the photo and aircraft industries. The eponymous Fairchild Semiconductor Corporation would soon become a market leader in the semiconductor industry and the prototype of a venture capital-financed enterprise. Rock took his early investment successes as an inducement to move to California and launch some of the first small venture capital pools.[13]

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[12] Regarding the father metaphor see Schilit 1991, 28; Gompers 1992, 4. For the history of ARD see Pfirrmann, Wupperfeld and Lerner 1997, 22; Ferris 2000, 85; Southwick 2001, 45.

[13] For the importance of Arthur Rock see Cringely 1992, 37; Gompers 1992, 6; Kaplan 1999, 50f.

What was the key difference between the investments of the American Research & Development Corporation or Arthur Rock and partners and “classic” venture capital financing?

Until well into the 1950s venture capital financing was almost exclusively the domain of private investors or a loosely organized network of individuals who pooled their resources for the purpose of investing in a company. Due not least to the activities of American Research & Development and Arthur Rock and partners, such ad-hoc financing on a deal-by-deal basis gradually began to take the form of financing through the subscription of funds intended for the longer term. The venture capital firms which began to emerge on a larger scale beginning in the 1960s, no longer solicited capital from individual investors to finance a single company. Instead, they raised funds in which banks, insurance companies, pension funds and foundations, as well as private investors could participate. The life span of such funds was generally limited to ten years. Limited “partnerships” were created between venture capital firms and the investors in their funds. The exact amount the investors had contributed was specified, as well as the manner in which proceeds from the investments would be distributed and which investment guidelines would govern the fund’s investment practices.[14]

The early brokers of the venture capital business who brought together investors and companies for concrete deals – in which they also invested their own money to some degree –

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[14] Cf. the detailed account by Florida and Kenney 1990, 63ff; Bygrave and Timmons 1992, 1ff; Fenn, Liang and Prowse 1995,7. On the role of private individuals who, as of the Second World War, began concentrating their venture capital investments in their own small firms, see Perez 1986, 40. The limited partnership model became increasingly popular. Whereas 40 percent of the U.S. venture capital pools were organized as limited partnerships in 1980, by 1998 the percentage had risen to 80. (cf. Gompers and Lerner 2000, 285; see also OECD 1986, 25). The investors are the limited partners, and the venture capital firms are the general partners. In general, see also Bhidé 2000, 144f.

were replaced by corporations, which gained a greater degree of autonomy vis-à-vis their own investors through the formation of funds. The venture capital firms were able to use the monies in their funds to finance young companies, more or less independently of their own investors. Their only obligation lay in reassuring the banks, insurance companies, pension funds, foundations and private investors who had made longer-term investments in the funds that their money was in good hands and in the process of growing copiously. This took place at annual conferences and through interim reports.

Only the institutionalization of the venture capital industry brought about by the regular subscription of funds, the formation of venture capital companies and the emergence of venture capitalism as a “profession” transformed “venture capitalism” into “exit capitalism.”

Especially the relationship between venture capitalists and company founders changed considerably through the increasing availability of venture capital funds. In the days of informal venture capital financing, company founders frequently trudged from one wealthy individual to the next, like supplicants. But with the institutionalization of venture capital firms and funds, the founders began to encounter financers who had to “get rid of” their money.

Wealthy individuals could still make investing in young companies contingent on the presence of an opportunity. If new no investment opportunities in start-ups presented themselves over a period of years, the individuals simply bought stock in established corporations like Ford or Bayer, or invested in commodities or real estate. Venture capital firms can no longer operate in this fashion. A venture capital firm cannot transfer monies back and forth at will between its investments in young companies, stock packages, government bonds and, say, certificates of deposit. It is “forced” to put its money into young companies.

The institutionalization of venture capital financing suddenly brought young companies face to face with investors who were actively “seeking” the opportunity to back them and were simply not in a position to elect other investment options.

((U3))The Growing Importance of Venture Capital Financing

During the 1960s and ‘70s venture capital played only a minor role in financing the emergence of new technology companies. In the late 1970s, however, venture capital financing exploded first in the USA, followed by Israel and, after a slight lag, by Europe and Asia. The charts depicting the amounts venture capitalists raised from banks, insurance companies, pension funds, foundations and private investors reflect exponential growth beginning in the late 1970s. In the industrialized nations, the percentage of venture capital-financed investments has increased more than tenfold over the last several years alone. At the height of the Internet boom U.S. venture capital firms alone raised $100 billion from investors, more than during the entire previous period of institutionalized venture capital financing from the late 1960s through the mid-1990s. And even though investment in venture capital funds plummeted in the aftermath of the bubble, it still remained at a level many times greater than ten years before.[15]

[15] For developements in the USA see in particular the information contained in the PricewaterhouseCoopers/Venture Economics/National Venture Capital Association Money Tree Survey 2002; see also Gompers and Lener 1999, 7; Mandel 2000, 46; Southwick 2001, 24. For the drop-off in investements following the Internet boom see Mandel 2001, 121; Feng et al. 2001, 16. The calculations pertain exclusively to

In the meantime, applied research and development are financed to a substantial degree by venture capital. Whereas in the 1980s U.S. companies financed research and development almost exclusively from their operating profits or through credit, relying on venture capital for a mere 3 percent, by the end of the 1990s the share carried by venture capital had risen to one third.[16]

What accounts for such explosive growth? One principal reason for the increased importance of venture capital was the dynamic growth of the NASDAQ in the U.S. and the creation of growth stock exchanges in Europe and Asia. Founded in the early 1970s, the NASDAQ over the course of its existence increasingly developed into a global exchange for growth and technology stocks. Even growth companies from Israel, Germany and Japan strove to be listed on this exchange and to raise capital for their entrepreneurial activities. Over 5,000 companies are traded on the NASDAQ, more than half of which were financed with venture capital during the start-up phase.[17]

The NASDAQ served as a model for high-tech exchanges in Europe and Asia which were striving, more or less successfully, to establish themselves as capital markets for growth companies. In the 1990s the NASDAQ Europe and NASDAQ Japan were founded as offshoots of the successful U.S. model. NASDAQ Europe (formerly EASDAQ) was founded

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venture capital raised and distributed by venture capital firms. Venture capital financing by business angels, corporate venture capital funds or initial public offerings has not been not included.

[16] Cf. Mandel 2000, 46; Feng et al. 2001, 27. Financing of research and development through initial public offerings by growth companies has not been included. The fugures are based on the 1999 Statistical Abstract of the United States, U.S.Census Bureau, Washington DC.

[17] Cf. Pfirrmann, Wupperfeld and Lerner 1997, 63ff; Gompers and Lerner 1998, 149; Jeng and Wells 2000.

under active participation of the European Venture Capital Association, with venture capitalists such as Ronald Cohen also contributing to the financing of the exchange. Venture capitalist Mosayoshi Son was the principal founder the NASDAQ Japan. His company, Softbank, is one of the most influential shareholders on this Asian growth company exchange. Of the additional exchanges founded in Europe – the German Neuer Markt, the French Nouveau Marché, the New Market in Brussels, the Dutch Nieuwe Markt in Amsterdam, the British Alternative Investment Market, and the Italian Nuovo Mercato – only some remained viable in the longer term.[18]

At first glance, the importance of stock exchanges lies in offering companies a further opportunity to raise venture capital at a later point in time. After raising seed money in the form of their own capital resources, soliciting funds from business angels and issuing shares to venture capitalists through an IPO, it is important for many companies to obtain additional funds at a later date to finance expansion.

Taking a closer look, the reason the exchanges play such a key role in the development of exit capitalism is because they offer early stakeholders an ideal opportunity to turn their shares into cash. An IPO offers an opportunity to trade shares within an officially sanctioned framework, not only for venture capital firms, which acquired their stake in a company early in the game, but also for the company founders, top executives and employees. Even companies like Microsoft, which achieved profitability so quickly that they had no need to raise venture capital in the stock market, conducted IPOs for this reason. The employees who

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[18] Concerning the NASDAQ Europe cf. Kay 2001; for the NASDAQ Japan cf. Bremmer and Kunii 2001, EB 28. Some of these exchanges (NASDAQ Japan, Neuer Markt etc.) closed their doors for business in the downswing following the Internet boom.

toil for their 10,000 shares while receiving meager salaries need to see some prospect of transforming their shares into cash. When a company has already been growing dynamically for three years, an executive might prefer having $1 million in cash over a 1 percent stake in the company. After all, the current owner of that little house in the country will generally expect to receive cash for it, not company shares that are difficult to negotiate.[19]

If stock exchanges for growth and technology companies did not exist, the only exit opportunities open to business angels, venture capital firms, company founders and employee shareholders would be to interest other investors in their stake, sell their shares to larger companies or offer them to management for a buy-back.[20] Not until the NASDAQ and the other more or less successful growth company exchanges were established, did an extremely lucrative variation on exiting companies emerge for venture capitalists. Simultaneously, this drove up the price of other exit opportunities.[21]

((U2))3. The "Democratization" of Venture Capital Financing

For many small investors the growth stock exchanges represent the first opportunity to try their hand as venture capitalists. Once a growth stock is listed on the exchange, a taxi driver, an economics student or a retiree can acquire shares of a company like Amazon, eBay or Intershop with a few mouse clicks or by calling a broker.

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[19] On Microsoft see Cringely 1992, 268.

[20] Cf. Bygrave and Timmons 1992 for a discussion of the NASDAQ.

[21] Various studies call attention to the great influence which opportunities to go public exert on the availability of venture capital.(as an example, cf. Jeng and Wells 2000; Gompers 1998).

Investing in companies traded on growth exchanges becomes especially attractive during periods of excess. Books are published explaining the road to riches and claiming to smooth the path to your "first million." Your colleagues report that, due to the excellent connections of their brokers, they were able to participate in the IPO of, say, the Red Hat software development corporation or chip manufacturer Infineon. The price of their shares more than doubled in just a few days. Friends install little screens on their computers that display real-time quotes for companies like Cisco, Lucent or eBay and announce that their stock portfolios are up 100 percent in only ten weeks. Your own mother or your children nag you about the returns on government bonds and make the case that the family should be buying growth stocks or at least shares in a growth mutual fund. The result is what "the pros" might derisively call a "small-fry bull market." where even microinvestors start trading speculative stocks.

But even a roaring bull market cannot conceal that these investors are at the very bottom of the venture capital food chain. Before Joe or Jane Public can start rejoicing over 30 percent gains on their Intel stock, numerous other investors have already cashed out before them. The founders – and those who supported them during the start-up stage – have seen the value of their stock packages in such success companies appreciate dramatically. The business angel and venture capital firm with a 10 or 20 percent stake in the company have often already reaped greater than tenfold returns. The funds, banks and major insurance companies have secured their shares before the IPO and generally also succeed in unloading them.

A glance at the enormous profits of the venture capitalists who invested during the start-up phase makes it understandable why small investors, who have previously only experimented with venture capital speculation on growth stock exchanges, now feel the lure of participating in various other phases of the investment cycle. It might be inappropriate to speak of a large scale conversion of conservatively oriented share holders, savings depositors and T-Bill owners into venture capitalists. But especially during boom times we can observe that in particular sectors small investors incline toward riskier investments and tend to adopt a venture capital mentality. Under battle cries such as the "democratization of venture capital financing" such small market players are offered instruments which allow them to participate in all stages of venture capital financing.

((U3))The Seed Stage: Investments by Friends, Family and Fools

In the early stages of a company's founding, the so-called seed stage, the founder will frequently provide the start-up capital (for example, $100,000) from his or her own savings, from the sale of a previous company, or from gains on speculative investments. But even at this early stage, it is not uncommon to see the beginnings of as yet informal "venture capitalist" participation. The aspiring entrepreneur approaches the so-called "3Fs" (family, friends and fools) as the unofficial providers of venture capital are known on the scene.

Often there are no formal agreements governing such initial venture capital investments. Sometimes friends and relatives provide this so-called "love money" without even knowing whether they have acquired a stake in the company, whether they have made a loan to the entrepreneur or whether the transaction was actually a present in disguise under the maxim, "make something come of it."

During times when the media publicize successful growth stories, entrepreneurs frequently encounter little difficulty raising this first infusion of cash. Putting out the word that one would “like to do something with the Internet,” has an idea for “a radically new hardware component,” or is thinking about launching a service that would reach an entirely new market sector is enough to arouse interest in the appropriate circles. Entrepreneurship has a certain sex-appeal, and when a company founder exudes promise, people come forward who would very much like to participate in the early stages of the company as “family,” ”friend” or “fool.”

((U3))Business Angels, “Incubators” and Small-Scale Venture Capitalists

Company founders who do not have sufficient equity of their own, can – after exhausting their informal sources of venture capital – approach business angels or business incubators in the second stage of the founding process. These investors may make a sum of, say, $500,000 available in return for a 10-20 percent stake in the company.

Business angels are frequently former entrepreneurs themselves, or top executives from major corporations who prefer venture capitalism over depositing their money in a bank or investing in stocks or bonds. They provide the entrepreneur with capital, draw on their network of former business associates to assist the company, or offer counsel and support.

The alternative to business angels are so-called business incubators – where young entrepreneurs are “hatched.” Such incubators, like Techfarm, Divine, Idealab and Garage.com in the USA, Ideas Hub and Jellyworks in Great Britain, Elevator7 in Switzerland or BainLab, Speed Venture, VentureLab or Webmedia in Germany, offer complete support services for entrepreneurs who have promising business concepts. They provide office space, computers and telephone lines as well as a network of contacts and modest amounts of start-up capital, for which they frequently demand a considerable share of the business in return.[22]

The market gap which business angels and incubators exploit involves a stage during the founding of a company when the founder and his friends and relatives can no longer supply large enough amounts of money, while the company itself is still too small to warrant a comprehensive review by a venture capital firm. The investment of “smart money” by business angels and incubators is intended to enable companies to develop a product very quickly, thereby removing any major obstacles on the path to subsequent rounds of financing. It is an important step when a business angel or incubator signs on, because as of this time – if not earlier – the founder no longer controls all of his or her company’s shares and cedes a voice in decision-making to outside financers and their exit-oriented reasoning.

Especially in boom times, becoming active as a business angel or incubator offers private investors an attractive opportunity to enter the venture capital business. The involvement of a multi-million dollar venture capital fund is not required, and private investors can rely solely on their modest personal wealth, their good advice and their contacts to gain companies for their “portfolios” at a very early stage.

((U3))The Growth and Expansion Stage: Enter the Venture Capital Firms

[22] Cf. Kozmetsky, Gill and Smilor 1985, 61; Schilit 1991, 75.

When a business idea proves to be promising, additional venture capital firms become involved in the third stage, at the $2-$3 million level, for example, for which they receive an additional 10 – 20 percent of the company from the founder. This infusion is used to finance a multi-year expansion phase during which the company readies its product for the market and develops market share. The object is to grow the company large enough that either an IPO can be attempted, the company can be sold to a major competitor, or a management buy-back can be taken under consideration.

Since this stage involves more than five or even six figure amounts, but millions of dollars, it is generally out of reach for private investors. The venture capital firms solicit capital from pension funds, banks, insurance companies and foundations and don't bother approaching micro-investors. For many years the only possibilities open to small investors were to buy stock either in the few publicly traded venture capital firms or to participate in the private investor pools launched by investment banks, which diversified their investments across different venture capital funds.

However, based not least on reports of the enormous returns achieved by some venture capital funds, small investors grow eager to participate in the very early stages of venture capital financing. In the meantime, a number of companies begin to offer investors the option of participating as "mini-venture capitalists" in very early stages of company growth.

For example, the products offered by companies such as meVC in the USA, VCH Best-of-VC in Germany, Private Equity Holding AG in Switzerland or Private Equity Performance AG in Austria, are directed at risk-loving small shareholders who are fed up with being able to acquire stock in a company only when it goes public. These firms claim that they are "democratizing" the venture capital scene and offering people with modest incomes an opportunity to invest in young growth companies. In turn, they put the small investor's money either directly into growth companies or invest it indirectly through participation in the funds of other venture capital firms. At meVC, the most prominent – and certainly the most controversial – venture capital fund for small investors, a minimum investment of $1,000 buys shares in a fund raised by meVC jointly with venture capital firm Draper Fisher Jurvetson. The fund in turn invested the $300 million raised in this fashion in 30 – 50 young companies.[23]

Within this context, transferring the concept of "democratization" from the political to the economic arena is little more than an advertising gimmick. Ultimately, the only issue at stake is that small investors are now able to participate in venture capital financing at stages from which they were previous barred.

((U3))The Shareholders' Exit Logic

When, in the fourth stage of venture capital financing, a company is taken public, it is frequently required to sell 20 – 25 percent of its shares. These shares are then traded by the public. An IPO on Wall Street, the NASDAQ or comparable European and Asian stock markets is considered the "royal road" and is celebrated as an "homage to successful ideas." On average, fewer than a third of the companies in a venture capital fund take this route. The

[23] Cf. Clifford 2000.

ones that do take it produce above-average profits, however, and account for a major portion of a venture capital fund's income.[24]

On the surface, the rules of the game for a shareholder of a listed corporation differ significantly from those for business angels, incubators and venture capital firms. The shareholder enters the game at a stage where risk is often disproportionately less than for companies which are as yet unlisted on an exchange. In general, listed companies already have a marketable product and already have net positive income – as opposed to many of the enterprises backed by business angels, incubators and venture capital firms.

In contrast to business angels, incubators and venture capital firms, a shareholder needn't tie up "a lot of money." In principle, even the smallest of shareholders could raid a piggy bank, buy a share or two of some company for €20 or €30 and thereby qualify as a micro-venture capitalist. For shareholders, buying and selling stock is far easier than for true venture capitalists, who can only buy and sell stakes in as yet unlisted companies through complex legal transactions.

Small shareholders are also not directly involved with managing a company. When business angels, incubators and venture capital firms purchase a stake, they also acquire the right to exert an active influence on the company's strategic orientation through the board of directors, support company efforts to tap new groups of customers, participate in the strategic reorientation of the company, and spin the company's employee carousel. Involvement at this level is generally not expected of most small shareholders and would indeed probably be perceived as meddlesome.

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[24] Cf. Gompers and Lerner 1999, 6.

On a somewhat deeper level, however, similarities do exist between early venture capital financers and shareholders on growth company exchanges. In the final analysis even small investors – exactly like the institutional funds which acquire shares in growth companies through an IPO – are venture capital investors. Both have high hopes of achieving exceptional returns in exchange for investing in a risky undertaking. Frank Schon, managing partner of venture capital firm Goal Venture, leaves no doubt that especially in boom times small shareholders and institutional funds alike enjoy playing “venture capitalist” in the stock market..[25]

Shareholders in exchange-listed growth companies are also generally uninterested in receiving stock dividends. When people buy shares in growth companies such as Amazon, eBay or EMTV, or even Cisco, Microsoft or Novell, many times their primary objective is not to hold the stock in their portfolios long-term and collect annual dividends. Stock in growth companies like Amazon or eBay is typically held for a few days at the most, whereas market leaders such as General Motors or Coca-Cola remain in shareholders’ portfolios for an average of two years. Exit-oriented shareholders, much like business angels or venture capitalists, speculate that the value of their shares will increase and they will be able to unwind their positions in the market at the appropriate time.

In these cases as well, shareholders are not content with annual returns of 2 or 3 percent. They set their sights on potential returns of 20-30 percent because of the high-risk nature of the investments. Similar to venture capital firms, shareholders also diversify their risk by acquiring stock in a number of different companies. Even if their portfolio contains a

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[25] Schon is an anonymized source.

high-profile flop like multimedia agency Kabel New Media or online grocer Webvan, they can still achieve their targeted returns if the stock of their other companies doubles or triples.

As with business angels and venture capital firms, the investment logic of shareholders on growth company stock exchanges consists of skillfully constructed entries and exits. For the venture capitalist exiting an investment represents a highly sensitive situation entailing intensive negotiations with the buyers of the company, investment banks and funds. For a shareholder in an exchange listed company, however, it implies no more than a few mouse clicks on a brokerage company web page or a telephone call to a company representative.

((U3))The Revolving Door

Every time a new venture capitalist enters the market, it presents a lucrative exit opportunity – in theory, at least – for a different venture capitalist who entered at an early stage of the game. Friends and relatives who financed the company in its infancy can now transfer their shares to a business angel or an incubator, who in turn subsequently has an opportunity to sell part of his or her stake if a venture capital firm decides to make a major financial commitment. If the company is taken public, early venture capital investors can offer their holdings directly on the exchange, or they can sell them to institutional investors.

During the early rounds of financing, however, new investors become wary if their decision to back a company is used by even earlier investors as an opportunity to head for the door. They ask themselves why the earlier investors are not staying on board, motivated – as they are – by the prospect of further company growth. For this reason, during the early stages old and new investors reach an agreement that the previous backers of the company will remain in possession of their shares or even increase their positions. Individuals who participate in IPOs are required to hold their shares for a period of six months or a year so that they cannot enrich themselves immediately to the detriment of the institutional and private investors who acquire positions through the IPO.

Once a corporation is listed on the exchange and the lock-up period for the early venture capital investors has expired, company shares can be traded freely. Venture capitalists who acquired stock in a company during the IPO can immediately re-sell their shares once the company has traded for a few minutes on the exchange. The person who buys the stock of the venture capitalists, in turn, also has the option of re-selling it immediately to the next party. In extreme cases, only a few seconds separate entry and exit.

The factors which contribute to accelerating entries and exits from venture capital investments are the “democratization” of the venture capital industry in the form of early investments by private investors, the involvement of business angels or incubators beginning with investments in the mid-five figure range, the participation of Joe Public in venture capital firms such as meVC and, finally, risky investment strategies following IPOs. The greater the number of investors involved as buyers and sellers in the venture capital market, the easier it becomes to exit a position and the faster entries and exits begin to spiral.

((U1))II

((U1))Founders, Managers and Employees as Venture Capitalists

"We live in an era of greed; no one troubles himself about the intrinsic value of a thing if he can only make a profit on it by selling it to somebody else; so he passes it on to his neighbor. The shareholder that thinks he sees a chance of making money is just as covetous as the founder who offers him the opportunity of making it."

Honoré de Balzac in his novella, "The Firm of Nucingne," published in 1839

If it weren't for the exit orientation, the venture capitalist's equation wouldn't balance – regardless of whether it involves a business angel, a venture capital firm or a shareholder on a growth company exchange. Only by seizing lucrative opportunities to exit an investment as they arise, can a venture capitalist turn a sufficient profit to keep his business running and begin delivering returns for investors after only three or four years.

It might suggest itself at this point to limit our remarks about capital market, exit and risk orientation to venture capitalists and to ascribe a fundamentally different logic to company founders, top executives and the employees of venture capital-financed companies. But all of the people associated with a growth company (potentially) play the role of equity holders in addition to their actual functions within the enterprise. At the very beginning company founders frequently own a larger number of shares than the venture capitalists, and during the initial growth stage the founders are – at least nominally – in charge. Top executives allow themselves to be lured into working for a growth company through equity participation, not uncommonly in the amount of several percent. The prospect of receiving company shares is used to "motivate" the employees of growth companies – or they are paid directly in company stock.

This chapter will elaborate the way ownership of company shares transforms founders, managers and employees, each in their own way, into "minor" (or "major") venture capitalists for the company concerned. Even if they usually don't acquire their share of the company through a monetary investment, in contrast to true venture capitalists, but through their labor, they adopt – to some extent at least – the venture capitalist exit logic.

((U2))1. The Spread of Exit Logic

The "classical" concept of company founders pictures them as people who launch only one business over the course of a lifetime, slowly building it up and financing it through company-generated profit. Then, as their lives draw to a close, they pass the company to a son or daughter. This notion includes the assumption that the founder is simultaneously also best-suited to lead the company as it passes through various stages of growth. In venture capital circles, the case of inventor Thomas A. Edison is cited as proof that this doesn't always hold true.

The example of the creator of the "phonograph", the "carbon filament lamp" and the "cinematograph" illustrates that the ambitions of an inventor and business founder also to become a “tycoon of industry” are not always crowned with success. Edison managed the company he founded so poorly that it soon stood on the edge of bankruptcy, and Edison himself had to be removed.

Entrepreneurs such as Compaq founder Rod Canion, Cisco founders Leonard Bosak and Sandy Lerner, and the founder of Autodesk software corporation, John Walker, are often cited as examples of the Edison-syndrome. Supposedly, they held on to their companies much too long and failed to recognize when it was time to pass the baton. Silicon Valley, according to the British business weekly, *The Economist*, is full of sad stories about founders who couldn’t find their way back out of their companies.[26]

Venture capital financing produced not only a new breed of founders, but also of executives and employees. They have different characteristics than “classical” founders, executives and employees. Their logic is different. Granted, those entering venture capital-financed companies with expectations of maintaining a life-long relationship can still be found, but the trend is increasingly shifting toward an succession of entries and exits from various “investments.”

((U3))The Serial Entrepreneur – A New Model for Business Founders

Although there is no question that the founders of some venture capital-financed companies envision themselves spending the rest of their careers managing “their” companies, exit-

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[26] Cf. *The Economist* 10.10.1999, 86.

capitalism follows a different star. The new founder culture in the USA, Europe and Asia extols the “serial entrepreneur” model, the individual who enters and exits entrepreneurship several times in succession. Peter Kirsch, marketing director for Informationhighway and consultant to companies which are financed with venture capital, notes that successfully building several companies is viewed on the founder scene as the mark of the true “aristocrat.” In capital market-oriented companies, Kirsch reports, founding three or four firms within 15 years is not taken as a sign of undependability but as proof of professionalism. Paradoxically, being a “company founder” has developed into its own mini-profession in which success is measured not in terms of founding a company and subsequently managing it “for the long run,” but in founding as many companies as possible.

To preclude any hint of the “Edison syndrome,” many founders signal early on that their business plan includes measures for their own departure. Martin Andersen, founder of online company SuperWebOffice, confesses that like many other founders on the Internet scene, he always kept an eye on his own exit strategy. His model was not Bill Gates, who spent 20 years building a company and will work there until he dies. Rather, his motto was: “five years” – then either take the company public, sell it or get other people on board. Rebecca Steinberg, co-founder of the Internet company, Netdollar, emphasizes that she already used the acronym IPO the first time she ever presented her business concept. Her idea of Internet-based payment systems sparked a lot of people’s imagination and had an impact on a staggering number of industries, which seemed to raise the possibility of launching an early IPO. At the time, she already realized clearly that she wouldn’t be holding on to her stake in the company forever, but would exit at some point.[27]

[27] Kirsch, Andersen and Steinberg are anonymized sources.

Both for the U.S. as well as the European founder scene, the paragon of a serial entrepreneur is Jim Clark. Clark's acclaim is based on three of the four companies he founded achieving a stock market value of over $1 billion. Clark first founded 3D chip developer Silicon Graphics and then built up browser maker Netscape. After taking Netscape public and selling most of its stock to America Online, Clark participated in setting up Healtheon, an Internet platform for conducting business with medical and hospital products. He then founded myCFO, an online company offering personalized financial management services for affluent clients.[28]

It is not uncommon for serial entrepreneurs to try to "turn a bigger deal" each time they establish a new company. Speaking at a founder convention, Swiss entrepreneur Peter C. Rudin reported that he sold his first company, a distributor of mini-computers he founded in 1957, after 14 years for a price in the single digit millions. In 1993 he established a second firm, MAC, a multimedia company which switched its focus from producing CD-ROMs to the Internet. Only four years later he sold MAC to Swisscom, a Swiss Internet Service Provider, for a two-digit million amount. He then had a disagreement with Swisscom and no longer wished (nor was permitted) to continue managing his company as an employee. So, in 1999, at the height of the Internet boom, he founded UPAQ, an online company which he was planning to take public after only two years for a three-digit million amount. The rhythm of ever shorter cycles between entry and exit as well as the increasingly higher returns from the

[28] Cf. Lewis 1999.

sale of the companies were viewed as signs of particular excellence and suggested that his fourth company could be sold after only one year for a price in the four digit million range.[29]

Even the bankruptcy of a company one owns does not qualify as a career obstacle for a serial entrepreneur. Adam Osborne, whose PC company, Osborne Computer, filed for bankruptcy with much commotion in 1984, received $2.2 million from his backers to start a new company less than a year later. Jerry Kaplan, whose hand-held computer company GO went under with great fanfare, encountered no appreciable difficulties subsequently obtaining financing for his online auction house, Onsale.com, from venture capitalists Kleiner Perkins. This was the same firm which had financed his first excursion into entrepreneurship and had seen millions go up in smoke. In the same vein, entrepreneur Ernst Malmsten, who bore responsibility for the first high-profile bankruptcy of an Internet company, continued to be viewed as finance-worthy by venture capitalists. Malmsten had first run a traditional publishing business with former fashion model Kajsa Leander and then created Bokus, one of the first Internet-based bookstores, before attempting to establish the first online fashion and sport apparel business with Boo.com. But even after Boo.com became the first high-profile Internet business forced to file for bankruptcy, venture capitalists expressed a continuing willingness to back Malmsten's new entrepreneurial initiatives. Ironically, he explained, it is easier for him to attract financing now than it was in the days of Boo.com.[30]

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[29] Cf. Bovensiepen 2000, 29. The third company was founded a year too late. Due to unfavorable conditions in the capital market, Rudin was not successful in taking UPAQ public as planned. He did not found a fourth company.

[30] Regarding Osborne see Perez 1986, 4; on Kaplan see Kaplan 1995; Harmon 1999, 38; on Malmsten see Malmsten, Portanger and Drazin 2001, 19.

The serial entrepreneur model demonstrates that company founders do not derive their profits from ongoing dividend payments. Rather, the payoff comes when they cash out of their company shares. Olaf Schmitz, an incubator at the venture capital firm of startup-jungle, observed that as a venture capitalist one is not interested in founders who have long-term plans to support themselves or base their livelihood on a company's annual profits. On the contrary, venture capitalists look for people who want to enrich themselves by making as much as possible on the sale of the company. According to Schmitz this produces professional founders who have the ability to make a company "IPO-ready" in a short amount of time.[31]

((U3))Executives – Quick Entries and Exits

One central requirement for rapidly expanding companies is to have the "right" executives in place for each stage of growth. Economists Thomas Hellmann and Manju Puri view such continuous adjustment to the evolving organizational needs of growth companies as the reason why venture capital-financed companies in Silicon Valley have twice the turnover rate for chairpeople as other corporations.[32]

Business writer Michael Mandel calls qualified, creative employees with entrepreneurial talent the decisive ingredient in the venture capital financing process. Executives should not be bound to an established corporation for the long haul, but should

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[31] Cf. Schmitz 2001.

[32] Cf. Hellmann and Puri 2001; see also Gorman and Sahlman 1989, 241.

represent a “mobile attack force” which moves in the direction of the companies and projects most readily capable of achieving the breakthrough.[33]

But how does one create such a disposition to change in executives? The rapid entries and exits of top managers are driven to a significant degree by stock packages and stock options. While executives earn up to 80 percent less in rapid growth, venture capital-financed companies than in established corporations, they are remunerated with a considerable number of company shares. After a company is taken public, high-echelon executives can quickly become multi-millionaires. The 2 – 10 percent stake a board member receives up front for joining a young company can already be worth several million dollars in a buy-out by another company.[34]

In the early 1980s, for example, company founder Adam Osborne used a stock package to lure top executive Robert Jaunich away from Chicago-based Consolidated Foods to Osborne Computer, his own deficit-ridden firm. Jaunich left behind an annual salary of $800,000 at Consolidated Foods for the prospect of making ten times that on the shares Adam Osborne had allotted him for Osborne Computer’s planned IPO. Much to Jaunich’s chagrin, Osborne Computer was forced to declare bankruptcy before the company went public. Two decades later Meg Whitman fared better. She was enticed away from her Old Economy corporation with a lucrative stock package and took the position of CEO at eBay. Just over a year later her stock package was worth a billion dollars – at least on paper.[35]

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[33] Cf. Mandel 2000, 31.

[34] In priciple cf. Sahlman 1990, 505ff.

[35] Regarding Jaunich cf. Malone 1985, 302; on Whitman cf. Byrnes and Judge 1999, 57 und Stross 2000, 216.

These are examples of top executives adopting the venture capitalist's exit logic. Cases where both financers and the company founder are intent on obtaining lucrative refinancing through the capital market in a short period of time call for a certain type of executive. Such managers must be available on short notice, work at top capacity for a short period and also be willing to leave the job quickly again, if the company can send a message to the capital market by replacing them.

((U3))The "Mercenaries" of Exit Capitalism: The Exit Logic of the Employees

It is difficult to say how great a chance "regular" employees in venture capital-financed companies have of becoming multi-millionaires through the shares or stock options assigned to them. There are stories about administrative assistants at Intel, Apple or Cisco, whose shares were suddenly worth several million dollars after the company went public, or the press officer at telecommunications corporation Mobilcom who became a millionaire at 27 thanks to exploding share prices (prior to the company's bankruptcy), or companies like software mill Siebel, where at times one third of the employees were millionaires based on the value of their stock packages. Such tales figure as important orientation points for employees in exit capitalism.[36]

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[36] Cf. Southwick 1999, 16; 175.

Companies can either pay their employees directly with company stock according to the motto “a thousand shares for a six month, total commitment in the marketing department,” or they can award so-called stock options. In young companies the stock options dangled before the eyes of employees are, in the final analysis, vague promises that the employees will obtain company stock in the foreseeable future at a very favorable price. Once the company is listed on an exchange, it can grant an employee the option of buying stock below the officially quoted price. If the stock appreciates considerably over two or three years, and the employee decides to exercise the option, the company will have made money for the employee. For example, if an employee receives options on 1,000 shares at a price of $25 per share in an IPO, and the price of the stock quadruples to $100 in two years, this means that the employee whose options were initially worth $25,000 now receives $100,000 for his or her stock.[37]

The increasing focus on the acquisition of shares in return for labor is clearly reflected in newly founded companies “reserving” ever-greater amounts of company stock for their employees. During the early days of institutionalized venture capital financing less than 10 percent of a company’s shares were generally set aside for employee stock grants. In the meantime the percentage has risen continuously. Ann Winblad of Hummer Winblad Venture Partners notes that “competition for talent” has caused the percentage of shares reserved for employees to increase to 20, sometimes even 25 percent since the early 1990s.[38]

The focus on acquiring shares causes high turnover among employees, just as it does among executives. Employees remain with a company as long as there is an increasing

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[37] Cf. Carberry and Weeden 1999, 249.

[38] Cf. Harmon 1999, 85; 116.

likelihood of receiving company shares, adding to their current holdings, or when they see the value of their positions appreciate. If they receive a more attractive offer from another company, they switch. The British business weekly, *The Economist,* observed that during the high-technology boom employees in Silicon Valley behaved like free agents, ever willing to switch jobs for more lucrative stock options. Jeffrey Pfeffer, a professor at Stanford University Business School, estimates that annual employee turnover in Silicon Valley ranges between 20-30 percent, which is significantly higher than most other industrial regions.[39]

This explains why a lack of company loyalty among employees was already viewed as a hallmark of Silicon Valley in the 1960s. The newly founded, venture capital-financed companies were located so close to firms established earlier that at the height of the PC boom Jerry Sanders, founder and president of Advanced Micro Devices, sarcastically remarked that any computer freak could change jobs without having to look for a new parking space.[40] At the height of the software boom in the 1990s a programmer at software mill Electronic Arts proclaimed that working for a company was very much like shopping in a store. If he didn't like the store, whatever the reason, he would simply move to the next where the prices were lower or the merchandise better. If you're not satisfied, changing jobs is the normal thing to do – it's just like shopping. If you start work as a programmer for one company on Monday, change to another company on Wednesday, only to discover on Friday that you don't like the

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[39] Cf. Pfeffer 2001; see also *The Economist* 1.30.999, 22; for estimates during the PC boom see Rogers and Larsen 1984, 87; for estimates during the Internet boom see Evans and Wurster 2000, 209.

[40] Cf. U.S. Congress Joint Economic Committee 1984, 80; see also Saxenian 1994, x; Kaplan 1999, 62.

job after all, then your new boss would be far from holding it against you on Monday or Tuesday of the following week.[41]

One exit strategy employees use consists of offering their services, either individually or as a team, to another company in return for commensurately better terms. In boom times teams of programmers at computer trade fairs such as Comdex in Las Vegas, Internet World in Los Angeles or Cebit in Hanover, Germany, roam from one stand to the next collecting offers which allow the entire crew to change jobs.[42] But switching from one company to another as a team is only one of the exit options open to employees. It is not uncommon for the exit mentality of employees to produce the seed from which new companies grow. Bob McSummit and Jo Martin, who authored one of the first studies on Silicon Valley, trace the impetus for young start-ups to the inspiration of individual employees to "take a handful of co-workers with them" when they leave the company. Even while they are still in the employ of one of the shooting stars in the venture capital firmament, individual employees or teams of workers are often already piecing together their own little start-ups, striking off on their own at the first good opportunity.[43]

Venture capital financing not only resulted in opportunities for employees, either individually or in teams, to switch jobs to competing companies. It had the additional effect of elevating the founding of one's own company – a venture capital-financed and therefore relatively risk-free alternative – to a commensurate level of prominence in the first place.

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[41] Cf.. McSummit and Martin 1990, 405f.

[42] Cf. Kerstetter 2000, 45.

[43] Cf. McSummit and Martin 1990, 406; a detailed analysis of such spin-offs in the hard drive industry can be found in Sahlman and Stevenson 1985, 18f.

((U3))Between Commitment and Exit: Exit Capitalism's Paradoxical Demands on Company Founders, Senior Management and Employees

What makes the ideal founder, the ideal executive or the optimal employee in a venture capital-financed enterprise? Under ideal circumstances, especially the founder and key executives will be able to draw on previous experience founding and growing several companies, although they will also be able to document their loyalty. When an entrepreneur or a top executive has no previous experience founding and growing companies, venture capitalists perceive this as a risk factor. But it's also seen as a risk factor when a founder inclines toward exiting companies too quickly.

The two requirements – experience in several companies, and loyalty – contradict each other. When venture capitalists seek the "ideal" employee for one of their companies, they find themselves in a dilemma similar to the personnel departments of established corporations during a search for high potential employees. On the one hand, high potential employees are expected to document a high degree of flexibility through an international academic background and a track record with a good number of different firms. On the other, they are must also reassure the recruiter that they will not bring their flexibility to bear in the specific job under consideration by taking advantage of the next best opportunity to switch companies.

Exit capitalism has produced its own service industry consisting of consultants, attorneys and academics who earn handsomely drafting contracts between venture capitalists, company founders, senior executives and employees. The object is to ensure that there are lucrative exit opportunities for everyone involved, while at the same time preventing the entire entity from imploding simply because a key player chooses to exit prematurely for purely egotistic reasons.

((U2))2. Worker-Capitalists: Beyond Dividends, Profit and Wages

The most important demographic development in our times according to Richard Nadler, Executive Director of the American Shareholder Association, is the rise of the first broad-based class of "worker-capitalists." Nadler uses this term to characterize employees who play the market as small shareholders themselves, make provisions for their old age through pension funds and have acquired a stake in the company they work for through employee stock plans. Many observers concur with Nadler that the divide between capitalists as "owners of the means of production" and those who are merely "unpropertied workers" is closing. Sociologist Ulrich Beck speaks of a "Capitalism without classes," in which the distinctions between investors on the one hand and employees on the other are blurring. Futurologist Matthias Horx observes that the "employee-culture" of the twentieth century is developing into a "petty capitalist society" where labor unions are losing ground and are increasingly replaced by a shareholder association. A type of people's capitalism is emerging, in which employee ownership of productive assets grows ever broader.[44]

Generalizing on experiences gained from growth companies is widespread. However, the dissolution of the configuration "here, owners of the means of production – there, mere unpropertied workers" is limited to certain sectors, and there is a tendency to portray it as a

[44] Cf. Nadler 1999; see also U.S. Congress Joint Economic Committee 2000, 2; cf. Beck 1986, 121ff; cf. Horx 2001, 60ff.

“megatrend” which applies to the entire economy or even society as a whole. Employees of the U.S. firm Callcenter, who have invested their retirement savings in a pension fund, presumably do not see themselves in the role of venture capitalist. The small shareholder who owns a few shares of Ford totaling $2,500 and makes the trip to Detroit for the general meeting of shareholders, is probably more interested in having a chance to see the chairman live, enjoying a little shareholder pampering and taking home a few promotional items, than influencing the auto-maker’s corporate strategy. The engineer who owns a handful of shares in his employer, say, General Electric, would probably not plead for his own termination so that the value of his stock package would appreciate.

In venture capital-financed companies, however, it’s a different situation. Here, we can observe clearly how investor logic and employee logic converge. The goal of the employees, of the founder or of senior management is to trade their labor for company stock, which can then be sold in the capital market at a lucrative price. Thus, founders, senior executives and employees – similar to venture capitalists – are not primarily interested in dividends which are paid out of ongoing business activities. Instead, the main objective is to increase the company’s value in the capital market, thereby creating an opportunity to cash out of one’s position with a high exit profit. A new type of employee is forming here, namely the worker-capitalist.

((U3))From the Intrapreneur, the Worker-Entrepreneur and the Ego Inc. to the Worker-Capitalist

Concepts like “intrapreneur,” “one-man (woman) corporation”, “worker entrepreneurs” or “Self, Inc.” reflect that the members of a firm do not view themselves as employees per se, but are functioning as “entrepreneurs within the company.” In management literature these terms are used to proclaim that one expects every employee to be entrepreneurial. The motto is now, “Reduce hierarchy! Make room to breathe! Promote self-organization!” After all, the logic runs, the purpose of a company is to accomplish something, not to leave things undone. For far too long, the “busybodies, bureaucrats and bean counters” have been ensuring that employees limit their activities to their specified job descriptions. The time has come, the management rhetoric runs, to throw out internal company “feudalism,” to ensure that employees no longer toil as vassals of their bosses but assume the role of independent entrepreneurial agents within the company itself. It is such “Ego, Inc.s” and “Me Corp.s” which make their “mobile competencies” available to a corporation only to switch jobs to a competitor when they are no longer satisfied with the price they are receiving for their efforts.[45]

This development is not as new as such modern concepts would make it appear. Ever since the abolition of serfdom and slavery, employees have had to develop and market their capacity to work like “entrepreneurs.” No later than the industrialization which began in England and subsequently spread to the European continent and the USA, the ownership of human beings by feudal overlords was abolished. Former slaves became “their own entrepreneurs” who could offer their labor power on the open market – or, better said, were constrained to do so. As owners of their own labor power, they were forced to offer their “ability to work” selectively and constantly to develop its potential for economic utilization.

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[45] Cf. Kellaway 2002, 29.

The moment slaves turned into employees, they were forced to offer their labor power as an enhanced although semi-finished product and to promise that those who bought it would be able to produce added value by using it.[46]

Offering one's labor power as an enhanced, semi-finished can also include components aimed at increasing the "benefit to the company." Independently acquiring new clients or developing a new production process on one's own, independent initiative – even when such efforts do not actually fall under one's job description – can be viewed as self-directed, entrepreneurial activities. From this perspective there is a fluid transition from workers as the "entrepreneurs of their own labor power" to economist Joseph Schumpeter's concept of managers as "wage-dependent employees" who can develop entrepreneurial activity even without an ownership stake in the company.[47]

In the companies of exit capitalism, however, it is no longer merely a question of an "intrapreneur," a "worker entrepreneur" or a "Self, Inc." in the narrow sense of the word. It is no longer strictly a question of extolling and developing one's own capacity to work or of assuming entrepreneurial functions. Rather, there is a tendency for the role of the seller of labor power to coincide with that of the company shareholder. The outcome is not primarily an "intrapreneur," a "worker entrepreneur" or a "Self, Inc.," but rather a "worker-capitalist."

Although worker-capitalists do receive a salary in return for their labor, their primary motivation is to acquire shares of their company in exchange for their labor (not in exchange for money, as a rule). And such compensation in the form of company shares translates into

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[46] Cf. Deutschmann 2002, 68.

[47] Cf. Schumpeter 1926, 111.

nothing other than worker-capitalists becoming shareholders in the companies which employ them.

In exaggerated form the argumentation of economist Joseph Schumpeter can be “turned right side up again.” Schumpeter contended that in capitalism the concept of an entrepreneur can be abstracted from the unity of capital ownership and managerial functions and that managers, as “wage-dependent employees,” can also develop entrepreneurial activity. In exit capitalism the functions of managerial oversight and capital ownership again coincide in certain respects, and in many instances a tendency can be observed for capital ownership and the value creation process to be combined in one individual.

((U3))The Infiltration of Investor Mentality

In the early 1990s U.S. economists Michael C. Jensen and Kevin J. Murphy authored an influential article in the *Harvard Business Review* advancing the claim that executives and employees who are paid fixed salaries like bureaucrats in large governmental organizations, also behave like such bureaucrats.[48] Even though we shouldn’t overtax the relationship between mode of compensation and employee behavior, in venture capital-financed companies the same argument – at least for analytical purposes – could be reversed. If executives and employees who receive the fixed salaries common in bureaucratic government organizations also behave like bureaucrats, then one might expect

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[48] Cf. Jensen and Murphy 1990, 138.

executives and employees who are remunerated with shares of stock to behave like shareholders. In exit capitalism there are indications that this is true.

According to the logic of worker-capitalism, founders, managers and employees, particularly during a stock market boom, are not primarily interested whether a company pays them a few thousand dollars more or less per year. Rather, their main concern is whether the company's stock option package is attractive. Instead of an executive calculating, "I receive a bi-weekly salary in return for advancing the company's interests," and an employee thinking, "I am selling my labor to work in exchange for a paycheck," a speculation-oriented investor mentality emerges parallel to rising stock prices. Members of the firm accept a substantial percentage of their salary in the form of company stock, which can make them rich in a short amount of time; it can also be worth nothing just as fast.

An investor's interest in a rapidly growing company focuses on forms of expansion that will increase the company's value in the capital market. Therefore, it is not merely the external investors (institutional investors, venture capital firms, small shareholders) who closely monitor whether the firm is tracking market sentiment, but the members of the organization themselves. They drive the company in directions that are oriented toward short to medium-term exit profits in the capital market. When the capital markets are booming, there is a tendency for the interests of "stakeholders" and "shareholders" in venture capital-financed companies to converge.

((U3))What Constitutes the Differences between Founders, Managers and Employees in Exit Capitalism?

Since a major portion of a company's financing in exit capitalism is provided by business angels, incubators and venture capital firms, the simple distinctions between founders, managers and employees dissolve. When determining the differences between founders, managers and employees, the question of how much of private equity each person invested when entering the venture can become secondary. The more important question appears to focus on how their activities contribute to advancing company interests and in what form are they compensated with company shares for their work. To overstate the point, in an abstract sense founding and managing a company, developing product, manufacturing and marketing all boil down to services which are remunerated with different percentages of company shares.

There is a tendency for the functions of founder, manager and employee to converge in the role of the worker-capitalist. In principle, then, what differences still remain between a company founder who has received virtually all of his or her seed money from venture capitalists, and an executive who has been lured on board 12 months into the game with promises of receiving 5 percent of the company's shares? What, basically, differentiates an engineer who, as Employee No. 1, receives 0.5 percent of the company, from the marketing director who joins the company two years later, when it has already expanded, for an insignificantly higher percentage?

The blurring of the logic and rationales driving company founders, executives and employees doesn't translate into an absence of negotiations, power struggles or conflicts of interest. On the contrary, the very fact that conflict is no longer polarized, as in "management here – employees there," or "in this corner, the capitalist – in that corner, the workers represented by the unions," is the reason why there are only limited possibilities for overarching, company-wide conflict resolution. Who would a collective bargaining agreement protect from whom? Whose interests would an employer's association represent, when a majority of the employees are company shareowners?

There is a tendency for the role of selling one's capacity to work to converge with the role of company shareholder, which results in unceasing negotiations within the company. Who holds the reins – the founder, who owns perhaps 15 percent of the company, or the new chairwoman, who receives a 5 percent stake? Who will be forced to give up how many company shares in the next round of financing? As an employee, how many additional stock options will I receive if I assume additional job duties in the marketing department?[49]

((U2))3. Entry and Exit Cycles

The belief that venture capitalists, founders and managers will find an opportunity to exit does not depend primarily on a company's operating profit, but on the company conveying a sense that it will be able to make a profit eventually. When a technology is at its height, even companies with no profit to show can be taken public. Even during the stock market boom in the PC and biotech industries in the early 1980s, every fifth company taken public on U.S. exchanges reported losses for the year prior to the IPO. At the end of the 20th century well over half of all the companies listed on the NASDAQ as well as on most of the new European growth company exchanges posted losses for the year before their IPO.[50] Whereas Wall Street or the Deutsche Börse place high demands in terms of revenues, earnings and company size,

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[49] For an example of negotiation structures in Silicon Valley see Saxenian 1994, 34.

[50] For the USA cf. Ritter 2001a; 2001b; for Europe cf. Arosio, Giudici and Paleari 2000.

the prospect of two-digit revenue growth with reference to innovative products or services will frequently suffice when a technology is experiencing a boom on exchanges for growth and technology issues.

For venture capitalists, company founders, executives and employees such circumstances present an opportunity to exit a company before it has ever earned a single dollar or euro profit. Nevertheless, the exit involves more than a simple strategy of cashing out after a period of excessive publicity and activity comes to an end, as the media would in part portray it. Granted, there may be founders who liquidate their holdings during the IPO and then retire to a yacht in the Mediterranean, a ranch in Montana or a mansion in California when their company files for bankruptcy. But such total withdrawals from exit capitalism are the exception. Far more commonly, venture capitalists, company founders, senior executives and the employees of growth companies have an interest in “staying in the system.” Thus, their exits are tied to measures designed to protect their reputations and to cultivate their contact networks, making every exit a delicate affair.

((U3))Exiting to Re-enter

In exit capitalism, venture capitalists, founders, managers and employees go through cycles. The typical cycle begins when a venture capital firm solicits funds from banks, insurance companies, foundations, pension funds or corporations for the purpose of launching a venture capital fund. It then leads from investing the fund’s monies in young companies, via assisting, counseling and controlling these firms during their growth stage, to withdrawal from the company by means of an IPO, selling it to another company or liquidating it. The cycle ends with the dissolution of the fund and the disbursement of earnings to the participating banks, insurance companies, foundations, pension funds, or corporations. If investors achieved lucrative returns, the venture capital firms will have little difficulty raising money from them a second time, and the cycle begins anew.

For serial entrepreneurs the cycle begins with developing a business concept, recruiting a founding team and soliciting money from venture capitalists. It leads to designing the first product prototype and positioning the company in the market, and culminates when the company expands to an international operation. During this stage the founder can already retire from running the company on a day-to-day basis and pass the reins to experienced managers. The sale of company shares to a large corporation, to the new management or to institutional and small investors (in the event of a public offering) allows the founder to dispose of his or her entire equity stake. The founder is then “free” to set up the next company.

For employees the cycle begins with an offer of employment, which is sometimes sweetened with the prospect of acquiring company stock. It leads via involvement in the company’s growth stage to an exit from the company based either on an attractive offer from another company, the decision to strike off on one’s own, or the failure of the company due to insolvency. A new cycle begins when the employee – under favorable circumstances – accepts a more promising position.

Through these cycles venture capital firms, company founders and employees create a track record, a kind of balance sheet reflecting their activities, which has a significant impact on their chances in subsequent rounds of the “investment and exit game.” Thus, venture capitalists with successful track records have the best chances of winning desirable young companies for their portfolios, attracting venture capital from other investors, selling the companies they have financed to other corporations for a profit, or launching a successful IPO. The perception that venture capitalists who "have been around the block," are well versed in the rules of the entry-exit game and "have a nose" for a trend, figures importantly when young companies, investment banks, other venture capitalists and investors decide to come on board. According to journalist Karen Southwick, having a reputation as a "venture capital rock star" who has been interviewed in *Playboy*, *Vanity Fair* or *GQ* increases the number of deals a venture capitalist transacts, makes it easier to recruit employees for the companies he or she finances and piques the interest of other venture capitalists in joining ranks with him.[51]

For company founders, the chances of receiving venture capital financing are especially good when they can point to one or two previous successfully founded companies. Bob Zider, president of the Beta-Group, explains that from the perspective of a venture capitalist, the "ideal founder" would have a track record and preferably even experience taking a company public. In Zider's opinion, venture capitalists invest in proven, successful people who have a good reputation, are presentable to investors and realize the cost of venture capital. Peter Fritsch of Cosmopolitan Venture explains that the optimal founder would have combat experience. There are, of course, young, successful founders who form the exception to the rule, but from a venture capitalist's standpoint, a thirty or forty year-old who has seen more than a university classroom is better qualified.[52]

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[51] Cf. Southwick 2001, 63.

[52] Cf. Zider 1998, 138. Various empirical studies support this theory; cf. MacMillan, Siegel and Narasimha 1985; Fried and Hisrich 1994; Murray 1996; Fritsch is an anonymized source.

Previous experience also plays a key role for top executives who are often enlisted during the second stage of a company founding at the urging of the company's financers. John Hoel of MACV explains that his company assigns deals to every manager and then appraises the value each manager adds to the firm as a means of evaluating performance. Using managers' track records, one can calculate what kind of internal rate of return they have achieved over the years.[53]

((U3))Investing in "People"

Raising the focus on track records to the next level results in the concept of investing not merely in business ideas, start-ups and companies but also in top business performers. Just as David Bowie issued $50 million worth of stock in himself (personal bonds) at the end of the 1990s so he could finance new recordings, concerts etc., the idea is to issue and trade shares in successful company founders, venture capitalists or top executives.

There's a joke circulating about successful venture capitalists like John Doerr: it facetiously claims that you could make more money taking him public (personally, including his address book) than you could on many an established company. A venture capitalist with a track record of backing companies like Compaq, Intuit, Sun Microsystems, Netscape and

[53] John Hoel is an anonymized source.

Amazon would be a safer investment than putting money on a promising business prospect but not knowing how it will be implemented.[54]

Company founder Dean Kamen aroused the interest of venture capitalists all over the world merely by announcing that he was working on a new invention called “Ginger.” Nobody knew exactly what “Ginger” really was, and speculations ranged from an anti-gravity machine, to an apparatus that could generate electricity from water, to a back-pack helicopter, to an ultra high-speed skate board . But financers were immediately willing to back him even without scrutinizing the project closely. Dean Kamen is the inventor of a wearable insulin pump, a portable dialysis unit and a stair-climbing wheelchair. His track record alone, in addition to a remark by John Doerr that the new invention could be more important than the World Wide Web, were enough to cause a significant stir and produce offers of blanket venture capital financing packages. When “Ginger” turned out to be an electrical scooter that looks like a push lawnmower, a certain disappointment was palpable among investors – but the world of company founders had gained yet another example of the importance of track records in exit capitalism.[55]

What is the explanation for the strong emphasis on “people” in exit capitalism? According to sociologist Niklas Luhmann there are three ways to determine how decisions are reached: through programs, through communication channels and through people. Programs are used to define which behaviors conform to company rules and which deviate from them. Communication channels (hierarchies, for example) define who takes orders from whom, who

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[54] Cf. Davis and Meyer 1998; see also Grose 1998, 45.

[55] Cf. *The Economist* 1.20.2001, 63.

must be informed of which measures, and especially whose communications may be safely dismissed as “background noise.” Using this approach to people Luhmann points out that decisions are dependent on a person’s level of education, the kind of vocational socialization a person has undergone, the kind of brainwashing people have been subjected to and the type of career situation in which they find themselves.[56]

The whole point of Luhmann’s approach is that each of these structural characteristics can be substituted for another. If, for example, one or two structural characteristics are in short supply, the remaining structural characteristics move center stage. If it is difficult to program a task, and the hierarchies cannot be expanded any farther, then personnel gains importance. If one cannot rely on one’s personnel, then one must define precise programs or strengthen hierarchical control. If one has difficult personnel and cannot integrate the personnel into an assembly line production type, then the importance of the hierarchy increases almost automatically.

The personnel factor is always key when both the possibility of standardizing tasks and of establishing of hierarchical control is only limited. The selection of a chairperson of the board is handled with such great circumspection because the chair has no superiors and is neither restricted by a set of rules nor subject to externally imposed requirements. Granting a professor lifetime tenure is a major decision-making process which mobilizes every subtle shade of micropolitical intrigue in the faculty because professors report to no one. They can remove themselves from the regulatory fancy of university and governmental bureaucracies by invoking their academic freedom (and their tenure).

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[56] Cf. Luhmann 1988.

In a very similar sense, the venture capital business is a "people business" because other opportunities to impose structure are limited. Frequently, company personnel does not enter an environment with an established set of programs and rules, functioning hierarchies and neatly defined overarching objectives. On the contrary, it is especially characteristic of venture capital-financed companies that business models must be changed quickly – dictated by the whims of the product and the capital markets – which also throws established targets, programs and rules into a state of constant flux.

If there is to be any security whatsoever in the decision making process, the personnel factor has to play a central role. New York venture capitalist Raman Reyes stresses the role played by management. If you can find a wagon with the right team of horses, venture capitalists will climb aboard without the slightest reservations. If not, they begin to have second thoughts about parting with their money.[57] The *grand seigneur* of the venture capital scene, Arthur Rock, claims that he never made the mistake of betting on the "wrong idea": his errors always involved backing the "wrong people."[58] Jerry Goodwin of venture capitalists Goodwin Alexander observes that an inept manager can wreck a good deal, whereas a good manager can turn a miserable company around and lead it profitability.[59]

For these reasons, venture capitalists are obsessed with the composition of management teams. Does the founder of the company know the industry and have

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[57] Cf.. Schilit 1991, 100.

[58] Cf. Doerflinger and Rivkin 1987, 21; MacMillan, Siegel and Narasimha 1985, 128 note that of the five most important criteria venture capitalists use to evaluate the founding of a company, four focus on the founders "track record" and personality traits.

[59] Cf. Perez 1986, 104.

connections to customers and suppliers? Does the founder have a track record he can use to document how he handles stressful situations? Does the “boy group” consisting of young consultants work well enough together so that they will not prematurely tear each other to shreds over the question of share distribution? Is the executive team capable of forging and managing a staff of loyal employees?

((U3))The Perpetual Motion of Success

The network of venture capitalists, founders and top executives is structured according to track records. John Hoel of venture capital firm MACV explains that particularly in the U.S. there is a network of established players with track records. In Hoel’s opinion, all of the deals that an experienced venture capitalist makes originate in previously financed companies. Former business associates call up and say that they have a “buddy” who would like to “try something new,” and the venture capitalists then supply the financing the “buddy” requires. Then, when the company is ripe, all of the analysts and investment bankers are already aware that it’s a good deal. This makes launching an IPO much easier for a company founder with a track record than for a person who is unknown.

Thus, a perpetual motion success machine is created. For people with good reputations, reports Marc Hicken of Grquick.com, good deals will come their way. As an entrepreneur, one’s goal is naturally to work with a top venture capitalist, a “super brand name” that will enable one to make contacts within the industry and smooth the road to an

IPO. The result is that entrepreneurs with a commensurate track record, who can more or less pick their own investors, wind up selecting established venture capitalists.[60]

This effect is magnified when the capital market is booming. Since entrepreneurs have no trouble raising money, they focus more on the “additional services” venture capitalists offer. Once financing is a given, companies can concentrate on a number of other questions: Which networks can the venture capitalist tap into? Will the venture capitalist’s reputation be helpful in recruiting new employees? Will the venture capitalist’s status be a plus in attracting subsequent financing? Will that be an additional bonus when the time comes to launch an IPO? This perpetual motion machine makes it very likely that the venture capitalists who are prominent now will also continue to be the most successful ones over the long term.

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[60] Marc Hicken is an anonymized source.

((U1))III

((U1))Capital Market-Orientation

"In the beginning trading securities consisted of the simple, occasional transfer of shares. However, through the diligence of stock-jobbers, who have taken control of the business, it has come to number among the perhaps most duplicitous, crooked forms of business ever to claim the guise of decency."

Daniel Defoe, author of the novel Robinson Crusoe, in the early 18th century

Two economists, Franco Modigliani and Merton H. Miller, used an assertion and several easily verifiable calculations to win the Nobel Prize in Economics. The winning theory, which played a major role in Modigliani receiving the generous prize in 1985, and Miller in 1990, was that the value of a company is little effected by whether it is financed with public equity or private equity. Whether a company is financed with the founder's reserves (private equity), gifts from friends, relatives and acquaintances (private equity), backing by venture capitalists (private equity), bank credit (public equity), publically traded debt instruments (public equity) or repayment deferrals from suppliers (public equity), is irrelevant for the price at which the company trades in the capital market.

Modigliani's and Miller's theorem presumes that market participants have access to complete information so that banks, shareholders and company owners are able to invest, borrow and lend at the same prevailing rate of return. The two economists compared a company which is financed 100 percent with equity capital (for example the founder's reserves or venture capital investment) with a company that finances 100 percent of its founding costs by borrowing outside capital. The researchers arrive at the conclusion that, assuming complete disclosure of all information, a lender would receive the same amount of annual interest payments as the shareholder who invested his or her own capital in the company. In short, the interest payments received by lenders and the dividends paid to investors are equal.

For an investor it is therefore ultimately immaterial whether he grants the company a $100,000 loan and collects annual interest in the amount of $5,000, or whether he purchases $100,000 worth of company stock and collects $5,000 in annual dividends. Since companies that pay their financers the same annual returns (for example $5,000) are also equal in value according to economic theory, the question of whether a company has been financed with private or public equity, or a combination of the two, has no effect on the calculation of it value.[61]

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[61] Cf. Modigliani and Miller 1985. Further premises of the Modigliani-Miller-Theorem are that there are no transaction costs, and that there is no risk of insolvency.

At first glance Modigliani's and Miller's line of reasoning is convincing. The stake a venture capitalist owns in a young company, the company shares held by banks, insurance companies and pension funds, as well as the stock owned by small investors initially represent no more and no less than a legal claim to the company's future earnings. Ownership of 40 percent of the shares of BMW AG by the Quandt family or 0.000000045 percent of all shares of online company eBay by Lisa McKenna entitle the owners to participate in company earnings via dividends. In the calculations of investors such dividend yield is weighed in relation to other comparable investment vehicles. The question which arises is whether one could earn similarly lucrative returns through government bonds, T-Bills, extending credit to a business or lending money to friends or acquaintances.

Upon closer examination, the Modigliani-Miller-theorem proves to be an example of how the science of economics can get the calculations right but still miss the mark when it comes down to business realities. So many basic suppositions are taken for granted that the mathematical proof no longer explains anything, except that the numbers and conclusions conform to the laws of mathematics. In exit capitalism, as explained above, the venture capitalist, the bank which holds company shares and the small stock-market investor are not interested exclusively (and sometimes not interested at all) in receiving dividends on their shares but in seeing the value of their shares appreciate.

Herein lies a key difference between equity and debt holders. By lending money one earns "only" interest. The projected interest income can be calculated precisely beforehand, and it is reasonable to expect that the payments will be posted to one's account for as long as the government, the bank or the company to which one extended the credit does not declare bankruptcy. While dividend payments on stock cannot be calculated with comparable certainty, owning shares offers a second potential source of income, namely a rise in the price of the stock. Such speculative considerations are always geared to projections of the company’s future growth , and the future has traditionally eluded mathematical analysis.

While the two previous chapters elaborated the effect of the exit logic on venture capitalists on the one hand and founders, managers and employees on the other, this chapter will demonstrate how venture capital markets function. Understanding how a speculative bubble forms is a prerequisite for grasping the orientation of companies which are geared to the capital markets. This chapter proposes that in boom times the strategies and structures of venture capital-financed companies do not result primarily from efficiency requirements. Instead, the objective of such companies is to use their strategic orientation, their organizational structure, their management team and their image to send the “signals” necessary to attract fresh capital in overheating capital markets.

((U2))1. The Venture Capital Spiral

How is it possible for the value of a stock package to appreciate in the first place? The precondition for a rise in the price of company shares is that they can be traded. At any time, venture capitalists, company founders and stock holders can convert their shares back into cash by selling them to a third party, assuming that an interested buyer comes forward. In the back rooms and board rooms where investors extol the shares they wish to sell, in the gray markets where stakes in small companies are traded, and on the exchanges, where – under official, government supervision – stock is bought and sold publicly, shareholders can convert their positions into cash (and naturally also exchange their cash for company stock).

When Intel shares rise by €100, the only reason a woman who owns stock in Intel can feel €100 richer is because her stock has the property that it can be sold. The only remaining difference is between “paper profits” and “realized profits.” A simple sell order conveyed to her broker results in a transfer of the proceeds from the sale to her account, and she can use her speculative gains to buy a used bicycle, a subscription to her local newspaper or stock in Ford Motor Company.

When shares are purchased, money seems to double in an uncanny fashion. On one side of the transaction, money flows from the owner of the capital to the company. In a public offering, the purchaser of shares transfers money to the company, which it can then use to buy machinery, pay salaries or print advertising brochures. In return, the shareholder receives nothing other than a claim to future earnings and the legal right to participate, according to the extent of his holdings, in decisions at the annual meeting of shareholders on certain very specific corporate issues as defined by law. Meanwhile, on the other side of the transaction, since shares can be converted back into cash at any time, the shareholder doesn’t really seem to have surrendered any capital. This doubling was the reason that Karl Marx referred to shares as “fictitious capital.”[62]

The uncanny doubling of capital creates two different “theaters of operation” for companies. In the one theater investors strive with the capital available to utilize the labor power of the “employers” in a manner that produces the highest possible earnings from the daily value creation process. In the other theater of operation the object is to present the company’s shares in a light which will ensure the highest possible share price.

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[62] Cf. Marx 1970, 484ff.

((U3))The Decoupling of Product and Capital

We would be drawing a faulty conclusion to assume a strong connection between product and capital markets. One might assume that profitable companies, the ones that develop the most interesting services, offer the best products and control their costs, also trade at the highest prices in the capital market. At first glance this may seem convincing, but developments observed in the capital market, especially during boom times, soon raise difficult questions. How does one explain, for example, that at the height of the Internet boom eToys, a totally deficit-ridden online toy store, was worth $8 billion on the stock exchange and was thus valued higher than competitor Toys'R'Us, a thoroughly profitable chain of retail stores with 50 times the revenues of eToys? How does one explain that during the same period Priceline.com, an online outfit offering airline tickets, rental cars and hotel accommodations with little to show other than several powerful servers, two dubious patents and big losses, had a stock market value greater than the entire U.S. airline industry? How does one explain that a small, money-losing Internet operation called Openshop was taken public at five times the value of Rohweder, a machine construction company with higher earnings than Openshop had revenues?[63]

During periods when a completely new sector of the economy is emerging and it is a question of new companies marking their turf, reporting profits, according the logic of the venture capitalist, can be a negative sign. Reporting profits during the development stage of a new technology or while a new industry is taking shape arouses suspicion in business angels,

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[63] Cf. Foust 1999, 58; Cassidy 2002, 3ff.

venture capitalists and small stock holders that the company is not investing heavily enough in growth, thereby forfeiting its chance to capture a dominant market position in the future. This brings to mind a joke which circulated on the e-scene. It claimed that no venture capitalist would finance a company that couldn't prove it would lose at least $50 million in the first six months. In California's Silicon Valley and in Silicon Alley in New York a cartoon made the rounds depicting an entrepreneur announcing that profitability was "for wimps" who simply weren't "aggressive enough." The idea became so popular that the Internet elite had the slogan "Profitability is for Wimps" printed on their T-shirts.[64]

One of the principal reasons for the decoupling of product and capital markets is that the capital market does not move primarily in response to a company's current business conditions but rather to its business outlook going forward. Such projections for the future allow wide latitude for interpretation. One might even call it speculation.

Especially in boom times, this latitude for interpretation causes the focus of the capital market to shift. Investment decisions are no longer based primarily on tracking actual business activity, but concentrate on monitoring other (potential) investors, who are in turn also watching business developments. In more concrete terms, the interest of a venture capitalist no longer focuses exclusively on whether a company will earn a profit, but on whether other investors believe that the company will be profitable. For small investors the question is no longer whether a company will earn sensational profits and therefore be able to pay dividends. The issue is whether other, subsequent small investors will share their belief that the company will soon report sensational earnings.

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[64] Cf. Hof 2000, 50; see also *The Economist* 9.19.1998, 78.

When the capital market functions in this manner, investor George Soros refers to it as "reflexive." Stock prices, according to the subtle but important differentiation Soros points out, are driven by perception of the facts, not by the facts themselves. In the final analysis, Soros claims, the stock market reflects nothing but people's opinions about other people's opinions. For investors with a short-term horizon, success hinges not on whether their perception of company data, of technologies or the product market is more on target than that of their competitors. Success lies in correctly perceiving the perceptions of other investors. The focus is no longer on the companies themselves but has shifted exclusively to the capital market.[65]

((U3))The Venture Capital Spiral

Particularly crass decouplings of the capital market from the product market are seen in the newly-developing industries which create a stock market boom. The history of the semiconductor industry, the PC industry, biotechnology, Internet technology and even nanotechnology shows that for newly-emerging industries no experience base exists which venture capitalists can use to orient themselves. Such lack of precedent frequently explains why newly-developing technologies often cause venture capitalists to base their investment decisions primarily on the investment behavior of other venture capitalists, resulting in a self-reinforcing process which takes the form of a venture capital spiral.

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[65] Cf. Soros 1987, 12ff; Soros 1998, 47ff.

A venture capital spiral can be triggered by a dramatic price rise in the stock of a new technology sector. Rising stock prices indicate that investors on the exchange are willing to acquire shares of companies in a previously "untested" business sector. This eagerness to trade the stock smoothes the path for other companies to go public. Since investors see that stock prices are rising quickly, they are readily prepared to subscribe to the IPOs of the new companies. In a venture capital spiral, investors often reap tremendous profits on the first day of trading. Daily returns of 100 or 200 percent can be achieved in boom times. Investors proudly report how the shares they subscribed to in U.S. online company eBay or German chip manufacturer Infineon or Italian ISP Tisoni more than doubled on the first day of trading.

A successful IPO in a new sector frequently produces a rush for growth company stocks and improves the opportunities for business angels, venture capitalists and company founders to unload their stakes and to find lucrative exits by taking companies public. In boom times investment bankers, who make millions on a single growth company IPO, scramble to take sector hot-shots public. The prospect of an IPO also drives up the price of other exit opportunities for venture capitalists, such as a buyout by another company, because the sale price of the company is also influenced by the amount it would earn through an IPO.

A lively IPO market makes it lucrative to back a company with venture capital at a very early stage of its development because one can count on higher returns on investment. Over the last 40 years banks, insurance companies, foundations and pension funds were always more inclined to invest in growth companies through venture capital firms when a positive market environment improved the chances that such companies would be taken public.[66] Established venture capital firms absorb investors' monies in ever-larger pools, while new venture capital firms likewise attempt to use the opportunity to raise money for their own purposes.

Venture capital funds, however, are also under *obligation* to invest their money. The funds they have attracted *must* be used to finance young, rapidly expanding companies because investors would not be satisfied with hum-drum returns. Thus, capital is literally searching for investment opportunities in growth companies. The supply of money available for growth opportunities drives up the share price of promising companies. In turn, the price a business angel or venture capitalist must pay for a stake in a young company, as well as the price of stock in already established companies, also begins to rise.[67]

Reports of rising stock prices, of high returns on the first trading day of an IPO and of entrepreneurs growing rich in just a few months or years, cause increasing flows of money into venture capital financing. Stock in growth companies surges. Demand intensifies for shares in companies with plans to go public, with the result that investment in venture capital funds spikes upward. Growth company stock continues to rise enhancing exit opportunities for those who already hold positions. Founders, business angels and venture capitalists find buyers interested in acquiring their shares. The process continues to spiral and creates a stock market boom.

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[66] Cf. Gompers 1992; Jeng and Wells 2000; Black and Gilson 1998; see also the in-depth discussion contained in Gompers and Lerner 1999, 22f.

[67] Cf. Gompers and Lerner 2000.

The effect is an ever-accelerating venture capital spiral. The question of an investment's long-term economic viability appears increasingly irrelevant because the ongoing replenishment of venture capital enables early investors to quickly turn their shares into cash. In a rapidly revolving venture capital spiral the shares of a company might change hands seven or eight times before it has to show a profit.

((U3))The Narrow Line between Venture Capital Spirals and Chain Letters

There is a mechanism in venture capital spirals that resembles chain letters. In chain letters – every new parent generation warns their children about them with striking regularity – the initiators or early participants actually receive the exceptionally lucrative returns promised because subsequent micro-investors, drawn in by the prospect of similar profits, provide a swelling influx of capital. The enormous returns of the first investor generation are financed through the monies of a second, broader generation of investors. The returns of the second investor generation are financed with monies received from a third generation. Since reports circulate about the returns achieved by the first investor generation, more and more money streams in and keeps the scheme afloat. At some point, though, the system runs out of steam, and the last generation of investors to participate is forced to write off its investments as a total loss.

The success of a chain letter depends on how convincingly its prospects for future profitability are depicted. A chain letter written by a ten-year-old girl, promising a lot of money to anyone who sends a dollar to the addresses at the top of the page, is flawed because the come-on isn't all that convincing; it's been over-used. The chain letter scheme designed by businessman Charles Ponzi in 1920 in New York was quite a bit more sophisticated. Ponzi discovered that due to currency fluctuations a person who purchased so-called International Postal Union Coupons outside of the USA would pay less than the coupons were worth when redeemed at a U.S. post office. His plan was to buy a large number of such coupons outside the USA and exploit the price difference. He promised a return of 50 percent to investors who lent him money for the deal for a period of 45 days. Although he never owned more than a few hundred dollars worth of International Postal Union Coupons, Ponzi was able to take in more than $15 million in only a few months. Since he paid his initial investors the interest they had been promised from the money invested by later participants, the come-on gained enormous credibility and was able to generate ongoing payments from a total of 30,000 investors.[68]

The difference between a venture capital spiral and a chain letter scheme is that the chain letter scheme is a front for the fraudulent intentions of a player whose only goal in launching the come-on in the first place is to make a sucker of gullible investors. For that reason – and that reason only – the ten-year-old girl or a coupon speculator like Charles Ponzi can be sent up for fraud, while nobody would ever dream of prosecuting the people responsible for such high-profile bankruptcies as Louis Borders of the firm Webvan in the USA, Peter Kabel of Kabel New Media in Germany or Ernst Malmsten of Boo.com in Great Britain. The theoretical, although slim, possibility that Webvan could have become the next Wal-Mart, that the tiny multimedia agency Kabel New Media would grow into the world's leading provider of Internet services, or that Boo.com could monopolize the online market for women's apparel kept Louis Border, Peter Kabel and Ernst Malmsten out of jail. Overstating

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[68] For Ponzi cf. Kindleberger 1978, 85f; Bulgatz 1992, 13ff.

the point: the minimal likelihood that a garage company backed by a venture capitalist will turn out to be the next Lotus, the next Apple or the next Genentech constitutes the minute but critical difference between a venture capital spiral and the mechanism behind a chain letter.

Whereas a chain letter represents a scheme concocted by a single individual with fraudulent intentions, a venture capital spiral is a “normal business process” in capitalism, which can be neither initiated nor controlled by a single individual. True, venture capitalists, fund managers, entrepreneurs, executives and small stockholders all try to take their cut and will occasionally also push the limits of legality in the process. But the way a venture capital spiral functions – with all due sympathy for conspiracy theories – cannot be attributed to the underhanded dealings of individual agents. Even when entrepreneurs, analysts and fund managers try to pump stock prices up, capital market players generally view such strategies as economically justifiable and legally permissible.

The art of venture capital-financed companies consists of exploiting the stock market’s positive bias in favor of a certain industry to finance a vigorous growth track. Raising money, however, requires using the company’s product, its organizational structure, the personalities of its top executives and its corporate culture to send the right signals to the capital markets.

((U2))2. Signal Politics, of Business Plans, Equity Stories and the Entrepreneur as a Hero

Robert X. Cringely, longstanding columnist for U.S. industry journal *ComputerInfoWorld*, speaks of the lamentable logic of a venture capital-financed start-up. In the final analysis, the founder more or less gives the company away over the course of its growth. According to Cringely the job of the company founders, the people with the grand plan, is to manage the distribution of company shares in a way that the final result is fewer shares but greater wealth. The job of a person who finances a company with venture capital, in Cringely's opinion, is to keep everybody happy by giving the company away piece by piece. In the end, the founders of venture capital-financed companies have more or less given away the entire operation to venture capitalists, top executives, key employees or small stockholders. Otherwise they would indeed remain the principal shareholders, but the companies themselves would be worthless.

When Bob Metcalfe founded 3Com Corporation in June, 1979, for example, he owned 100 percent of nothing. By the time 3Com, which manufactured network cards for PCs, went public in March, 1984, Metcalfe's holdings in "his own" company amounted to only 12 percent. The rest had been "lost" through the distribution of shares to venture capitalists, top executives who had been enticed with company shares to join 3Com, and by issuing employee stock packages. But in the meantime Metcalfe's 12 percent stake had made him minority shareholder of a company with a market value of $80 million. The stake he had retained was now worth $10 million.[69]

But what's the best way to "give away" a company? Founders can't "give it away" entirely right at the beginning because they wouldn't receive a very much money for it, and for themselves. They also wouldn't have enough shares left to attract new financing, desperately needed top executives or service providers later on. The art consists of stretching

[69] Cf. Cringely 1992, 234; see also Wilson 1985, 177; Clark 1987, 11.

the “give away” with the goal of basing an increasingly convincing company story on as uninterrupted an inflow of capital as possible. The company thereby earns a more favorable valuation in the capital market which in turn results in increasingly large infusions of money. As a first step, the entrepreneur can surrender, say, 25 percent of the company and use the proceeds to develop a prototype, build a functioning organization and establish a brand name. Even if these steps don’t lead the company to profitability, it still has a far greater market value than the day it was founded. This enables the founder to release further shares in a first major financing round with several venture capital firms, thereby raising new equity under more favorable terms. This round of financing allows the company to enter the market. Once the company’s product has been launched in the market, a subsequent, second round of financing through venture capital firms can raise eight times the amount of the first round, although this time the founder only parts with an additional 10 percent of the company’s shares. In an IPO, as a third round of financing, a further 10 percent of the company is sold for 20, 30 or 50 times the price per share received in the initial round of financing.[70]

Especially when the price of a company’s stock rises sharply after an IPO, the company can attract further capital at extremely favorable terms by issuing additional stock. While it is difficult to judge whether the price at which shares are issued during an IPO precisely reflects the company’s true market value, additional shares can simply be offered on the exchange at the actual market price (minus a small discount).

In order for the company to raise successively larger amounts of money in each round of financing, it must be able to present a convincing growth story. Economist Michael Spence

[70] For more detailed calculations see, for example, Wilson 1985, 182.

calls this “signaling.” Spence applies this term to the strategy of extolling one’s strengths in the face of great uncertainty. For example, since employers cannot be sure how well a job candidate will actually perform on a day-to-day basis, they fall back in their evaluations on the signals the candidate sends, such as self-presentation, employment history or education. Job seekers are aware of this and “engineer” their resumes to suit the application. They pick and choose among their basic and advanced educational qualifications, their practica and leisure activities, basing their selections not only on professional relevance or interest but also on whether they send the “right signals” to the potential employer.[71]

The process of “giving away” a company in the capital market is no different. The company’s strategic orientation, its business plan, the demeanor of its chief executive, and even some apparently minor aspects such as dress code choice or corporate language policy are not based exclusively on what is most effective in creating value within the company, but also on sending the right signals to the capital market.

((U3))The Business Plan as an Advertising Piece

At first glance, a company’s business plan is the document which sets forth the firm’s goal and describes its product, its market environment and growth strategy. The business plan contains data pertaining to the overall development of the market environment in which the

[71] Cf. Spence 1974: 3ff.

company operates, its competitive situation, plans for staff expansion as well as revenue and earnings projections for coming years.

Text books on the founding of companies portray the business plan as a tool which enables management to clarify company goals and formulate a well-defined strategy. The main purpose of the business plan is frequently seen in promoting communication among members of the founding team and in compelling them to develop systematic plans for the company.

As a rule, though, a business plan serves as more than just a set of internal guidelines; it also functions as an advertising piece for prospective investors, and as such, it plays a role no different than the flyers handed out at a trade fair hawking a cell phone or junk mail promoting a bus trip. Frank Schon of Goal Venture explains that company founders include in a business plan only what they believe will have a persuasive effect on venture capitalists, not what they believe is reasonable and correct. According to venture capitalist Robert J. Kunze of Life Science Ventures in San Francisco, if books about venture capital were to state that companies need a revenue potential of $100 million to qualify for venture capital financing, company founders would find a way to manipulate their numbers to meet such demands.[72]

The marketing angle of business plans is also readily apparent in the tailoring of revenue and earnings projections to suit the changing criteria of venture capitalists. If it is considered acceptable on the venture capital scene for a company in the software industry to be in the red for three years, then founders will write their business plans to conform with such expectations. Losses will be projected for, say, the first two or three years, but

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[72] Cf. Kunze 1990, 31.

profitability will be anticipated by year three, year four at the latest, allowing repayment of the majority of venture capital investments to commence in year five. If the capital market is skittish, and companies are required to achieve shorter-term profitability, then expenditures for marketing and international expansion are reduced commensurately, and a convincing case is made that profitability can even be reached in two years.

Founders demonstrate similar flexibility in tailoring their business plans to current trends in the capital market. During the Internet boom business models that were originally built on direct sales to the end-user (business-to-consumer) were re-vamped within a matter of days to models which entailed providing programs to other businesses (business-to-business). The model that Internet companies planned to use for generating income was transformed in some business plans within a matter of months from customer payments to advertising revenues to the sale of customer information.

Just as in marketing for an electric shaver, a power tool or evening courses, promises and reality diverge when business plans are used for marketing. When a CEO states that a company can reach profitability by year end according to the business plan, the same skepticism applies as when a vacuum-cleaner salesman uses a marketing piece to convince you of the incredible cleaning power of his top-of-the-line model. Peter Kirsch of Informationhighway referred to the business plans of venture capital-financed companies as the largest possible lies which could still be defended with credibility. Kirsch draws parallels to the five-year-plans in communist countries which were continually revised and re-issued, although everyone knew perfectly well that the true purpose of the plans was external representation and that their links with economic reality were tenuous.

It would be a mistake to lament the marketing character of business plans, however. Like it or not, the politics of sending signals to the capital market is one of a business plan's central functions. The challenge for investors lies in evaluating the company's strategy, its management team, the potential of its product and its revenue projections as realistically as possible *in spite of* the business plan. For entrepreneurs, the challenge lies in solving the problem that they are judged by their adherence to business plans which were written primarily with an eye on the capital market but reflect business reality only to a limited degree.

((U3))A Company's Top Salesmen

Capital market orientation results in a completely new type of prominence for company founders, chairpersons and important executives. The buyers of a truck or a washing machine take little or no interest in the CEO of the company that manufactured the vehicle or washer. When a company is being offered in the capital market, either in the tiniest of pieces or in its entirety, people who acquire a stake do take an interest in its chief executive officer.

The purchase of a truck or a washer generally concludes when the merchandise is received in exchange for money. Even detailed knowledge about the manufacturer's management team will no longer improve the quality of the product after the fact. But in a stock purchase, members of the management team in particular come to represent a quality guarantee. Prominent entrepreneurs who have already launched several successful IPOs create a sense of security that their company is a sound investment.

A media-savvy approach to presenting a company numbers among the skills a CEO requires for survival, i.e. for raising capital and ensuring that company product finds its way onto retail shelves. Founders invent stories which they pitch to the media as human interest lead-ins for articles about their companies. Adam Osborne, who founded one of the most ambitious computer companies of the 1980s and also numbered among Silicon valley's most colorful personalities, declared that he did use the press, but that the press also wanted to be used. Every journalist is interested in a story that sells, in Osborne's opinion, and creates this product for the press – just like the founder of a venture capital-financed company. One of the reasons Jeff Bezos, founder of Amazon.com, started his firm in a garage was to evoke associations with the garage-based founding of Hewlett-Packard, thereby providing representatives of the media with the perfect lead-in for their coverage. And then there was the trio of young entrepreneurs who founded an online outlet for discount brands and simply copied an Internet business model that had already proved acceptable to U.S. venture capitalists. Of course, when they spoke with journalists, they did not portray the knock-off process as their reason for founding the company, but instead told stories of late-night Web surfing and the sudden flash of genius that one could actually be paid for surfing the Web.[73]

The aura of celebrity that soon surrounded company founders in the USA developed parallel to the establishment of the venture capital industry and the formation of growth company exchanges, and reached a preliminary peak during the Internet boom. The founder of eBay, Pierre Omidyar, and the company's chairwoman, Meg Whitman, not to mention Yahoo co-chairmen Jerry Yang and Timothy A. Koogle, or the founder of Priceline, Jay S. Walker, achieved a cult status in the media comparable to Madonna, Britney Spears or Jürgen Drews. In business journals like *Business Week* they (i.e. Omidyar, Whitman, Yang, Koogle and Walker) were hailed as "empire builders," "innovators," and "pacesetters" of a new

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[73] Regarding Osborne cf. Malone 1985, 302.

economic order and portrayed as “masters of the Web universe.” The weekly magazine *Time* named Amazon founder Jeff Bezos man of the year, placing him in a pantheon along with John F. Kennedy, Martin Luther King, Jr. and the Ayatollah Khomeini.[74]

U.S. observers in particular looked on with unmistakable amusement as the celebrity cult surrounding entrepreneurial personalities spread to Europe with the opening of growth company exchanges and the burgeoning of the venture capital industry. In *Business Week* U.S. journalist William Echikson opined that as time went on legends similar to those of Silicon Valley were emerging in Europe. The garage in California, where Bill Hewlett und David Packard founded their Hewlett Packard computer company, translated into a deserted Lutheran parsonage in Eastern Germany, which housed the first office of 22-year-old university drop-out Stephan Schambach and his online company Intershop. With the market value of Intershop occasionally peaking at €11 billion, the founder’s self-proclamation as “East Germany’s first billionaire” and the relocation of his company headquarters to San Francisco, Schambach delivered the very stories that play such a pivotal promotional role in the capital markets. In conjunction with an article on media entrepreneur Thomas Haffa, the British business journal *The Economist* remarked that the concept of businessman as showman had now become socially acceptable in Germany as well. *The Economist* noted that in taking his company, EM.TV, public (actually it still had a distinctly Old Economy feel) he had shifted his focus from selling animated cartoons selling the firm.[75]

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[74] See *Business Week E.biz* 9.27.1999, EB 13f.

[75] Regarding Schambach cf. Echikson 2000, 19; on Haffa cf. *The Economist* 3.11.2000, 89.

Particularly in capital market boom times the lengths to which entrepreneurs will go to create a buzz themselves take on bizarre dimensions. Compaq CEO Michael Capellas posed in blue jeans with an electric guitar for U.S. business media, calling himself the cheerleader of the entire company, who not only stood for hard work but also for having fun. Mark Breier, head of the online company Beyond.com, had no qualms about appearing on business channel CNBC in boxer shorts to get the message across that you can download software from Beyond.com even if you're naked – well, half-naked at least. Boy Young, whose Red Hat company distributed Linux-based software solutions, appeared in a red hat to advertise his company wherever he went. Todd Krizelman and Stephan Paternot, founders of Theglobe.com, not only worked the business show circuit but offered flirting tips on afternoon talk shows, too. Kim Schmitz, a former hacker who still resides behind prison bars on a regular basis, founded Megacar, which provides multimedia Internet access on wheels. Schmitz had no compunctions about appearing with the cast-off, female one-night-stands of more or less talented rock stars, earning himself the title of the hottest groupie of the New Economy."[76]

((U3))The Politics of Words

Beginning no later than the institutionalization of the venture capital industry over the last several decades, one can observe that during periods when new technologies emerge,

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[76] Cf.. Capellas 2001; see also Heuer 2000.

companies will attempt to signal that they are part of the great new wave through their names and their to use of language. This becomes especially clear in the terminology of the New Economy, which companies use to herald that the rules are changing, that industries are being redefined and new business opportunities are emerging.

Due to the forgetfulness of the business media the term “New Economy” has been repeatedly taken out of verbal mothballs at regular intervals for over 30 years and used to indicate that we are faced with a fundamentally new set of economic realities. The former publisher of the business periodical *Purchasing*, Dean S. Ammer, was already using the term “New Economy” during the stock market boom of the late 1960s as a means of signaling that we had entered upon a technology-driven phase of continuous and unlimited growth of economic wealth. In the mid-1980s books were published with titles like “Doing Business in the New Economy” or “The Financial Dynamics of the New Economy,” which showed how to conduct business successfully in a high-tech-oriented business environment. In the 1990s the term was increasingly applied to economic developments in the field of information and computer technology and used to describe companies with Internet-based operations. As a diffuse collective term, the New Economy not only came to designate firms in the e-commerce, telecommunication and biotechnology industries, but also stood for the new economic order of the emerging knowledge society.[77]

During the various phases of the New Economy, companies used their names to indicate that they were part of something and to signal that they conducted business in a new, attractive sector. In the late 1960s, for example, when the exchanges craved electronics

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[77] Cf. the definitive work on the concept of the New Economy by Madrick 1999; 2001. For the 1960s see Ammer 1967; for the 1980s see Albrecht and Zemke 1985 and VanCaspel 1986.

companies, the names of most Silicon Valley firms ended in “techs,” “tecks” and “texs” resulting in companies like Advantek, Caltex, Disotec, Kylex, Nortec, Omnitek, Ramtek, Xebec, and, as the crowning achievement, Ultratech. In the late 1970s and early 1980s as the computer industry opened up to the end-user market, “original” company names were all the rage, using models found on pantry shelves, in comics or movies. This resulted in companies with names like Apple, Bits and Bytes, Centurion, Commodore, Gemini, Snook, Stellar Systems, Thor and Quest. Shaking his head in wonder, journalist Michael Malone observed that in the 1980s reading the plethora of company signs in Silicon Valley with names like Qwyxes, Qumes, Xebexs and Epids gave one the feeling that the sign painters might have been on some very potent drugs. At the height of the Internet boom companies added the promising “dot.com” suffix to their names or began with an “e-” in an attempt to signal the capital market that they operated under entirely new economic principles which promised previously unheard of returns. Journalists reported on the land of “e-Everything,” proclaimed “e-Books,” “e-Travel,” “e-Training,” “e-Entertainment” and “e-Engineering” the business sectors of the future, and extolled the virtues of firms such as E*Trades, eToys, eAssist and eBay. Companies like Beyond.com, Mail.com, Delti.com, Yazom.com, eCurator.com or Amazon.com even wrote their commitment to the values of online commerce right into their names. Rumors on the New Economy scene claimed that companies with “dot.com” in their names had better chances of receiving venture capital financing and would achieve better IPO results than those with names associating them with the Old Economy.[78]

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[78] For the earlier periods cf. Rogers and Larsen 1984, 14; Malone 1985, 305f; regarding the land of e-everything see Rebello 1999, EB 8; on the advantage of having a New-Economy name for launching IPOs see *The Economist* 9.5.1998, 59.

If we view terminological creativity not as an attempt to define an economic sector in precise terms, but as a component of the signal politics of capital market-oriented companies, it resolves complaints of historical forgetfulness with regard to the term “New Economy” and of the lack of clear conceptual definitions. The coinage of new terminology in the environment surrounding capital market-oriented companies represents a more or less adeptly applied marketing strategy. The idea of using new words is based on the consideration that established terminology is associated with certain concepts and has a tendency to wear out. There is either consensus over what a word means, with no further thought given to the matter, or the correct interpretation of the word is contentious, or the term is rejected merely because it is an emotive word. Under such circumstances it can make good sense to create new vocabulary in order to open a discussion and provide fresh impulses.

Although new vocabulary obviously does wear out, for a certain length of time it fulfills its purpose. In the sense that these neologisms create the impression among shareholders that the company is part of a grand new wave, thereby pumping up share prices, they do create value in the truest sense of the word for capital market-oriented companies.

((U3))Dress Codes

In boom times companies can use a casual dress style to signal their lack of connection to any of the traditional business sectors. During the biotech boom in the early 1980s (and early 1990s to some extent) growth company executives wore corduroy trousers and lumberjack shirts as a way of saying that their companies’ brilliant discoveries had no need of formal business attire to legitimize them. When the computer industry emerged, long beards, T-shirts and jeans were a plus when dealing with venture capitalists because they signaled that super-smart geeks were hatching something big. Dress code politics peaked during the Internet boom. In the Cluetrain Manifesto, the creed of the New Economy, the signers decry that administered and managed companies have stolen their employees' identity, requiring that they wear uniform clothing, use appropriate language and play their roles perfectly during the course of a meeting.[79]

U.S. Treasury Secretary Larry H. Summers declared that the Internet boom was the first time that business people could earn $100 million even before they bought a suit. Summers failed to see that the image of the suitless multi-millionaire rears its head during every venture capital boom. Even in the 1960s and 1970s, Silicon Valley was pointing to 30-year-old tycoons in T-shirts who had made their first $100 million during the high-tech boom in semiconductors, PCs, or software, before they bought their first pinstripe suit."[80]

The extraordinary feature of the Internet boom, however, was surely the effect of its dress code. Executives in established corporations felt compelled to make at least some concessions to the fashions of the growth companies. Even the chairmen of major corporations such as General Electric, DaimlerChrysler and Bertelsmann appeared without a tie at public functions to signal that they were learning from the New Economy and were adapting their own companies to the Internet.

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[79] Cf. Malone 1985, 279 for the early periods.

[80] Summers in a speech before the New York Economic Club, 8.9.1999, quoted in Mandel 2000, 13. Interestingly, the information differs with respect to the question of earning the „first million" or the „first 100 million." For background information on the image of tycoons in T-shirts see Malone 1985: 7.

New Economy gurus such as Craig Kanarick, founder of Web agency Razorfish, with hair dyed blue, could declare to the chairmen of the Old Economy that a revolution was at hand. This led to the chairmen later taking off their jackets so some New Economy sex appeal would rub off on them. Seasoned Old Economy managers who followed the call of the New Economy and switched jobs to young start-ups – like the online bank E*Trade – got up on chairs during initiation rites and cut off their ties. Emilio Mayer of Internet outfit Natha.com tells how his company instituted "uncasual Fridays" in a parody of the Old Economy: for once, every programmer, web designer and executive could dare to appear on the job wearing a business suit.[81]

((U3))Shifting the Focus: Latent Functions

Descriptions of "fantasy-based" strategic orientations, of business plans that were decoupled from reality, the celebrity status of top executives and the creation of company neologisms stand in contradiction to the self-portrayals of the venture capital industry itself. Admittedly, a product must capture the imagination of the capital market, but the true motivation behind strategic orientations is seen in the opportunities offered by the product market. The management of venture capital-financed companies is convinced that their business plans are blue prints for the company's further development, and not primarily marketing materials

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[81] Cf. Lee 2000, EB 36. Mayer is an anonymized source.

aimed at venture capitalists. Within the companies, terminologies are not canonized in language codes, but adopted almost as a matter of course by the employees.

But even if such measures in venture capital-financed companies are often not the result of conscious, calculated signal politics, they still frequently develop as latent functions. There can be no doubt that the differentiation between consciously intentional, manifest functions on the one hand and latent functions on the other, as proposed by U.S. sociologist Robert K. Merton, numbers among the most exciting discoveries in the social sciences. It created an awareness that while many social processes cannot be attributed to intentional activity, they fulfill important functions nevertheless.

The difficulty with latent functions is that they frequently cannot be discussed openly. We use the term “executive assistants,” but what we mean is “status symbols for managers.” The need for status symbols cannot be openly discussed, which explains why we must continue talking about “executive assistants.” Especially when the stock market is booming, companies develop a capital market orientation as a latent function. Decisions relating to strategy, personnel and organizational structure are made under the guise of improving product saleability. In reality, however, they are geared toward shaping an equity story for the capital market.[82]

The main point of Merton’s concept is that latent functions are not considered pathological. On the contrary, latent functions receive particular recognition for the central role they play in ensuring an organization’s survival. Sometimes it is not management’s conscious intentions and the exercise of control that account for a company’s success, but the

[82] Cf. Merton 1957.

latent functions which form in the shadows of consciously planned and communicated activities. Thus, the signal politics of capital market-oriented firms fulfill their own purpose and cannot be characterized as a pathological outgrowth of exit capitalism per se.

The ensuing question, however, would be: what risk do companies assume when they concentrate primarily on using their strategic orientation, their organizational structure and their top management echelons to send the “right” signals to the capital market?

((U2))3. The Dominance of Capital Market Orientation

In major corporations like General Electric, Ford or Alcatel the strategies targeting the product market and those aimed at the capital market are developed and supported by different units. The investor relations department, the press office or sections of the accounting department focus on the capital markets, whereas the production division, marketing or purchasing are responsible for ensuring trouble-free production to every possible extent.

This offers the advantage of creating two organizational units with only loose ties to each other. Each operates under its own local rationale and puts forth its best effort for the company. Naturally, maintaining a presence in two different areas is expensive, but if a company is willing to make the investment, it can at least partially decouple the games played in the stock market from those played in the product market. Setting up a separate press office, naming a chief financial officer, having the CEO trek from one interview to the next, coining new expressions that reflect the company’s revolutionary character, and targeting advertising to investors can be viewed as expensive but necessary promotional efforts directed at the capital market. To a large extent, such efforts can be decoupled from the sale of products or services.

The term which organizational researchers Richard Cyert and James March have suggested for the buffer which allows this decoupling is “organizational slack.” What Cyert and March mean by “slack” is this: companies don’t operate in stable environments to which they can respond using an adaptive, rational, conflict-free organizational structure. Excess resources represent a sensible strategy for dealing with the contradictory demands companies face from their environment. “Slack” ameliorates conflict because it puts excess capacity, a buffer or even a resource cushion at the organization’s disposal which allows competing objectives to coexist peacefully.[83]

In the case of many established corporations a “conflictual equilibrium” exists between capital market and product market orientations, which is continually balanced through daily adjustments at the management level. In exit capitalism, however, especially when the stock markets are booming, a capital market orientation assumes an increasingly important role.[84] Each company holds out the promise that its business operations will achieve profitability in the short, medium or long term and – to overstate the point – that at some point the venture capital market will no longer be a concern. In the short term, however, financing the company through the capital market is often simpler than focusing on profits from business operations.

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[83] Cf. Cyert and March 1963, 36ff.

[84] Cf. Hellmann and Puri 2000, 981.

For this reason companies have a tendency to shift their perspective increasingly from the product market to the capital market. The companies which emerge are primarily capital market-oriented. Their expansion strategies, marketing campaigns and accounting practices are all geared to securing refinancing through the capital market, and securing fresh capital requires writing a success story at any cost.

((U1))IV

((U1))The Dual Reality of Capital Market-Oriented Companies

"A timely exit is, after all, a key component of the mental Enron model."

Corporate consultants Richard Foster and Sarah Kaplan in praise of Enron employees for always finding exits from risky deals in time. Only months before Enron declared bankruptcy the two McKinsey consultants portrayed the company as a paragon of "successful corporate transformation."[85]

The bankruptcy of U.S. energy concern Enron shows how closely high profitability can be followed by sudden, life-threatening losses. Enron had at times ranked as the seventh largest corporation in the USA. On October 16, 2001, after many years of profitability, the company announced third quarter losses totaling $618 million. During the following weeks, after failed attempts to sell the company to competitor Dynergy and to obtain short-term infusions of capital from the Bush administration, losses continued to mount and chairman Kenneth Lay declared the company bankrupt. A corporation which at the end of 2000 was still recommended as a "good long-term investment" by investment bank J.P. Morgan, had

[85] Cf. Fosterand Kaplan 2001.

declared bankruptcy less than one year later. The same corporation that management consultants McKinsey & Co. had called the very model of enduring, profitable corporate development and extolled for its exceptional ability to re-define itself, suddenly emerged as a corrupt morass of trickery and fraud.[86]

Immediately after Enron's bankruptcy, U.S. economist Paul Krugmann prophesied that the debacle would mark a more significant turning point in American society than even the terrorist massacre of September 11. Enron's demise, the largest corporate bankruptcy in U.S. history, is interesting because it did not involve the slow, inexorable decline of a dinosaur from the Industrial Age but the collapse of *the* New Economy corporation among U.S. energy suppliers. Most investors, analysts and other companies were taken by surprise. A model corporation which had been widely commended in the U.S. media, a stock market darling that had transformed itself from an energy producer into an Internet-based energy trading company, had suddenly caved in.[87]

The Enron bankruptcy cannot be explained by a collapse of the company's markets, by the loss of important customers, by an enormous rise in the company's purchasing, salary or production costs coupled with a soft sales market so that clearing a profit was no longer possible. In fact, product market conditions for large energy suppliers could hardly have been better at the time Enron declared bankruptcy. As a result of intervention by Enron, the administration of George Bush, Jr., who had received campaign contributions in excess of

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[86] Regarding praise for Enron cf. Baghai, Coley and White 1999, 86ff, 204f; Scherreik 2000, 60. Harvard Business School published a case study which endorsed Enron's business model.

[87] Cf. Boyd 2001b; Sloan 2002; Kadlec 2002. For a discussion of Enron's New Economy orientation see for example Boyd 2001a.

half a million dollars from the company, had pushed through legislation further deregulating energy markets. The purchase price of energy was reasonably stable, and several of Enron’s competitors had begun to report increased earnings. Of the standard explanations for corporate bankruptcies in capitalism, namely “growing competition,” “rising purchasing costs” and “falling profits,” none apply in the case of Enron.

To the contrary, the company’s failure was related to the difficult situation in the U.S. stock market which rendered further financing through the capital market impossible. Due to the situation in the financial markets, Enron no longer had the option of maintaining its own liquidity by issuing new stock, borrowing or founding unconsolidated subsidiaries where it could park losses temporarily in order to stay solvent.

The case of Enron as well as the similar cases of telephone company Worldcom, photocopier manufacturer Xerox, Dynergy energy corporation, the telecommunications concerns Qwest and Global Crossing or the multi-industry conglomerate Tyco, were discussed primarily in terms of the ravenous appetites of executives for stock options, the failure of the accounting profession, ties between government and private industry in the USA, and the (possibly) criminal manipulations on the part of management. The political, legal and media penalization of management and the accounting firms, however, obscured the systematics operating behind the Enron case.

This chapter explains why, based on the capital market orientation described in the previous chapter, “creative bookkeeping” in venture capital-financed companies can make very good sense. We will discuss why it pays for companies to enlist business consultants and accountants and achieve a high degree of professionalism in tailoring their financials to the expectations of the capital market.

((U2))1. Business Plan Economy

In the search for the systematics operating behind the artificial inflation of revenue and earnings figures, there is one obvious clue: the executives who stand to reap particular profits from rising stock prices based on the options they have been granted. In order to drive up the stock price of their own company, suspicious voices frequently allege, executives act like show masters spinning tall tales of unlimited growth and exploding profits for an audience of greedy shareholders. The managers blow these soap bubbles, it is said, out of pure self-interest, and their creative bookkeeping occasionally contributes to fulfilling their forecasts.

According to the general tenor of the media, there is a system behind this method. At the end of the 1990s the top executives of major corporations were granted three times as many stock options as at the beginning of the decade. With almost revolutionary zeal the business media report that such option packages have increased the salaries of the top management echelon from 80 to 500 times the salary of “regular employees” within 20 years. The media further report that in the 1990s this “American disease” of exorbitant option packages increasingly spread to Europe and Asia. In the meantime not only senior managers at AT&T, Tyco or City Group receive generous option packages, but also the top echelons of companies such as Telekom, Deutsche Bank or DaimlerChrysler are “shamelessly enriching” themselves by abusing the practice. The alleged result is that managers pursue increasingly risky business strategies for egotistical reasons and that this deceptive form of compensation drives high-tech companies in particular to the brink of the abyss.[88]

It is indeed correct that executive compensation has an effect on company strategy. After all, the alleged "shameless enrichment" is one of the main reasons why executives are on the go for their companies 70 or 80 hours a week. But the discussion over the justifiable upper limits of management compensation and the more than bizarre controversy over whether management and employee salaries can legitimately differ by a factor of 500 or only 100 or 200 obscures the truly important aspects.

Far more important than the question of individual enrichment strategies – which is merely of moral or, in extreme cases, of legal interest – is that company survival strategies in exit capitalism depend to a large degree on rising share prices. This applies to venture capital-financed growth companies as well as to major corporations which are quoted on the stock exchange and currently on an expansion track.

((U3))The Milestone "Dictate"

Managing liquidity in venture capital-financed companies bears a resemblance to crossing the Sahara by Jeep. Reaching one's destination (and, if the going gets rough, one's own survival) depends very much on "gasoline management." If the drivers of the Jeep don't make it to the

[88] Cf. Heusinger 2002, 17.

next gas station in time, they have a serious problem. They will be forced to fetch gasoline at from the next gas station on foot, or they will have to beg small amounts of gasoline from passing cars.

Capital market-oriented companies which are in the growth stage but have not yet achieved profitability through their business operations, or have borrowed heavily for their expansion, are in a similar situation. As a rule, additional venture capital financing is only forthcoming if pre-set goals with respect to revenues, performance improvement, technology developments, staff growth or international expansion are achieved. Companies make ambitious “promises” to their investors. “We will double our customer base in the next ten months.” “We will have the beta version of our software finished in time for Comdex in Las Vegas, and we will be able to demonstrate it to attendees.” “Over the next two years we will open bases in four new countries.” “We will be in the black by year end.” Such “promises” represent the milestones the company intends to reach in a specified period of time.

If the company fails to reach one of its milestones, reports Wally Davis of venture capital firm Alpha Fund, then as a venture capitalist one is under no obligation to release the next installments of previous financial commitments. The reaction, at least according to journalist John W. Wilson, is frequently, “Get back in touch with me when you’ve reached the milestone.” Robert Bauer, CEO and founder of Foodstep, explains that especially the small capital market-oriented companies, which have no cash reserves and also generate no revenues, are under all circumstances dependent on achieving the growth targets their venture capital financers require.[89]

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[89] Cf. Wilson 1985, 141; see also Murray 1996, 47.

Capital market-oriented companies which are traded on the exchange face similar challenges. Investors are quick to sell their shares if a growth company makes an ad hoc announcement that it will miss certain growth targets. When the valuation of a company is based predominantly on a “convincing story,” shareholders are very sensitive to missed targets. Every milestone unreached casts doubt on the company’s story.

((U3))The Sword of Damocles Hanging over Companies in Exit Capitalism

A Damocles Sword hangs over rapid growth companies: negative reports will cause investors to withdraw their money immediately. Marc Hicken of venture capital firm Grquick.com calls the situation schizophrenic when companies promising almost unheard of growth rates of 100 percent and earnings increases of 30 percent are penalized without mercy if they are even slightly off target. They face market sanctions, according to this investment manager, if their growth comes in at 25 instead of 30 percent. Nobody cares any longer that their overall results are in fact excellent. The company missed its growth target, and that's all that matters: sell it, dump it – and down goes the price. Even “good companies” which set the bar very high based on market conditions have been brutally penalized. Martin Andersen of SuperWebOffice reported that failing to reach a milestone by only a straw broke his company’s back. In boom times, when venture capital investors have an array of opportunities to exit a company, they would not raise an eyebrow if a growth target were not met exactly. But the moment stock prices falter and exit opportunities become elusive, failing to reach a milestone by even a hair is used as justification to halt further financing.

This danger increases exponentially because investors are not only concerned about the company's vulnerability but are also watching the reactions of the capital market to possible bad news. The only difficult issue is distinguishing whether shareholders are pulling out because they are "personally" disappointed that "their" company has missed an important milestone and cannot fulfill growth expectations, or whether they are anticipating the reactions of other investors and trying to withdraw their investments before others do. It is also not always clear whether a venture capital firm is pulling its money out of a young growth company because it believes that a missed milestone reflects management weakness and views closing market windows as sudden technical problems, or whether it sees no further chance of attracting other venture capital investors to finance the company down the road..

For this reason we must not underestimate the attraction of "window dressing" as a means for capital market-oriented companies to secure the next financing rounds or support the high price of their stock. Peter Kirsch of West Germany-based Internet firm Informationhighway sees milestone fixation resulting in the emergence of a planned economy. In venture capital-financed companies he sees a "business plan economy" developing which is not all at far removed from the planned economy of his colleagues in the Easy German Zone in decades past. Just as the planned economies of the Eastern Bloc used every conceivable trick to achieve their plan objectives (at least on paper) Kirsch sees venture capital-financed companies striving to reach the projections in their business plans. With all means at their disposal the firms seek to avoid the risk of a financially devastating penalty from the capital market or of missing the next tranche of money from their backers.

((U2))2. Producing "Good Numbers"

Public discussion of “bookkeeping errors,” “balance sheet manipulations” and “creative accounting” is cyclical. During boom times in exit capitalism the tricks growth companies use to doctor their financials receive little play. Investment managers, analysts, business consultants and journalists (to the extent they read balance sheets) are generally well aware of corporations' creative accounting practices, but it's not an issue because when all eyes are glued to rising stock charts, nobody particularly cares. In boom times, even stock market regulators have trouble making an effective public case for their suspicions.

Only in the bust which follows the boom do corporate balance sheets receive closer scrutiny. Suddenly, the creative accounting of former stock market stars becomes a topic the media can use to attract attention. In the face of concern among investors, analysts and journalists over the ability of companies to survive, “flexible accounting methods” are suddenly the subject of wide discussion, and accounting practices which were at best viewed as original during the boom become the stuff of scandal overnight.

((U3)) Strategies to Increase Sales

Proven sales growth is one of the main valuation categories for capital market-oriented companies. Over and above the “standard methods” of increasing sales such as Internet, television and print media advertising, PR work and direct marketing – all of which have the drawback of costing something – “creative bookkeeping practices” are also an option.

One proven strategy of driving up sales consists of barter transactions with other companies. Although such transactions were generally known as a “trademark of short supply” under the communist system of the Eastern Bloc countries, over the last several years they have experienced a renaissance among companies which are under pressure to report high sales. Here is an example of how such barter transactions work. First, the companies place each other's advertising banners on their respective Websites. Each company then records the advertising space sold as a receivable and the advertising space purchased as a payable. In this manner a company can drive up its own revenues with very little effort, and money never changes hands.[90]

An “aggravated form” of this method of increasing sales consists of treating the exchange of services between departments as outside sales. In the case of AOL Time Warner, for example, running an ad for the Warner film „Harry Potter” on the AOL homepage could be accounted for in the same way as if Coca-Cola or Wal-Mart had run the ad. In turn, the advertising costs AOL incurs for having its free CDs inserted into Warner magazines such as *Time* or *Fortune* can then be booked in exactly the same way as if McDonalds had inserted a scratch-off ticket. By booking the internal exchange of services between different divisions the company is able to report increased sales and project the suggestion of growth externally. In the final analysis, by recording the services rendered between its own divisions a large company can show continuing sales growth for years, without transacting any business whatsoever with an outside customer.

Companies also have the opportunity to drive up sales by recognizing the shares they receive from other companies in return for services as income. Especially major Internet companies such as Amazon.com are not paid in cash for the advertisements they post on their

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[90] Cf. Yang 2000, 70.

portals, but rather in company shares. These shares are then as increases in cash sales and not as an investment in another company. Amazon simply “pretends” that the stock package it has received from an advertising client with a value of, say, $100,000 has actually been posted as a cash transfer. But since this income is not immediately available as liquid cash and since the value of such Internet stock in particular fluctuates widely, this method of increasing sales has different implications than the sale of a CD, a book or a palm computer to an Amazon customer, which puts money directly into the till.[91]

Yet another strategy consists of not merely using a company’s actual core product to achieve sales growth, but also producing bogus transactions by buying and selling additional services. Firms which broker products on the World Wide Web, not only record their commission for brokering the products as income, but also the price of the entire product. Machinery, air travel or hotel accommodations are all treated as if they had been bought outright by the broker and subsequently sold to the end customer at a higher price. This applies equally when the transaction consists of nothing more than referring the customer to an airline or hotel, as in the case of travel agencies. As an example, Priceline.com, an online distributor of airline tickets, hotel accommodations and rental cars, booked the full price of a flight or rental car as sales although only a fraction of the price remained in the company till. In the third quarter of 1999, for example, Priceline successfully used this method to report revenues of $152 million. $134 million were then deducted as production costs for hotel accommodations, airline tickets and rental cars. In plain English this means that Priceline’s revenues from brokering fees amounted to only $18 million. Software companies use the trick of buying computers, loading their own software onto them and then selling the combined

[91] Cf. Elstrom 2000, EB 68.

product, thereby reporting impressive revenues for a software company. In the case of the Trius, a developer of telecommunications software, the ruse consisted of buying a large number of hard drives, loading the company's own Teliman software onto them, and then selling the enhanced hardware to a third firm which handled the retail sales. This allowed Trius to delight investors with the good news that it had been able to increase revenues by 76 percent to €3.2 million in one year. The fact that €2.5 million of the revenue resulted solely from selling computer harddrives and that software, the company's actual core business, had accounted for only several 100,000 euro went unnoticed in a sea of fine print.[92]

((U3)) Performance Improvement Strategies

The graphs depicting overall business development projections which are included in the business plans of capital market-oriented companies always show a "checkmark form." Following substantial and continually mounting initial losses over the first few years which make the chart go down, the line suddenly turns up. As the company's business expands, the losses become progressively less. Three or four years after start-up the firm reaches profitability and earnings explode. At this point, the business plan would suggest, the company will be on a firm footing and no longer depend on additional financing from the capital market. Investors will be rewarded with a high dividend for their readiness to back the company early on.

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[92] Regarding Priceline cf. Yang 2000, 70; for Trius cf.. Mattauch 2002, 41.

For venture capital investors it is important that companies pass through this checkmark form. Frank Schon of the venture capital firm Goal Venture explains that the famous chart showing projected losses and earnings is a feature seen in every company founding. Schon explains that if you found a normal technology firm, you will have initial losses because you first need to develop the product. But at some point the chart should start heading north. The reason many growth companies fail is because investors lose faith in the company’s ability to make the chart turn up. Martin Andersen of SuperWebOffice explains that during the Internet boom it was long the fashion to announce that one would soon be asking customers to step up to the cash register for services received. This was intended to suggest that the phase of initial losses would soon draw to a close and that the company would soon be in the black.

Particularly when doubts arise whether a growth company can finance itself through product sales, advertising, customer payments for services rendered or through a business-to-business approach, great attention is focused on the company's performance development. In this phase companies do their utmost to fulfill the expectations of venture capitalists, analysts and the media, and to present a positive performance trend. If necessary, they resort to methods which allow them to imply such positive developments.

The “Enron method” consisted of hiding debt in subsidiaries whose balances were not reflected in the balances of the parent company itself but were at best mentioned in footnotes to the financial statements. Such so-called “non-consolidated subsidiaries” can report very high losses, for example when the debts of the subsidiaries are secured through stock of the consolidated corporation. In the case of Enron billions of dollars in debt accumulated in the subsidiaries while the corporation as a whole posted record earnings.[93]

A variation on the “Enron method” consists of spinning off part of the firm as an independent subsidiary and subsequently selling the concern's intangible assets, such as patents, trademarks or licenses, to the subsidiary, thereby improving the results of the parent company. Especially by legally divesting research and development departments, companies can conceal the source of losses which will only affect the company's balance sheet in later years.

But it doesn't always have to be that complicated. The simplest method is to book receipts very early. This is frequently practiced with receipts around year end, in order to make one's results appear either better or worse. In some cases, however, a service which has been posted too soon is carried forward from balance sheet to balance sheet, until one day the Potemkin village simply collapses. In the 1980s, for example, database company Oracle recognized product as sold which had not yet even been shipped. Even product which did not yet exist – and in some cases was never developed – found its way onto the balance sheet under income. As long as the company reported earnings increases every year, analysts overlooked the growing mountain of open invoices Oracle was carrying. When the optimistic mood on stock market soured, however, public pressure forced Oracle to fundamentally restate its balance sheet. During the Internet boom the founder of Microstrategy, Michael J. Saylor, used a similar method to enhance his balance sheets. He booked sales which were spread out over several years immediately as revenue at full value instead of distributing them

[93] In the case of Enron the losses were hidden in two “special purpose entities” (SPES) LJM and Chewco (cf. *The Economist* 2.9.2002, 67).

over the entire period. This enabled Saylor, who was busily crisscrossing the USA as the Messiah of cyberspace, to document the success story of Microstrategy with big revenue and earnings increases – or, better said, great reductions in losses.

A further simple method of improving results are write-offs. The ability to manipulate write-offs lies in extending their useful life, or shortening it if the object is to reduce the amount of earnings reported. The longer the period of useful life a company establishes for a machine it has purchased, or a computer program or a film, the smaller the impact of the purchase on the company's short-term results. For example, if film rights costing $10 million are expensed over a period of 10 years, they will be reflected on the balance sheet as an expense of $1 million per year. If the film is expensed over 20 years, the balance sheet will only reflect expenses in the amount of $500,000. The media company EM.TV, for example, used this method of expensing to report profitable results but in so doing also simultaneously suggested that its children's movies like “The Flintstones” or “Porky Pig” would have good sales over a very long period of time.

A special variation on balance sheet cosmetics can be seen when a growth company has launched a successful IPO and is flush with cash. The firm then sets out on a shopping spree and acquires another company. When the markets are overheated, the cost of acquiring another company frequently exceeds the amount of money that the new subsidiary shows available. In the language of the accounting profession the difference between the purchase price and the actual value of the company being purchased is called “goodwill.” The company which has completed the acquisition can record the goodwill as an asset. This is justified by claiming that the acquired company owned highly regarded “intangible assets” which do not appear on the balance sheet of the newly formed company. But a large amount of goodwill is justified only if the business model of the acquired company proves successful, markets expand and no new surprise competitors emerge. If the business model fails, the markets stagnate or competition unexpectedly crops up, the goodwill can soon prove excessive. This can result in the company seeing itself forced to make a special adjustment and write a portion of the good will off, which adversely affects results.

((U3)) A President's Gray Areas, or The Difference between Right and Wrong

At the height of the U.S. corporate accounting scandals, President George Bush, Jr., who normally inclines toward simple differences like “black or white,” “good or bad,” or “with us or against us,” declared that accounting matters aren't simply “black or white” and that a lot of gray areas needed to be examined.[94] Certainly Bush's goal in this sudden revelation of differentiations was to justify his own previous business practices when he sat on the board of Harken Energy Corp. and to divert attention from any suspicion of insider trading. In mentioning those gray areas, though, he did hit the nail on the head. Accounting is not a precise discipline in which there is only one right way to post an entry. Rather, bookkeepers, controllers and accountants have great latitude in interpreting how receipts and expenditures are to be recorded.

Which barter transactions between companies is it impermissible to record as sales? Can a customer's order be viewed as so certain that it would be allowable to post it

[94] Cf. Kleine-Brockhoff 2002, 20.

immediately, or is one obligated to wait until the last signature dries? Can the films in a company’s possession be expensed over 10 or 20 years? Can a software package a company has programmed for itself be considered an asset, or must the costs simply be recorded as expenses?

In exit capitalism a company’s professionalism lies in selecting the gray areas in such a way that a stock market success story can be written which will not collapse as soon as the company’s accounting practices come under question.

((U2))3. Management by Potemkin

Companies resort to creative accounting practices in exit capitalism because their survival depends importantly on fulfilling the expectations of the capital markets. It begins with venture capitalists making their investments in young start-ups contingent to a large extent on the achievement of certain milestones, continues after the IPO has been launched, and doesn’t spare “established companies,” in the event that they attempt to finance their expansion policies through the capital markets.

While such all-out efforts to meet the expectations of the capital market do not reflect a company's internal business environment exactly, they do not represent any kind of pathology inherent in exit capitalism. Instead, they are the hardly-avoidable result of the firm’s capital market orientation.

((U3))Exit Capitalism's Dual Reality Function

The discrepancy between the performance characteristics set forth on balance sheets, in business plans and annual reports, and the figures intended for internal company use can be defined though the concept of a "dual reality." The term implies that companies operate on two different levels of reality. The one consists of "official reality," i.e. explicit rules, figures based on official calculations, defined processes and clearly delineated structures. The other level involves "de facto reality," in other words how people cooperate from day-to-day, how the company functions in the real world or its true liquidity situation. There is often a considerable disparity between "de facto reality" and official balance sheets, work assignments, instructions, channels, organizational plans and fixed rules.

It is to the credit of sociologists John W. Meyer and Brian Rowan that they do not endorse popular demands that the gap between the two levels of reality be closed. Rather, they point out that the development of external representations which are decoupled from the organizational reality as perceived from within does indeed fulfill a purpose. Meyer and Rowan's thinking is essentially based on the following considerations. Organizations are confronted with contradictory demands and norms. They must not only fulfill technical *efficiency requirements* and produce, for example, cooking pots, automobiles or software programs that work, but they must frequently also satisfy political, legal, economic and scientific *legitimacy demands* issued by their environment. The problem is that the often-contradictory legitimacy demands are generally incompatible with efficient production. A company must pay serious attention to requirements for environmentally sound production, to shareholders' rationalization requirements, or the need to reconcile production structure with the latest management methods, even though such demands frequently hamper the organization of efficient, streamlined production.

Organizations react to such contradictory requirements by disconnecting their internal core structures and the processes necessary for day-to-day operations from their surface structures, the ones which can be observed from without. This allows them the necessary latitude to continue functioning in spite of the requirements. They are able meet legitimacy demands *and* at the same time focus daily activities on the concrete necessities directly associated with creating value. Ultimately, there is no way to avoid the resulting "hypocrisy" and "disingenuousness" of companies.[95]

One central function of disconnecting legitimization strategies from business reality can be seen in preventing internal company disturbances from immediately resulting in critical inquiries from the environment. A true-to-life depiction of a company's circumstances would raise external questions about its legitimacy and lead to fault-finding probes from political institutions, the media, banks or even regulatory agencies. The probing would be assimilated into the organization in the form of insecurity, which would in turn aggravate internal conflict and discord.

The crass forms of balance sheet cosmetics can be traced to the growth models underlying most venture capital-financed companies. Since they are dependent on receiving further rounds of financing from the capital markets, companies must take very specific steps to avoid sending any signals which could be disconcerting. The failure of venture capital

[95] For relevant information see specifically Meyer and Rowan 1977; regarding the function of hypocrisy see Brunsson 1989.

investors to transfer funds, reduced opportunities to raise new monies through an IPO, or a drop in the price of company stock – the currency companies use for acquisitions and refinancing – can quickly spell the end for a capital market-oriented enterprise.

((U3))The Limits of the Dual Reality

The main problem companies encounter in exit capitalism is the inability to manage the "dual reality" effectively. The discrepancy between "official reality" and "de facto reality" must be adapted to the sensitivities of the organization's environment. Boom phases, when investors in the capital market thirst for growth and expansion stories, allow companies great leeway with their window dressing. When the stock market is rising, the question is not primarily who's making money and who's losing it, but who's making how much. During such periods interest in looking behind the scenes is not particularly keen.

The tolerance for discrepancy between "official reality" and "de facto reality" diminishes, however, when stock prices begins to crumble. Granted, a bear market isn't particularly pleasant even for companies with business models based primarily on selling products. As a rule, though, it doesn't threaten their very existence. As long as the company's income from the sale of products and services continues to exceed its expenditures, its liquidity is not directly threatened. The observers of capital market-oriented companies, however, are fully aware of how dependent such companies are on their good standing in the capital market.

This explains why the capital market reacts very sensitively during downswings if the management of a company pushes the discrepancy between “official reality” and “de facto reality” to the limit and, for example, is forced to restate its financials. When Tandem, the now mostly forgotten computer manufacturer, had to restate its balance sheet in 1982 because it had prematurely recognized computer sales, and revenue growth for the year amounted to “a mere 50 percent,” the company's stock lost half its value. In 1990, when accountants at database developer Oracle ran out of ways to continue their numbers games, and their pyramid of very prematurely recognized sales collapsed, the stock market penalized the company with a 31 percent drop in share price. The founder of the company alone sustained a paper loss of over $300 million. When Microstrategy was forced to announce at the turn of the century that it had only been able to meet earnings projections through the accounting trick of prematurely recognizing revenue and had been ordered to restate its financials by the U.S. Securities and Exchange Commission, the company's stock went into a tail spin. When the company was then forced to report a $30 million loss instead of just under $13 million in profit, the price of its stock dropped 62 percent. The company, which was worth $25 billion on March 11, 2000, lost $11 billion in value on a single trading day.[96]

In exit capitalism such sudden drops in share price can easily break a company's neck. Enron, WorldCom and Qwest, the paragons of exit capitalism, didn't go under because they were shown to be deeply troubled companies after the balance sheet manipulations had been discovered, but because their apparently “creative accounting” had caused the capital market to lose confidence in them, and their capital market-oriented business model no longer

[96] Regarding Tandem cf. Malone 1985, 288; for Oracle cf. Kaplan 1999, 144f; for Microstrategy cf.. Yang 2000, 70.

worked. Or, stated even more provocatively, the exit capitalist companies that performed the financial manipulations did not go bankrupt because chaos reigned behind the scenes, but because their leadership had not organized the accounting sleight of hand adeptly enough. Their management of the dual reality was simply not sufficiently professional.

((U1))V

((U1))Growing Pains: Organizational Problems in Venture Capital-Financed Companies

“During the Internet boom in many cases all it took to get hired was a normal body temperature and the ability to stand on your feet.”

Martin Andersen of SuperWebOffice quoting a popular saying from the Internet scene.

The organizational structure of venture capital-financed companies exerted an attraction that reached far beyond primarily capital market-oriented companies. At the height of the venture capital boom one was under the impression that a new form of management, a new kind of organizational structure was developing which could serve as a model not only for businesses but also for bureaucracies, hospitals or non-profit organizations. If the boom only lasts long enough, managers, consultants and academics begin to plead the case of a new “democratic” style of company, presenting the organizational structure of growth companies such as Apple, Lotus, Cisco or Amazon as the new "best practice."[97]

Even in the 1960s, semiconductor manufacturer Fairchild Semiconductor was already earning praise because its top management had no private offices. There were no reserved parking places, no dress code, no separate executive canteen and no impermeable middle management layer. Fairchild's venture capital-financed competitor, Intel, also experimented with decentralization, teamwork and project management long before such approaches became popular in other companies. When venture capital-financed computer manufacturers like Apple, Atari or Osborne Computer began their (sometimes very short-lived) victory march, they likewise earned kudos for their "people-friendly" management principles.[98]

Growth companies were driven by founding élan and enjoyed financial security through venture capital. This, coupled with their dynamics, commitment, and organizational abilities, prompted them to proclaim a management revolution. Not only did management distribute a product or service, but within the framework of an overall organizational marketing strategy the companies also put themselves forward as models for the business organizations of the 21st century. Venture capital-financed companies presented themselves as small, flexible units, which are especially viable in times of rapid change and can adapt easily to the vicissitudes of the market.

At the height of the venture capital boom, established corporations did not remain unreceptive to the appeal of such startups. When the Internet boom reached its peak, Rupert

[97] Cf. Malone 1985, 418.

[98] Cf. Malone 1985, 97; Cringley 1992, 40; Saxenian 1994, 29 und 50; Kaplan 1999, 51f.

Murdoch, for example, remarked that the world was changing very quickly. “The world is changing very fast,” the media mogul stressed. “Big will not beat small anymore. It will be the fast beating the slow.” Automobile manufacturer DaimlerChrysler sent out invitations to a convention which was to allow automotive executives to learn from the managers of small dynamic Internet startups. Union leaders voiced suspicions that the board wanted to transform well-established companies like Mercedes, Chrysler or Freightliner into start-ups in order to drive up stock prices and experiment with new management techniques. Global media concerns like Bertelsmann acquired young Internet companies such as Pixelpark, Lycos or Webmiles not only as a means of tapping into new business sectors but also to profit from the companies’ management ideas.[99]

What is it about the exemplary quality of these firms, that periodically makes them the subject of admiration? What role does venture capital financing play? This chapter will explain that the exemplary character of these companies is connected with their group-like organizational structure during the start-up phase and, not with the discovery of new management methods. Once venture capital financing has promoted their growth, however, the companies then realize the necessity of creating more complex, differentiated organizational structures. Specific organizational problems, which become apparent no later than the end of a boom phase, are the result.

((U2))1. The Organizational Promise

[99] Cf. Malmsten, Portanger and Drazin 2001, 203.

The attraction of start-ups lies in the apparent ability of these young, venture capital-financed companies to a get a handle on organizational problems which have plagued the automobile, chemical and machine-tool industries, banks and insurance companies, and vast government bureaucracies for decades: hierarchies create protracted, complicated decision-making processes; employee motivation is low; and cooperation between separate units is poor.

Venture capital-financed companies hold out the following promises. *Hierarchies*, if we are to believe the companies' self-portrayals, play almost no role in the early stage of start-ups. The Cluetrain Manifesto, a creed of company founders, managers and employees in the Internet sector which today is of historical interest only, tersely states that hyperlinks undermine hierarchies. In companies where employees cooperate with each other independently of organigrams, regulations and management dictates, hierarchies – according to the manifesto – lose their purpose. The days when managed and administered companies appropriated the identity of their employees are over. Supposedly, the goal now is finally to really enjoy work, with no boss and no alienation.

Managers in early-stage, venture capital-financed firms can only smile at the *motivation and control problems* which pose a never-ending chore for executives, consultants and motivational trainers in traditional companies. If one is to believe the reports of growth companies, their employees are upbeat and motivated when they come to work and stay as long as it takes to get the job done, despite comparatively low salaries. Assignments are finished without the need for management monitoring the results. And employees who don’t have an assignment on their hands, seek tasks somewhere else within the firm.

Likewise, *coordination between different units* does not seem to pose a problem for growth companies. The departmentalization of functional units appeared to be an alien concept during heyday of the semiconductor, PC, biotech and Internet industries. Geoffrey

James of the Institute for Business Wisdom and author of a small book on “Business Wisdom” of and for “the Electronic Elite” explains that forming any type of bureaucracy would be suicide because markets change so quickly. Very few growth companies encounter problems with the so-called “over-the-wall” approach to product development (known from the automotive and machine-tool industries) where each division works in isolation, and when the product is finished it gets “thrown over the wall” to the next unit. Employees collaborate on a common product, and when a customer project has a tight deadline official boundaries between divisions are no longer observed.[100]

((U3))A New Era of Cooperation or a Redefinition of the Relationship between Capital and Labor?

The organizational promises during hype phases culminate in declarations of a new relationship between capital and labor. The companies which emerge with each successive venture capital cycle are hailed as harbingers of a new era of cooperation between investors, managers and employees. When chip manufacturer Intel was still in its infancy, for example, it was once ironically labeled a model for “entrepreneurial communism,” in which a large research team set its sights on the goal of market expansion and profit maximization through

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[100] Regarding James cf. Southwick 1999, 25; in principle see The Cluetrain Manifesto 2000; see also Locke 2000; Weinberger 2000a; 2000b; Levine 2000.

common effort.[101] The venture capital-driven boom in the Internet sector was used as an occasion to herald the end of opposition between employers and employees. There were euphoric proclamations that the capitalist era with its fragmentation, discord and contradictions was re-casting itself as a service and information society, and was headed toward a pinnacle of perfection in its Internet edition.

From this perspective, unions, works councils and other labor representatives looked like relics from the prehistorical period of class struggle which could no longer claim any raison d’être in the working environment of the New Economy. When the Washington Alliance of Technology Workers (Wash Tech), a U.S. union, attempted to recruit members at Amazon, the company’s CEO, Jeff Bezos, declared that his employees had no need for unions in their shop. On Amazon’s internal Web site information for managers was posted suggesting that the earmark of a recalcitrant employees was hanging around the canteen and the bathrooms. Karsten Schneider, who was second in command at Intershop, declared that management would have failed if the company were to be unionized. Paulus Neef, head of multimedia agency Pixelpark, speaks of an identity of interest between management and employees in his company. His employees could find five other jobs in a different company at the drop of a hat, and therefore naturally had no need for union representation.”[102]

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[101] Cf. Malone 1985, 14ff.

[102] Regarding Amazon cf. Koch 2001, 67; on Intershop cf. Hapke and Müller 2001, 34; on Pixelpark cf. Neef 2000, 28. For examples of attitudes during the early stage of exit capitalism see Rogers and Larsen 1984, 191.

((U3))The Model and the Cycles of Venture Capital Financing

The discussion of start-ups as model organizations, of the final resolution of conflict between capital and labor, and of the dispensability of unions follows venture capital cycles with a certain time lag. When venture capital is flowing into a sector, start-ups are shooting up like mushrooms, stock prices of exchange-listed companies are exploding, and employees in booming industries can choose freely between employers, then companies present themselves as exemplary organizations. They praise their free “perks” for employees such as private shopping services, domestic house-cleaning services and massages. They extol their employee stock packages and introduce innovative forms of management.

When the ongoing venture capital flows into a sector dry up, when stock prices – an important source of financing for high-tech companies – collapse and customers are no longer willing to pay any amount for products, the exemplary qualities of the companies soon evaporate. Growth tracks must quickly be brought to a halt. Rationalization measures require branch closings and layoffs. Companies no longer bear such a strong resemblance to the model enterprises of capitalism in the 21st century. On the contrary, they frequently lead us to suspect a relapse to the days of early capitalism when workers were put on the street without warning or security.

This wave already occurred during the PC and software boom in the 1980s, but it was especially clear during the Internet boom at the end of the 20th century. When the stock market tanked in 2000 and venture capital flows dried up, the Amazons, eBays and Intershops ceased being an employee paradise from one day to the next. No longer were the differences between investors, management and employees seemingly resolved, and the companies were suddenly pilloried for their vicious hire-and-fire policies. Sometimes unions were formed to protect employees against supposedly autocratic management practices only months after the management (and the employees!) of the same venture capital-financed companies had announced that they did not wish unionization. Such cases often resulted in employees racing with management to organize a union in time, before the first wave of job cuts, so there would be a basis for negotiating settlement packages. When the Internet bubble burst, the owners of model companies, like Jeff Bezos of Amazon, Stephan Schambach of Intershop and Paulus Neef of Pixelpark, were hard pressed to explain why their employees were clamoring to unionize.

Venture capital cycles offer evidence supporting both the commendation as well as the condemnation of labor relations in venture capital-financed companies. At the beginning of a cycle representatives of employer associations, politicians and journalists can polish their image by pointing out that paradisiacal working conditions make union representation superfluous. When the economic downswing comes, their opponents can pipe up with, “I told you so” and point to the necessity of labor representation in the workplace. To a large extent, however, such cyclical analysis does not address the question of why venture capital-financed companies do not suffer– at least during certain periods – from the typical organizational problems which plague established firms.

((U2))2. Communal Living As an Organizational Principle

Business economist and company founder Stephan Jansen characterizes the organizational ideology of start-ups as “management by Enid Blyton.” This children's book author sends her protagonists off on adventures exhorting them to be “five friends.” Company founders seem to adopt such advice as a management philosophy.[103] As the first employees are brought on board, the original three, four or five friends might come to number 10, 11 or even more. The start-up views itself as a “clique of friends,” as a “living and working community,” or as a “family,” with all members towing the same line and experiencing the adventure of “the company.”

The special part of this “management by Enid Blyton” is that the sense of friendship, family or communality extends not only to individual employees but to the company’s entire staff. Friendships, personal relationships or even love affairs *within* organizations are also commonplace in corporations like General Electric, UPS or IBM. The sales force of a turbine manufacturer might regularly attend baseball games together – it sees itself as one big family. The production line workers of a shipping company might share a chummy camaraderie, almost a friendship. The head of a software development team might find her secretary especially attractive. But when the management of these major corporations tries to create “a sense of family” by launching million dollar internal ad campaigns, most of the employees at General Electric, IBM or UPS wouldn't dream of describing their relationship with the other 100,00 or 200,000 employees in terms of family or friends.

In start-ups the situation was different. Here, mutual attractions were not limited to individual members. Rather, employees identified with the dynamics and cohesion of the group as a whole. Tom List, a team leader at online company Netdollar, describes the atmosphere in the early days of the firm as “family-like.” “When I talk about family,” List says, “I simply mean a special kind of togetherness that goes further than strictly business.” In

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[103] Cf. Jansen 2002, 6.

this respect relationships were entirely different from those in Old Economy companies. "They were genuine personal friendships that people made there – more than just a few beers after work. You could really open up, and talk heart to heart."[104]

The friendly, communal feelings and the sense of family arise in no small part because young, venture capital-financed start-ups are face-to-face organizations. Many decisions in such organizations are taken through an interactive process involving all of the members. For solving problems, making important decisions, or providing information to all associates, the entire staff is convened around a table in the canteen, in the conference room or in the entrance hall.

Face-to-face organizations, therefore, are characterized by direct interactions. Everybody knows everybody else from working together on day-to-day basis, and even if personal antipathies in individual cases may interfere, in principle every person has direct access to every other member of the firm. An employee in a start-up with a group-like structure can approach the chairperson of the board directly, without causing an annoyance, let alone breaking protocol.

These organizations reach decisions without being tied to rigid communications channels, formal sets of regulations or exact descriptions of job duties or areas of responsibility. There are few meta-decisions (decision premises) governing the manner in which decisions can be made. Thus, decisions arise spontaneously from the group dynamic, are recorded only in the memory of group members and can easily be called into question through a simple new decision.

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[104] List is an anonymized source.

((U3))The Attraction and Brutality of Face-to-face Organizations

Why do employees in face-to-face organizations identify more strongly than in traditional companies?

The first reason relates to the near impossibility in start-ups for informal domains to develop. Since the 1930s research monographs on major corporations have repeatedly stressed that employees often identify more strongly with informal groups within a company than with the overall company itself. Identification with an assembly unit within an electronics factory or with the shaft crew in a coal mine is greater than with either of the overall enterprises themselves. Outside of the formal structures small “informal worlds” arise, which have their own dynamics and can create a high degree of identification.[105]

In face-to-face organizations the formation of such informal domains can only be observed to a limited degree. The majority of interactions within the company occur in public. What any two members of the organization may be concocting is perfectly clear to everyone else. It is difficult to keep a conversation secret, and important information reaches all of the employees in only a short time. Differentiation between “formal” and “informal” is present only in a rudimentary form.

The second reason is that in start-ups with group-like structures, where staff members have day-to-day contact with each other, relationships are frequently not precisely defined. In

[105] Cf. The standard works by Roethlisberger and Dickson 1939 and Trist and Bamforth 1951.

the work environment of highly differentiated organizations employees are evaluated according to how much they can contribute to achieving a goal, and questions which have no relevance for the goal are of secondary importance. In contrast, relationships between members of a small group can only be reduced to a specific purpose to a limited degree. There is ample room for employees to bare their souls and for the creation of new forms of interaction beyond the scope of the professional issues at hand. Relationships are experienced as personal, not just as encounters between “work horses.”

For this reason the integration of new employees in face-to-face organizations is a question of a “total yes” or a “total no.” The demarcation from the surrounding environment is maintained to a large degree by the individual members of the group, but it does not preclude the integration of new members. The moment new members join the group, they are expected to contribute to maintaining the group’s assertion of exclusivity. In contrast to larger organizations there is only little room for withdrawing into a small sub-group, for working by the book, for differentiated identification with the company or for abstracting oneself from the idiosyncrasies of one's colleagues. Sooner or later employees in face-to-face organizations must decide whether they accept the club together with all of the personality quirks of its members or whether they will seek a different club.

These two factors, namely the difficulty of creating an informal domain and the mixing of personal and private roles, have consequences for personnel recruitment by face-to-face organizations. Hiring new personnel in such organizations is frequently not geared to matching pre-defined job duties with a qualified applicant. Instead, it focuses on whether the job seeker’s social behavior is suitable for the company.

((U3)) Quick Strategy Changes

Face-to-face organizations have a major strategic advantage; they can change their corporate game plan very quickly. U.S. social scientist Renato Tagiuri compares them to canoes which, in contrast to giant ocean liners like the Queen Elizabeth II, can change course on very short notice. Granted, the canoes might not have sophisticated life-saving systems like the Queen Elizabeth II, but instead they can react to change with the utmost dispatch.[106]

"Established" organizations are very restricted to an existing definition of their overall purpose due to their formalized procedures, the machinery and technology they have acquired and the staff they employ. Such corporations find themselves on a developmental track they can only change through substantial capital spending and by overcoming massive resistance from those involved. With their group-like structures, start-ups don't have to wrestle with these problems in the same way. As yet, they have not established elaborate value creation processes, there are no job descriptions which are toilsome to change, and no clear interdepartmental boundaries to redraw with every strategy revision. Since people are frequently not hired to fill a specific position in start-ups, they can be moved around within the organization with relative flexibility. The face-to-face organization bears a remote resemblance to a circle of friends which can quickly reach a decision to take in a movie instead of spending an evening playing games.

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[106] Cf. Perez 1986, 89.

Thus, face-to-face organizations achieve a certain degree of “flexibility” in their strategic orientations, which is ideally suited to responding to the demands of the capital market. Since the survival of venture capital-financed companies depends on continuing money flows from the capital market, the firms feel pressure from investors to catch the latest “trend of the week.” Whether we decry or applaud the logic inherent in the capital market orientation, the central issue remains that companies with group-like structures are fully capable of adapting, as organizations, to such rapid business model changes.

((U3))The Growth Company's Dilemma

The circumstances under which capital market-oriented companies operate are inherently contradictory and can be summed up as follows. In the early stages their group-like structures make them ideally adaptable to the demands of capital market logic. They are characterized by a high degree of employee identification, dynamic external self-representation and the ability to shift strategies and goals quickly. The dilemma of capital market-oriented companies, however, is that their dependency on the capital markets forces them to grow very quickly.

In boom times a commonly held notion is that companies can grow at a speed similar to the market itself. The exponential growth which shaped ideas about the development of new markets was applied to growth expectations for venture capital-financed companies. But are the “market” type system and the “company” type system so similar that their growth processes also resemble each other? What happens when a company tries to achieve a growth rate similar to a market which is developing exponentially?

((U2))3. The Problematic Formation of Structure

The kitchen table management style seen in start-ups and their resemblance to communal living or a circle of family and friends, not only points up the attractiveness of the management models they make possible, but also suggests the limitations of this organizational form. Social systems which focus exclusively on promoting verbal communication through direct, face-to-face contact have not proven particularly successful in addressing complex tasks.

In community living, in families and circles of friends, all of the coordination processes – from planning large parties to common gardening activities to caring for the sick – are handled primarily through direct verbal communication. This method of communication, however, has proven successful only in accomplishing relatively uncomplicated tasks. It is successful when applied to organizing a relocation, stabilizing emotionally insecure members of the group or raising children. Organizational forms based exclusively on verbal communication have, however, not been effective in addressing comprehensive production processes or satisfying complex customer needs.

Companies which rely heavily on verbal communication among all members as a coordination style quickly suffer from the symptoms of overload. As they attempt to keep all employees informed of all matters while continuing to dispense with rigid regulations and hierarchies, complexity threatens to suffocate them. The companies realize that it is time-consuming and nerve-racking to inform every employee about the acquisition of a new customer when it entails walking into many different offices and suddenly facing employees one has never seen before. Even group e-mail, the miracle cure, is threatened with failure no later than the moment when employees have to spend two or three workhours just to stay current with their e-mail – frequently without even knowing who the mail is from or whether it is at all relevant for their jobs. Using the e-mail command <all@beenz.com> to ask each and every colleague for help finding one's favorite coffee mug may still have a certain charm among "five friends," but receiving such a message from a colleague one hardly knows by name will probably be rather annoying. During growth processes, reaching decisions through consensus, communication or negotiation soon runs up against its limitations. It becomes clear that too large a number of participants makes negotiations extremely time-consuming. Expectations, individual agendas and group egotisms threaten to inundate the organization, and there are no mechanisms in place to mediate between conflicting interests or even to reject them. Established power structures and constellations of interests can result in great organizational lethargy. The danger arises that interminable discussions will ensue, blocking important decisions.

The signs of overload during growth stages can frequently be seen when employees demand not that management launch a new "communications offensive," but that it clarify "who should be talking less to whom." The situation in a growing organization can be compared to the human brain. In order to prevent an epileptic fit communication between brain cells must be restricted, even if only a fraction of the brain's capacity can be marshaled at one time as a result.

Companies do have mechanisms to govern who "should be talking less to whom," namely hierarchies, organizational divisions and regulations. When companies discuss "stronger communications structures," the issues involved are how to establish hierarchies, where to draw the line between departments, which job descriptions individual employees are to receive, and what rules and procedures they will have to follow. Even if it is preferable to replace the negative connotations of “hierarchy,” “department,” “regulations,” and “job descriptions” by substituting “information channels,” “team,” “value creation process,” and “task profile,” in the final analysis it always remains a question of determining who should have less to do with whom in the organization and in which areas an intensification of a verbal communication is at all meaningful.

Sociologist Talcott Parsons pointed out that hierarchies – in combination with the formation of departments – separate the levels within an organization from each other, thereby making only certain clearly-defined verbal communications permissible. The paths verbal communications must take are determined through the chain of command and reporting and communication channels. By defining in precise terms which verbal communications must even be considered relevant, hierarchies effectively protect each level from becoming overloaded with communications requests from other levels. The head of a company can, for example, ask a Web programmer to discuss any problems first with the appropriate team leader.

According to the work of Nobel Prize Laureate Herbert Simon, only this separation of levels enables organizations to process great amounts of complexity. Through the use of hierarchies, organizations divide themselves into subsystems which are in turn divided into further subsystems. The density of communication *within* the individual subsystems – where solutions are developed and then made available to the entire organization – is greater than *between* subsystems. Because of the divisions the organization no longer needs to the develop overarching solutions, but can fall back on the partial solutions devised in the various subsystems.[107]

But this very partitioning is what destroys the special character of face-to-face organizations with their high degree of employee identification, their dynamic external representations and their ability to quickly reorient themselves to new goals. Especially venture capital-financed companies find themselves in a bind. On the one hand they recognize the need for mechanisms to prevent communication and restrict it to selective channels by creating hierarchies, departmental boundaries, job descriptions, regulations and programs. On the other, they would like to retain the strengths of a face-to-face organization and the spirit of friendship as long as possible.

The result? Venture capital-financed companies often introduce structure in a halfhearted way. “You now have a department head, but naturally you can still come to me with any problems. Even though I’m chairman of the board, my door is always open.” “We now have detailed procedures for dealing with customer orders. But if you find that they don’t work for you, then just disregard the rules and make sure the customer is happy.” “We now have job descriptions outlining precisely what each employee is supposed to be doing. Of course, we still expect everybody to retain that old entrepreneurial spirit and latch on to opportunities, even if they're not part of your job.”

Such inconsistent attitudes toward the formation of organizational structure lead to very specific “growing pains” in start-ups.

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[107] Cf. Simon 1978, 96.

((U3)) Unwanted Centralization

Hierarchies have a bad reputation in venture capital-financed companies. They are held responsible that information flows cannot to be directed to specific recipients. Since information which is important to the entire company is not generated only at high echelons of the hierarchy, the existence of a central decision-making level is seen as dysfunctional. The opinion is that hierarchies create information deficits for many employees, which demotivates them and causes them to leave.

U.S. management consultant Charles Leadbeater maintains that hierarchical organizations fail in a complex environment. Leadbeater claims that examples like IBM show that hierarchically organized companies focus on a limited number of goals, clients and competitors and thus become myopic. While hierarchies do allow employees to concentrate on specific tasks, Leadbeater claims that they simultaneously restrict employees through a complex system of regulations and dampen their initiative. Firms in growth sectors can ill afford this effect.[108]

In venture capital-financed companies a tendency to play down the importance of hierarchies can be observed. Expressions like “extremely flat hierarchies,” “dispensing with classical hierarchies” or “the end of hierarchies” signal that one plans to avoid falling into the same traps as the “dinosaurs” of the same industry.

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[108] Cf. Leadbeater 2000, 62; see also Evans and Wurster 2000, 218.

But is this critical view of hierarchies really founded? Herbert Simon pointed out that hierarchies generally do not function through the „brute force" of orders, and that orders frequently do not need to be carried out against the will of those who have received them. The authority conferred through hierarchies can be worn down if it resorts to overt threats and sanctions too often. Thus, rather than issuing orders and meting out punishment, the important roles in hierarchies tend to involve inconspicuous control over information flows, the assignment of task packages, and mediation between the conflicting interests of subordinates.[109]

Naturally, a hierarch may be required to give direct orders ("As this company's CEO, I am instructing you to . . ."), implement decisions over employee resistance ("Even if you don't agree, do it anyway.") or even issue threats ("You will receive a reprimand."). In extreme cases superiors may also resort to their rights to terminate an employee or bar his or her advancement.

In venture capital-financed companies there is a special situation. Due to the rapid growth of most of the companies direct hierarchical orders are seldom necessary. When venture capitalists are clamoring for the companies in their portfolios to implement aggressive "money burning" policies, and many firms are under the impression that virtually unlimited financial resources are available, the distribution of resources is rarely a matter of serious contention.

Such special circumstances during the growth stage lead many venture capital-financed companies to believe that they have either "an extremely flat hierarchy," a "very

[109] Cf. Simon 1957.

special” one, or none at all. Positions such as chairman of the board or director of marketing are seen as necessities for external representation, while internally the clout of such hierarchical positions is viewed as extremely limited. The positions are created and impressive titles are printed on business cards because customers from traditional industries flatter themselves with having high-ranking contacts. But internally the positions command no particular authority.

What effects stem from such hesitation to implement hierarchic decision-making structures to the fullest?

Managing to a large degree without clearly defined hierarchic structures makes every decision, in principle, subject to criticism by every employee. Feeble, ineffective hierarchies put every employee, male or female, in a position to question the decisions of others, because the decision-makers have only limited recourse to legitimizing themselves by saying, “I'm the boss, and that's the way we're doing it.”

The consequence of reservations about fully implementing hierarchic decision-making structures and of fuzzy interdepartmental boundaries is a strong politicization of business decisions in venture capital-financed companies. The reasons for conflict are frequently perceived not as the result of different positions within the company or poorly defined structures, but rather as personal discord. There is only limited understanding for the conflicts which can arise from task differentiation – which testifies to the lingering effects of the growth company's group-like structure in its early days.

French organizational sociologist Erhard Friedberg pointed out that the depersonalization of problems typically seen in organizations can fulfill a purpose. In bureaucratic organizations the decisions made by people in their role as position holders are viewed as external to the people themselves, as quasi impersonal actions. The people therefore base their decisions solely on the role they play as members of the organization. And while there can be no doubt that major decisions have consequences for the affected individuals far beyond their organizational roles, retreating into their roles enables them not to view the decisions as a "personal affront," a "termination of friendship" or the "degradation of an entire human being." Personalizing a workplace conflict can deeply scar those involved and sometimes even qualify as "mobbing" – while the organization itself has no memory of such injuries.[110]

Graver consequences for the company are created when managing with as little hierarchical structure as possible leads to the exact opposite of the desired effect. In the very companies which value especially flat hierarchies, decisions are frequently not reached in a centralized rather than a decentralized fashion. Since the middle management level is weak, it can offer little resistance when the CEO appropriates decisions which actually fall under the purview of the department heads. Thus, *decentralization leads to centralization*.

The centralization effect can be observed in the histories of many venture capital-financed companies. For example, Apple CEO Steve Jobs commanded a degree of hierarchical control some Old Economy CEOs could only dream of. With Apple, the paradox was that a company which had been praised for its family atmosphere in its early days developed an increasingly autocratic management style; employees wondered whether the entire company would collapse if Steve Jobs were run over by a bus one morning.[111]

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[110] Cf. Friedberg 1993, 64.The definitive film on the subject of growing pains is *Sartup.com* by Hegedus and Noujaim (2001) (available on video at Amazon.com).

[111] Cf. Malone 1985, 386; Cringely 1992, 196 f.

((U3))The Sudden Escalation of Organizational Problems

In boom times venture capital-financed companies are still able to get a grip on their organizational problems in the short term through an enormous investment of resources. For problems in accounting or controlling, consultants are brought in to develop solutions, short-term though they may be. Freelance software developers are hired to create computer-based platforms for departmental coordination. Coordination problems are also solved by intensifying communications. Employees, motivated by stock options and a gold rush mentality, are willing to work evening and weekend shifts so that steps for the future can be developed as teamwork.

Only when the stock market sours do the structural problems outlined above become generally obvious. In boom times the strongly centralized decision-making which is always a feature of venture capital-financed companies due to weak middle management, and the limited effectiveness of rules, programs and routines are already present in outlines. In most companies, however, they only emerge as problems when financial infusions from the capital market dry up and precipitate a crisis.

((U1))VI

((U1))Profit as Myth: The Threat of Collapsing Capital Markets

"The founding of a company always has something to do with wishful thinking, on the part of the founder as well as the investors. Often, the wishing thinking focuses on finding a quick, lucrative exit from one's own investment. And in all of the overpriced office lofts in New York, Los Angeles and Chicago the exit sign had to be hung in a clearly visible place."

Economist and company founder Stephan A. Jansen[112]

Loss of faith in growth potential combined with falling stock prices is the maximum credible accident for capital market-oriented companies. The first major bankruptcies of companies in an industry, falling high-tech stock prices and difficulties "placing shares" during an IPO have the cumulative effect of producing a massive loss of investor confidence. Death lists appear citing companies that are burning a lot of cash, and calculations are made for how long these firms can survive without additional financing. Since investment strategies in exit capitalism do not hinge primarily on factual knowledge about companies, an industry or a technology,

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[112] Cf. Jansen 2002, 6.

but on the perception of such facts by other investors, venture capitalists react extremely sensitively to the first signs of panic in a market sector and withdraw their capital from companies in that industry.

Whereas venture capital investors and entrepreneurs maintain almost harmonious relationships during boom times and regularly declare their loyalty to each other during periods of stock market euphoria, conflict now erupts. When the two parties cannot agree on mutually acceptable language which disposes of the guilt question, such as “bad luck,” “unfortunately somewhat too late,” or “this crazy stock market,” a generally internal but occasionally also public round of passing the blame begins. Company founders feel that they have been left in the lurch because the speculator community is not willing to extend further credit once the initial advance has been squandered. Venture capitalists declare that they naturally had no intention of pouring the money down the drain and point the finger at the entrepreneurs who were not capable of using the financing they received to create a basis for sustaining the company in the medium term.[113]

While the previous chapters have focused primarily on describing the situation of venture capital-financed companies during a stock market boom, this chapter will concentrate on their attempts to survive when the capital market collapses. Plunging stock prices mean that existing companies will only be able to obtain further financing from the capital market under the greatest of difficulties and that their “currency,” namely their shares, loses value. Now they can no longer (so easily) use company stock to compensate their employees or pay the service providers of exit capitalism. Now they must put up dollars, euro, pounds or yen. In

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[113] Cf. *Gegenstandpunkt* 2001, 125.

this phase venture capital-financed companies change the message they are broadcasting on all channels from “growth” to “profitability.” The object is not only to cut costs and ensure their own liquidity as the capital markets collapse. By reporting, “We will soon be profitable,” the firms hope to attract a little more financing even amidst the decline.

((U2))1. The Decline of a Company's Most Important Currency – Its Own

Capital market-oriented companies use their own stock like a currency with which they pay suppliers, employees and business partners. In a booming stock market the exchange rate of this company-owned currency is favorable for the companies, and a business culture develops in which company shares are the most important “coin of the realm.”[114] Service providers speculate that they will get a better deal if the currency continues to rise than they would if they took payment in U.S. dollars, British pounds or euro.

Even companies which are not yet traded on the exchange can buy services cheap or receive them gratis by pointing to the forthcoming IPO and the issuance of their “own coin” which will be associated with it. Advertising agencies, for example, develop initial concepts at no charge because they hope to gain an attractive account after the company obtains venture capital financing or goes public. Consultants offer their services at reasonable prices because they reckon with privileged access to the client once the company has been established. Employees are willing to work 60 or 70 hours a week at low salaries because

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[114] Cf. *The Economist* 11.18.2000, 85.

vague promises of stock options make them dream of getting rich once the company goes public.

This system of paying the bills with company stock or the promise of company stock works beautifully as long as there is a prospect that share prices will rise rapidly following the IPO. But the system implodes as soon as share prices drop or the date of the company's public offering is postponed until the remote future. When stock prices fall and ongoing financing evaporates, the result is a rapid and almost unstoppable decline of the company’s own currency.

This changes the basis on which the company conducts its business. When a company teeters on the brink of bankruptcy because the flow of money from the capital market is drying up, business partners suddenly demand market prices. Business consultants, personnel consultants and software suppliers now offer their services only on a payment-in-advance basis. Service providers who had agreed to deferred terms of sale with an eye on their client's impending IPO, now instruct their attorneys to sue for payment. Relationships between companies which were characterized by trust during the boom times are now increasingly replaced by legalities.

Employees see their stock options becoming worthless and demand appropriate salaries paid in the customary fashion. In both the software and the hardware boom as well as during the Internet boom, for example, employee shares and stock options lost most of their value when stock prices on the high-tech exchanges plummeted. The employees sneered at receiving payment in the form of company shares as a “fair-weather event” and laughed at the “funny money.”

((U3)) The Problematical Fusion of Capital and Product Markets

Doubts concerning the viability of capital market-oriented companies also have a direct effect on their ability to sell their products and services. End users, middlemen and other businesses are extremely hesitant to buy a firm’s products if they are no longer certain it will not be bankrupt in five or six months. According to one senior executive at Internet-based Netdollar, the question, “Will you guys still be around for a while?” was key after the stock market collapsed.

Such doubts about a company's long-term ability to deliver goods are problematical. When money flows from the capital market are drying up, firms are especially dependent on receipts from product sales. When stock prices fall, income from the sale of products or services must replace the majority of income from the capital market and keep firms afloat until they can obtain capital market-financing once again.

The problems are further aggravated because companies must be able to report products sales in order to attract dwindling capital inflows. If a company can no longer report product sales, investor interest declines even further. Venture capitalists, investment funds and small shareholders are no longer receiving the necessary signals indicating that the company will be able to sustain itself in the foreseeable future.

Even Baan, a business software manufacturer and occasional serious competitor of SAP, fell into the trap of too tight a fusion between capital and product markets. The company was built around rapid growth supported by a high stock price. When American business analysts began to level criticism at the firm’s management, share prices nose-dived. The company encountered increasing difficulties attracting new capital while operating losses reduced liquidity even further. At this point customers like Siemens and Carrier Corporation jumped ship and switched to products by competitor SAP because they were no longer certain how long Baan would be in business. This process, in turn, directly reduced Baan's income fuelling doubts in the stock market whether the firm was still viable.[115]

As the stock markets melted down, the former paragons of the Internet sector, where customers had lined up at the door during boom times, were forced to document their financial health every time they negotiated transactions. They could only market their Internet services or their software developments if they could prove that they still had a large enough financial cushion. The public offerings which many companies had also used to advertise their products suddenly turned into leg irons. Every time a drop in a company's stock price was reported, its customers asked themselves how long it would manage to survive.

((U3))The Incubator Implosion

During boom times a number of firms expanded their business models to include supporting growth companies during their earliest stages. This incubator model is based on continual refinancing with venture capital. During a bull market, breeding young companies and taking them public is an excellent way to attract capital. Ideally, a parent corporation can repeatedly put money in the till – even if its own operations are unprofitable – by constantly spinning off money-losing subsidiaries and taking pampered growth companies public.

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[115] Cf. Baker 2000, 20.

The moment financing from the venture capital market begins to slacken, the flow of money into young companies is the first to dry up. Venture capitalists believe it will be difficult to buck the trend and still take the young incubator companies public or sell them to a larger corporation. Under such circumstances the owner of an incubator is left sitting on his "eggs" and cannot anticipate selling them even as "chicks" let alone "hens." Since companies are not profitable in their earliest stages, incubator owners have no alternatives other than repeatedly dipping into their own reserves to finance their companies, or pulling the plug and risking that most of the chicks in the incubator will die. Since incubators are not backed by contractual financing obligations from venture capital funds and cannot charge their investors non-performance-based management fees, their well quickly runs dry.

For these reasons even the model incubators of the Internet boom imploded when the stock markets collapsed. After the Internet bubble burst, Ideallab founder Bill Gross, who is credited as one of the inventors of this business model and had opened branches in Silicon Valley, Boston, New York and London, had to face accusations that his incubators had bred nothing but rotten eggs. Stock in his publicly traded firm lost well over 90 percent of its value over the course of 2000. Companies which had been coddled in his incubator, such as Eve.com and eToys, went bankrupt..[116]

The only remaining alternative for firms which operated their own incubators was to close down as quickly as possible the companies they had formerly pampered and board up their incubators. Firms like Marchfirst, BlueC and Pixelpark which had all shuttered ambitious incubator projects wrote off their incubators with substantial losses. They attempted

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[116] Cf. *Business Week* 1.8.2001, 59.

to stretch their continually dwindling liquidity, but their attractiveness to investors who had bet on rapid growth had been lost once and for all.

((U3)) The Problem of Competitors Failing

Conventional economic theories, written with product market-oriented companies in mind, maintain that a competitor's bankruptcy spells an advantage for the surviving company. It offers an opportunity to capture the markets and recruit the most competent employees of the failed company. Additionally, the theories run, price wars subside and direct innovation pressure is reduced. This is why bankruptcies of major corporations in markets with few suppliers also attract the attention of antitrust authorities who fear the creation of monopolies which could distort competition.

In capital market-oriented firms the reasoning is entirely different. Here, the success or failure of a competitor is viewed as an important indication of whether a business concept is viable or not. If an important competitor folds, doubts immediately arise whether the basic idea is a moneymaker or not, and investors threaten to withdraw their financial support of businesses based on the concept. The sole reason why many venture capitalists invest in a company is because it already has successful models in the USA, Great Britain, Germany or Israel. By copying the existing model, they hope to create a company which can either compete with it successfully, or will at least to be bought out by the model company for stock or cash. But the moment the major competitor declares bankruptcy, investor confidence in the business model is lost along with any possibility of a buyout.

The situation was particularly problematical for European enterprises in the Internet sector. Marc Lecomte of Ad Venture, a venture capital firm with business interests spread over the entire world, explains that there is a phase lag of about two years between the U.S. and Europe. Many venture capitalists in Europe justified their investments in European companies by pointing to the obvious successes of the same business plans and models in the USA. The instant the U.S. competitor folded, Lecomte explains, venture capitalists no longer had sufficient grounds for investing in comparable European enterprises, and immediately cut off financing.[117]

A good example is the concept of surfing the Internet for pay. The bankruptcy of the firm Alladvantage, which had billed itself as the world's fastest growing Internet community and advertised that it paid its members for surfing the Internet, directly reduced the survival chances of competitors such as BasicPoint, BePaid, CashFiesta, Fairad or PaidforSurf. Competitor Cyberprofit, which sold target group-specific advertising over the Internet via the Cash Machine pop-up window and paid its customers for surfing if they would tolerate an advertising banner on their screens, had to file for bankruptcy four months after Alladvantage. Once market leader Alladvantage had filed for bankruptcy, the business model of “surfing for pay” was ranked as a failure, and venture capitalists were no longer willing to back companies in the sector.

A further example are do-it-yourself web sites. The bankruptcy of Hotoffice, the market leader in the sector, immediately slashed the chances of competitors to attract venture capital and created major difficulties for companies like Intranets.com or SuperWebOffice.

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[117] Lecomte is an anonymized source.

SuperWebOffice CEO Martin Andersen explains that for New Economy firms the failure of a competitor is not good at all. If a well-conceived company can’t make it, according Andersen, then that's a bad sign. After his competitor folded, funds which had invested in the firm announced that they had lost interest and would rather back something else.

((U3))The Vicious Circles of Capital Market-Oriented Companies

Developments during collapsing capital markets can be distilled into a simple hypothesis which contradicts classical economic theory: the stock prices of capital market-oriented companies do not collapse because the companies are experiencing a product market-related downturn. Rather, the downturn companies experience is caused by the collapse of their stock.

Even though this hypothesis places a different emphasis than classical economics, we must not overlook developments in the capital and product markets that – as was shown – escalate in a vicious circle. The decline of a capital market-oriented company's own “currency” (i.e. its stock) results in its having to pay cash for services, which in turn exacerbates the company’s liquidity crisis thereby fuelling further doubts about the value of its stock. When capital infusions are no longer forthcoming, additional skepticism arises questioning whether the firm can even continue delivering product. The resulting lack of product-related business prevents the company from reporting good sales and revenue figures, thereby sending a message which might encourage investors to provide another round of financing. The companies are caught in a vicious circle which can escalate to a life-threatening situation. The moment refinancing from the capital market falters, the companies are left with very high fixed costs with hardly any operating income to cover them.

The classic reaction of product market-oriented companies under such circumstances is to buy fewer raw materials, reduce working hours, or cut staff in order to lower fixed costs. If, for example, automobile maker Ford finds itself in a financial crisis, it can lower costs by laying off 35,000 workers and closing five plants. Such measures enable companies to adapt to imploding markets and remain solvent.

Capital market-oriented companies cannot readily implement such strategies. Martin Andersen, founder of SuperWebOffice, remarks that when additional financing is no longer forthcoming, belt tightening is well nigh impossible. Once a large team has been assembled, even smaller, as yet unlisted companies have monthly fixed costs of $200,000 to $300,000 based on salaries, office space and servers alone. Each C-level position such as chief executive officer or chief financial officer runs up the tab by another $150,000, regardless of whether the firm has any income or not. In the opinion of this company founder, once things are up and running there's no cutting back.

How do capital market-oriented companies react in this crisis?

((U2))2. A Survival Strategy: Using Profitability to Send a Message

"We understand." That sums up the message growth company CEOs broadcast on all channels when their industry becomes involved in a downward venture capital spiral. For example, after the capital markets had been fed slogans like B2B (business-to-business), B2C (business-to-consumer) or C2C (consumer-to-consumer) for an extended period during the

Internet boom, the catchword P2P (path to profitability) was introduced. The mantra “grow big fast,” which was associated with rapid international expansion, large-scale marketing campaigns and explosive revenue growth, was replaced with the logic of “get profitable fast.”

Suddenly the business principle of “keeping your expenditures lower than your income” was celebrated as the new maxim of venture capital-financed companies. Robert Bauer of Foodstep explains that the collapse of the capital markets shook the business model of the Internet companies. Somewhere along the way attempts to replace the important axiom of “earnings equal revenues minus costs” – which is so central to market economies – with the formula “revenues through venture capital” had stopped working. Narween Jain, founder of Infospace, a wholesaler of Internet content, explains that he traces his firm's success to advice he received from his mother, “Always spend less than you earn.” Meg Whitman, CEO of Internet auction house eBay, who was also celebrated in times of crisis, reported that she had one very simple criterion for a successful company: increase your revenues faster than your costs.[118]

It is important for companies to anchor their promises of profitability to concrete dates. Even Jeffrey P. Bezos, CEO of Amazon, who at the height of the Internet boom consistently refused to prognosticate when his firm would achieve profitability, made a commitment to a concrete date once the stock market had collapsed. According to New Economy analyst Mary G. Meeker of Morgan Stanley Dean Witter, this was the only way he could prevent Amazon's investors from bailing out.[119]

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[118] Regarding Jain cf. Harmon 1999, 184; for Whitman cf. Whitman 2001, 50.

[119] Regarding Amazon cf. Hof 2001, 41.

The object of setting a concrete date for profitability is to create the impression among investors that the Damocles Sword of bankruptcy will soon no longer be dangling over the company. Granted, when the market declines even the most optimistic CEO cannot prevent stock in her company from no longer evoking profit fantasies, but by repeating the mantra of soon-to-be-reached profitability as if it were written on a prayer wheel she can at least avert panic sales by shareholders who fear that their investments will be lost entirely.

But there are also various other possibilities for venture capital-financed firms to signal that they have switched business models from relentless growth to profitability. Among such models are disassociating the company from firms which have failed, revising the company's use of language and changing its dress code.

((U3)) Disassociating the Company from Failed Business Models

When the market turns down, constant repetition of the profitability principle is often heard in conjunction with the observation that now the good companies will finally be separated from the bad. Some poorly managed companies which were built on shaky foundations will now have to pay the price, the reasoning goes, but the well-managed ones with promising products will prosper over the longer term. Thus, when the Internet bubble on the stock exchange burst, Jeff Bezos of Amazon complained that his industry had attracted swindlers. Many business plans, Bezos complained, had been geared exclusively to pumping up stock prices as quickly as possible, and then getting out and leaving others holding the bag. Paulus Neef, whose firm Pixelpark reported increasing losses every quarter during the Internet boom, commented that in the wake of the capital boom the market was going through a necessary cleansing and only the companies with sound business practices would remain in the field.[120]

Once a company gets caught in the venture capital melt down and files for bankruptcy, fund managers, analysts, venture capitalists and business partners drop it like a hot potato. A clear distinction is drawn between companies which go bankrupt due to mismanagement, flawed business models and faulty market assessments, and the “good” companies which are losing value unfairly.

The very question of whether one has already filed for bankruptcy or not seems to determine whether one still belongs to the group that welcomes the separation of wheat from chaff, or whether one already numbers among the chaff. Company executives extolled the cleansing process in the industry as an urgent necessity. They ridiculed the rip-off artists the sector had attracted, as long as their own companies did not derail completely, and they themselves did not deserve to be seen as examples of such despicable crooks.

((U3))The Name Game

Particularly when new industry sectors are developing – as mentioned previously – specific terminology emerges which companies can use to signal their affiliation with some very special trend. Companies which make use of an industry’s vogue terminology almost automatically receive a bonus in the capital market. The drawback, however, is that such

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[120] Regarding Bezos cf. Lütge 2000, 39; on Neef cf. Neef 2001, 70.

language “sticks” to companies when the industry goes into decline. The terminology loses its appeal. It is associated with a failed business model, with bankruptcy and investor fraud, and now shackles the company. The order of the day, under such circumstances, is “save yourself if you can.” Management mounts an all-out attempt to revamp the company’s use of language. Terminology which had attracted much attention while the sector was receiving excessive publicity but is now worn out and therefore discarded.

For example, associating a company with the New Economy, with the land of “eEverything,” and decorating its name with the dot.com label were attractive as long as they implied being part of “something big.” As soon as the NASDAQ and the European and Asian growth stock markets collapsed, however, the New Economy terminology lost its cachet. Meg Whitman, CEO of eBay, announced in public that the New Economy was dead beyond any shadow of doubt. Martin Andersen of SuperWebOffice observed that venture capital investors had financed New Economy companies blindfolded for a time. Once the capital markets began to crumble, though, all of the “e-something” firms were put on hold and in many cases simply written off as losses.[121]

Linguistic creativity during the decline following the Internet boom focused on finding language which played up differences from the exhausted terminology of the New Economy and demonstrated that companies were focusing more on profitability. The “Real Economy” now came to be viewed as the “New Economy of tomorrow.” Linguistic coinage such as “Real Economy” but also terms such as “Next Economy,” “One Economy,” “Digital Economy” or “True Economy,” some of which were trademarked, were used to signal that the

[121] Regarding Whitman cf. Whitman 2001, 50.

Internet sector, too, had now adopted a profit-oriented mindset, and that the rules of the New and the Old Economies were in principle hardly that divergent at all.

Companies which had once flaunted their “e-prefix” or their “dot.com” ending to signal their affiliation with a major trend, now attempted to shed their previously so attractive sobriquets. As an example, online tire seller Delti.com simply dropped its “dot” and became Delticom – suddenly, no more tell-tale dot. The “dot-word” had been transformed from an e-commerce seal of approval into a danger sign for investors. At the height of the New Economy boom the Israeli incubator Yazam.com used the dot-com ending to signal that it intended to invest only in Internet companies. When the opportunities to exit Internet companies dried up, Yazam.com quietly dropped its little suffix in an attempt to distance itself from its exclusive Internet focus.

((U3)) Dressing for Success

A market downswing causes a change in dress codes too. Corduroy trousers, long beards, T-shirts, bright red hair and a public striptease by the CEO are viewed as remnants of glory days which are now passé. The shift was especially clear during the capital market collapse following the Internet bubble. The days of coquettish stories about millionaires who didn't even own a pinstripe suit and had no table manners were old hat by mid-2000 at the latest. Differences once celebrated through style of dress and appearance were suddenly symbols of bygone days; nobody wanted anything to do with them.

In this vein, business consultant Tom Noelle proclaimed at a major telecommunications conference, to enthusiastic applause, that it had all been the fault of the "West Coast hippies" who hadn't considered it necessary to make a profit with the Internet. Female CEOs like Meg Whitman of eBay, who had inclined toward classic business suits as opposed to trendy New Economy outfits even at the height of the wave, suddenly became sartorial role models for other female heads of online companies. Among men, too, classic business dress held sway once again. Robert Bauer of Foodstep, for example, declared that the men who had survived the New Economy could now often be seen wearing ties, which Bauer interpreted as an attempt to make a good impression on venture capital investors – succinctly put: "We understand."[122]

((U3))Profit Sends a Message to the Capital Market

The most obvious way of interpreting the proclamations of "paths to profitability" heard from entrepreneurs during an economic downswing is to take them at face value and view them as attempts to reorient companies from the capital market to the product market. During the downswing the predominant view in newspapers, periodicals and books is that growth companies are now finally behaving like "real" companies.

Whether such profitability rhetoric genuinely fulfills the primary purpose of reorienting companies from the capital market to the product market is, however, open to

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[122] Regarding Noelle cf. *The Economist* 6.2.2001, 21; for Whitman cf. *Business Week* 1.8.2001, 41.

question. The majority of growth companies are so totally dependent on serial infusions of new capital from the capital market that a sudden transition to financing based exclusively on profitable sales of products or services is impossible. Companies that have invested heavily in establishing international offices, improving products and increasing revenue don't automatically begin reporting profits when they close the foreign offices, concentrate on their core business and shelve their market conquest strategies. Their business models are frequently based on becoming profitable only after dramatic revenue increases. Otherwise their heavy investments in computers, software programs or the development of Internet portals would never pay off.

An interpretation which casts profit as a myth offered to the capital market is more convincing. Profitability is predominantly a message addressed to the capital market in an attempt to secure ongoing financing even in difficult times. The survival strategy pursued by the management of capital market-oriented companies consists of sending the message that "We only need a very small amount of additional funding to reach profitability. If you finance us one more time, we'll be able to stand on our own two feet. Otherwise, your entire investment until now will go up in smoke."

((U1))VII

((U1)) Of the Strengths and Weaknesses of Capital Market-Oriented Companies

If you had bought $1,000 worth of Nortel stock one year ago, it would now be worth $49.00. Enron stock would now be worth only $16.50. With Worldcom, you would have less than $5.00 left. If you had bought $1,000 worth of Budweiser (the beer, not the stock) one year ago, drank all of the beer, then turned in the cans for recycling, you would have $214.00. Based on the above statistics my current investment advice would be to drink heavily and recycle.”

A calculation which circulated on the Internet following the collapse of the stock market boom in the late 20th century.

There was hardly a buzzword over the last decades that played as important role as “shareholder value,” that is the value of a company to the stockholder. Advocates of shareholder value demand that firms orient their business policies to the interests of the people who own company shares, instead of focusing on the interests of customers, employees or managers. If the entire company were geared to the wishes of the capital market, then over the long haul this would also benefit its customers, managers and employees. Since dividends for shareholders increase only when a company’s returns also rise, shareholder value is often associated with rationalization and, in the final analysis, with loss of jobs. Downsizing by cutting personnel and production costs and concentrating on core businesses should, the assumption runs, make greater earnings possible and thereby raise shareholder value.

The concept of shareholder value can be traced to economist Alfred Rappaport and is based on the premise that the capital market will reward companies that consistently focus all of their business processes on increasing returns. To achieve this, a company should be divided into independent business units. Such corporate subdivisions would then be subjected rigorous financial controls and focused on achieving precise profit targets. If the profit goals are not met, the alternatives are either to take rationalization measures or to spin off the company unit in the interest of the shareholders.

The concept of shareholder value is based on the assumption that the capital markets orient themselves to a company's fundamentals. According to the views of Rappaport and his disciples, shareholders invest in the companies promising the highest returns, thereby contributing to a Darwinian selection of the fittest companies.

So far so good (or bad). Rappaport's theories notwithstanding there are repeatedly phases during which shareholders achieve only relatively paltry returns based on the concept of shareholder value. As the biotech boom of the early 1980s and the Internet bubble at the end of the 1990s have shown, companies with no earnings and no downsizing are repeatedly able to achieve higher stock market valuations than companies that do everything right according to Rappaport. Companies reporting high losses are suddenly rewarded with a jump in share price because the losses are attributed merely to expansion into promising, heretofore largely untapped markets, which will pay off in the long term.

While the theory of shareholder value often views layoffs as a sign of consolidation and recovering health, during a stock market boom it is extensive staff recruitment that drives up the stock price of venture capital-financed companies. The question of whether a company has achieved the personnel growth projected in its business plan ranks as an important point of reference for stock prices. In boom times neither management nor investors are particularly interested in how much the new hires will cost, how they will be put to use or how they are to be financed ultimately.

To overstate the point, when a growth sector is booming in the capital market, the private investors, fund managers and venture capitalists who gear their investment strategies to company earnings will probably earn lower returns than those who target high-loss growth companies. In this case adhering to Rappaport's shareholder value criteria would result in underperformance of one's own investment. But the capital market shapes the way companies orient themselves in an entirely different way than the advocates of shareholder value imagine.[123]

When the venture capital markets are in a drought (the last one followed the Internet boom) it is easy to theorize that normal business practices will return after a period of overheating, that profit-oriented companies will now finally reap their just rewards, that the logic of shareholder value will be restored and that, after a period of “irrational exuberance,” the “normal principles” of capitalism supposedly obtain once again.

During stock market declines it becomes very popular to condemn the capital market orientation, but one frequently neglects to consider the rationality of the behavior of venture capital-financed firms during a period of capital market hype. This chapter shows that there are recurrent boom phases in which deficit-ridden, venture capital-financed firms can utilize

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[123] Cf. Rappaport 1986; see aslo Aglietta 2000.

their standing in the capital market to exert pressure on companies with profitable business operations. Using the high value of their shares as “currency” they can acquire market share, raid profitable companies for their employees or even take them over entirely. Not infrequently this results in major, “established” corporations also adopting a capital market orientation and thereby integrating venture capital principles.

((U2))1. Solvency, Not Profit

It is a far-reaching abridgement of the science of business management to interpret all economic processes based on the standard assumption that a company will survive if its products and services are in demand and its customers are willing to pay a price which exceeds the cost of production and distribution. This abridgment equates profit from business operations with company survival, and the company’s operating profits are taken as a point of departure for all further considerations and recommendations for action.

Of greater importance for a company's survival than operating profit, however, is the availability of sufficient financial resources, as *solvency* is so nicely called. The paragon among Silicon Valley founders, Alan Shugart, observes that cash may be more important than your own mother, but operating profits aren’t the only way to obtain cash. In addition to operating profit there are other ways to stay solvent such as new, ongoing tranches of financing through the capital market, government subsidies or cross-financing from associated companies.

Sociologists Marshall W. Meyer and Lynne Zucker point out that even a deficit-ridden company can survive if it succeeds in establishing a high degree of legitimacy in its political, economic, cultural, scientific or mass media environment. If important players have an interest in the company's continuing existence, it will be able to carry on regardless of its economic performance. Examples such as German steel manufacturer Krupp, the U.S. newspaper *Herald Examiner* or Rath Packing Company, at times the second-largest meat packer in the USA, all demonstrate that companies can survive for decades without turning a profit.[124]

During hype phases, however, companies find themselves in a different situation. Interest in their survival on the part of important players is based solely on the *assumption* that the companies will eventually reach a ripe age, achieve considerable size and substantial economic, political and social significance. Only prospects such as these ensure the companies political support, media attention and, of special importance, refinancing through the capital markets.

Initially, the confidence of industry representatives, of the business media and politicians that a company which is as yet unprofitable will soon play a similarly important role in the global economy as Wal-Mart, Microsoft or General Electric, doesn't put any money in the company till. Receiving kudos from the head of an industrial association, being named entrepreneur of the year by the nation's leading business magazine, or an encouraging handshake from the Secretary of Commerce nets a company nothing. A good reputation in economic circles, the media and politics must first be transformed into cash or at least into a quantity of one's own shares which can be used as "currency," and the venture capital market plays a key role in the process. Then, based on their high degree of legitimacy in the capital market, unprofitable companies have either cash or their own, tradable shares at their disposal with which they can buy market share, employees or other companies.

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[124] Cf. Meyer and Zucker 1989, 31ff; on Shugart see Schilit 1991, 20.

((U3))Buying Market Share

The starting point for buying market share resembles the opening of a new line of business within an established, profitable company. The order is issued, “It essential to crack this market, so for the time being don't worry about profits, just capture market share come hell or high water.” While such expansion is made possible in established corporations through cross-financing from profitable business divisions, growth companies make use of their high-profile in the capital markets to finance their market share acquisition campaigns.

The first strategy consists of repeatedly issuing new stock on the exchanges to raise cash, and then using the cash to secure market share. In the early 1980s company founder Mitch Kapor raised just under $5 million in venture capital for his company, Lotus. He then invested almost the entire sum in a broad-based marketing campaign for his Lotus 1-2-3 spreadsheet and had soon driven all competitors from the market. The founder of computer company Compaq, Rod Canion, obtained $20 million in venture capital on short notice. This enabled him within one year to establish a national dealership network, mount a major marketing campaign and siphon off customers not only from smaller Silicon Valley competitors but also from major, established corporations such as IBM.[125]

The second strategy, as has already been shown in principle, consists of paying for services or for product development directly with shares of one's own company.

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[125] Cf. Bhidé 2000, 147f; Bhidé 1992, 113.

Priceline.com, an airline seat consolidator, did not use cash to convince airlines to participate in its program. Instead, it offered them stock options valued at almost $60 million for the privilege of selling their unfilled seats. U.S. online drugstore Rx.com “paid” television channel CBS for $37.5 million worth of advertising and promotion in the form of its own stock.[126]

Traditional companies referred to the pressure which venture capital-financed companies exert when they exploit their high stock prices to buy market share, as “being Amazoned.” The term describes the process by which a venture capital-financed Internet start-up such as Amazon, for example, uses its high stock price to buy its way into the market of a traditional company and then attempts to sell the same product to customers at half the price of the previous supplier.[127] Using dumping prices and intense marketing efforts Amazon was able to report strong revenue growth. Although the revenue growth didn't necessarily make the business more profitable, it helped to write a growth story for the capital market, thereby driving up Amazon’s stock price even further. This, in turn, generated further resources with which to buy market share.

((U3)) Recruiting Employees

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[126] Cf. Cassidy 2002, 3; Kaplan 2002, 81.

[127] Cf. Modahl 2000, xii.

It has already been clearly demonstrated how strongly personnel policies in exit capitalism depend on the allure of the company's currency, i.e. its shares. In major corporations, employee stock and stock options, important tools for recruiting and “locking in “ staff, are available only to a limited degree. Thus, in boom phases on the capital market, growth companies have the advantage of being able to attract employees with the prospect of an exponential rise in the price of their stock.

This is why the earliest history of most venture capital-financed companies reads like David and Goliath. A small start-up lures experts and top executives away from corporations a hundred times its size. As an example, even in the first year of its existence Compaq had already succeeded in attracting top-notch executives from well-established competitors. Based on the rapid growth potential of the stock packages they had been promised, the managers were initially also willing to accept lower salaries. Jerry Kaplan, who founded the computer company GO in the early 1990s, reports that the enormous growth potential of the stock packages at his start-up enabled him to attract top programmers from far larger competitors.[128]

Once a start-up has developed into a sizeable corporation, however, its shares lose their enticement value, a situation which is in turn exploited by smaller competitors who lure employees away, promising the kind of exponential stock package appreciation possible only in small growth companies. Thus, during every boom, companies which have already established themselves in the product and capital markets must deal with a brain drain in the direction of rapidly growing venture capital-financed companies and cope with the concomitant dulling of their competitive edge.

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[128] Regarding Compaq cf. Bhidé 1992, 113; on GO cf. Kaplan 1995: 22ff.

During its storm and stress period in the 1970s, Intel successfully attracted employees from many competitors by highlighting the growth potential of its stock packages. Later, during the PC boom of the 1980s, Intel lost many venturesome employees to start-ups in spite of (or, better said, because of) its position as market leader. As a major corporation Intel was in a position to grant its employees only the tiniest of stock packages, and on an annual basis the price of its stock – and therewith the stock packages – was "only" doubling. Intel boss Gordon Moore referred to venture capitalists has "vulture" capitalists that lured employees away from successful, major corporations with the promise of a fast buck, thereby producing a detrimental effect not only on the corporations but also on the entire national economy.[129]

((U3)) Buying Up Companies

Every boom phase produces a phenomenon which seems paradoxical at first glance. Companies which gear themselves to achieving rapid profitability and relatively slow growth do not survive. Due to their small size, their regional limitations or their modest revenues, both venture capitalists as well as stock market investors tend to underrate the value of such companies. The company's profitability, or near-profitability, is a secondary consideration because the general tenor of the market is focused on growth.

The high capital market valuation of rapidly expanding companies causes the price of their stock, which is ultimately the currency they will use to acquire other firms, to skyrocket,

[129] For background information cf. Wilson 1985, 194; on Moore see Malone 1985, 293.

and managers can go on a shopping spree. Rising stock prices not only increase the amount of cash which can be raised by issuing new stock; take-overs of other companies through stock swaps also become more attractive.

In boom times, as a result, there are certain companies which have never operated profitably and report constant losses, but have millions of dollars at their disposal either in the form of venture capital financing or from the proceeds of an IPO and therefore have an incentive to acquire slow-growing but profitable companies. Acquiring such firms allows capital market-oriented companies to steadfastly continue writing their growth histories. Taking over another company is a convenient way to expand internationally, increase staff and raise revenues.

It is correct that a company which is in the sole possession of its founder is under no obligation to accept a buyout offer from a larger, primarily capital market-oriented firm. But since growth at all cost is key for capital market-oriented companies in an overheated market, the buy offers they are willing to field for the firms they wish to acquire often greatly exceed the potential earnings the founder could achieve through the sale of products or services. Resisting a fast buck or a fast euro would require the founders to have especially strong emotional ties to their firms.

This could be observed repeatedly in its purest form during the Internet boom. The global players of the digital industry such as Cisco Systems, Lucent, Abode or Yahoo would acquire up to 40 smaller companies a year and integrate them into their respective concerns. But there were also many smaller publicly traded companies that exploited the high price of their stock to acquire companies in other countries and thereby continue their expansion policies. Some Internet companies even used their high stock price to acquire traditional Old Economy firms which the stock market viewed as less attractive.

The most famous case was the takeover of TimeWarner by online company AOL. At well over $100 billion this was one of the largest takeovers at the end of the 20th century with a size that far exceeded, for example, Glaxo Wellcome's takeover of pharmaceutical manufacturer Smithkline Beecham. Based on its high market capitalization AOL was able to structure the stock swap so that TimeWarner shareholders received not only a one-to-one exchange but also a small premium. Even if AOL TimeWarner faced the usual merger problems, and the chief economist of the Federal Communications Commission desperately wondered wherein AOL's economic reasoning might lie, the takeover of TimeWarner turned out to be a stroke of luck for AOL. When analysts titled their stock reports "Buy TimeWarner, Get AOL for Free," thereby indicating that the old market value of the TimeWarner concern equaled the amount the combined company would be worth two years after the merger, they unintentionally hit the nail on the head. AOL had acquired TimeWarner as a cash cow, thereby ensuring – at least temporarily – its own survival even when the economy turned sour.[130]

At the height of the Internet boom, DoubleClick, a company that sells advertisements for hundreds of websites and develops software to monitor web-surfing behavior, acquired Abacus, the largest address broker in the U.S. Abacus maintains a database containing information on 90 percent of all U.S. households based on periodical subscriptions and invoices. The purpose of acquiring it was to let DoubleClick amalgamate information from the online and the offline worlds. Even if the acquisition unleashed a major uproar over potential data privacy violations, it enabled DoubleClick to establish itself in the profitable address brokering sector of the Old Economy.

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[130] Cf. Fischermann 2002, 30.

((U3)) Beyond Condemnation of the Capital Market-Oriented Companies

In light of the opportunities presented by the high price of a company's own "stock-currency," namely buying market share, attracting highly-qualified employees and acquiring other, profitable companies, it appears shortsighted to declare the capital market orientation a failure.

Naturally, capital market-oriented companies also adopt strategies which prove to be mistakes in retrospect. The marketing campaigns at the height of the Internet boom, where some companies spent millions on ads during major sports events, often did not result in the market dominance they had hoped for. Buyouts of Internet companies with high market valuations by other Internet companies, likewise with high valuations, generally proved to be expensive mis-investments which seriously strained the buyer's cash position during the downswing. Establishing expensive incubators for small emerging companies would also prove to be a costly excursion in cases where the strategy was only implemented once the capital markets were already approaching their peak.

But the history of exit capitalism shows that companies repeatedly succeed in exploiting the high price of their own shares as "currency" for a successful long-term expansion strategy, thereby knocking competitors with a short-term profit orientation out of the market.

((U2))2. The Pressure on the Dinosaurs

The degree to which a capital market boom can put growth companies in strategically strong negotiating positions is reflected clearly in the reactions of established corporations to competition from unprofitable venture capital-financed firms. At first the established corporations do not view the growth outfits as serious competition. But the more the growth companies succeed in securing ongoing venture capital financing, and the higher their stock surges on the exchange, the more concerned the established corporations become. At the height of the Internet boom DiamlerChrysler CEO Jürgen Schremp complained that since Mercedes and Chrysler manufactured the vehicles with which orders from Internet companies were ultimately delivered, his company should kindle just as much enthusiasm as the start-ups. But in spite of this DaimlerChrysler stock was not rising, much to his chagrin. Manfred Schneider, long-standing chairman of Bayer, lashed out at the end of the century saying that his company was healthy to the core, but that he couldn’t “raise the price of his own damn stock.”[131]

During hype phases the established corporations first feel the pressure in the capital market, not in the product market. Investors tend to put their money into growth companies rather than into “boring” major corporations. The high-tech stock exchanges show greater gains than the indexes based on standard issues such as the Dow Jones, Eurostoxx or the DAX. Analysts, fund managers and small investors insist that established corporations keep

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[131] Cf. Slodczyk 2000, 27.

pace with the rising share prices of the young growth companies and start making themselves look sexier to investors.

But during an extended boom, established electronics, telecommunications and retail corporations fear that the growth outfits could exploit their attractiveness in the capital market to exert increasing pressure on the established corporations in the product market as well. They have mounting concerns that the growth companies, driven by permanent refinancing from the capital market, could capture market share through advertising campaigns or with dumping prices. The major corporations also begin to notice an exodus of employees who have been enticed into joining the new companies with lucrative stock packages, and they are anxious that the émigrés will turn to poaching in the hunting grounds of their former employers.

Thus, at the end of the 20th century the message for Old Economy firms read: “Build an Internet business, buy an Internet business, or be replaced by one.” During the frothy days of the New Economy the success of companies like Amazon, Yahoo and eBay was taken as an indication that “digital” would conquer “analog,” that the new media would grow faster than the old, and that the leaders of the Internet economy were destined to achieve establishment status in the 21st century. According to Bruce Leichtman, one of the directors of market research company Yankee Group, the torch would be passed to New Economy firms.[132]

During periods of hype such pressure results in well-established corporations increasingly orienting themselves to the logic of venture capital-financed companies and

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[132] Cf. Siklos and Yang 2000, 33; on the “message” cf. Vickers and Coy 2000, 52.

trying to ride the capital market wave by buying up growth outfits, founding incubators and their own venture capital arms, as well as spinning off their own attractive divisions.

((U3)) Buying up Growth Companies

When it becomes apparent that a new technology, a new distribution channel or a new industry is gaining ground, and the first venture capital-financed companies are capturing substantial market share, well-established corporations frequently come forward to acquire such growth companies. They reason that acquiring growth companies will ensure access to the new technology, distribution channels and industries. But this strategy also reflects their intention to take over potential competitors as long as the companies can still be acquired at affordable prices.

The buyout strategies were particularly plain to see during the Internet boom. Traditional corporations acquired interests in various growth outfits so they could quickly develop the strategic “online business.” As an example, the Bertelsmann concern became heavily involved in the Internet sector and acquired multimedia agencies, Internet booksellers and direct marketing firms. In Europe Bertelsmann founded joint ventures with AOL and Lycos, and launched BOL and the online division of Barnes & Noble as competition to Amazon.

In addition to strategic planning games such expansion policies were also influenced by the consideration that a well-established corporation could use the acquisition of growth companies to signal the capital markets that it was investing in the technologies of the future.

U.S. venture capitalist Robert J. Kunze explains that frequently the only reason for large corporations to take over growth companies was to give management an opportunity to present itself to the capital market as visionary “shakers and movers.”[133] Thus, over and above any strategic importance, the aggressive acquisition policies of a major corporation such as General Electric fulfilled the purpose of sending the message to the capital markets that the Internet ranked No. 1, 2, 3, and 4 on the corporation's priority list (in the words of General Electric’s then-CEO Jack Welch).

For venture capitalists, founders, executives and employees the buyout of a growth company by a major corporation presents a lucrative exit opportunity. During the boom phase, the price for a so-called “trade-sale” depended on the company’s stock market value or on its projected value in the event of an IPO.

((U3))The Founding of Company-Owned Incubators and Venture Capital Funds

Instead of acquiring an existing growth company at a high price, an attractive alternative for major corporations is to develop growth companies through incubators and venture capital pools of their own. The corporations’ primary hope in the undertaking is to copy the success strategies of the independent venture capital firms. Gary Hamel, a professor at the London Business School for many years, explains that company-owned incubators and venture capital

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[133] Cf. Kunze 1990, 80.

funds give employees in major corporations a chance to develop concepts in business plans and to compete for financing from in-house venture capitalists. If the concern approves a business plan, it acquires a stake in the start-up through its venture capital subsidiary, but also enables the employee to hold shares in the venture and to profit from an idea as an equity shareholder. The expectation is that there will be a tendency to transform hierarchical, status and job security-oriented company policies into a Silicon Valley mentality. The leadership of the corporation no longer focuses on reducing the number of possible flops but speculates on maximizing opportunities. The corporation, at least according to Hamel's thinking, is revamped and becomes a marketplace for ideas, capital and talent. Employees who in boom times might otherwise have succumbed to the lure of venture capital and left the company can now seize the opportunity to make "big money" within their own corporation.[134]

The history of such corporate venture capitalists is closely tied to the boom phases of the stock market and venture capital industry. By the mid-1960s more than one-quarter of the 500 largest U.S. corporations had already founded their own venture capital arms. Automobile manufacturer Ford alone invested more than $10 million in start-ups over five years in an attempt to gain access to new technologies. In the early 1970s the founding of General Electric Technology Venture encouraged GE employees to develop previously unutilized technologies within their own companies. The founding of corporate venture capital arms, however, proved to be a flash in the pan. As the financial markets collapsed in the early 1970s most of these experiments by major corporations were shut down.[135]

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[134] Cf. Hamel 2000.

[135] Cf. Wilson 1985, 149.

A second founding wave of venture capital organizations within the framework of major corporations began in the early 1980s when the boom in personal computers, hard drives, disk drives and software worried well-established corporations that they were missing out on an important trend. Corporations which had abandoned their cautious forays into venture capitalism during the recession following the oil shock in the early '70s, now founded their own venture capital organizations once again. At the height of the second wave in the mid-1980s the venture capital arms of major corporations controlled over 10 percent of all venture capital resources. When the stock market crashed on October 19, 1987, however, most of them withdrew from the venture capital business.

The third boom occurred during the heyday of the Internet at the end of the 20th century. Whereas there were fewer than 100 venture capital firms under the control of major U.S. corporations at the beginning of the 1990s, by the end of the century the number had multiplied. Wal-Mart, for example, established a center for “e-Tailing” together with Accel Partners in Silicon Valley for the purpose of developing its own Internet operations. Siemens founded a “Center for e-Excellence” where Internet concepts could flourish beyond the reach of the notorious Siemens bureaucracy. At the height of the boom Rupert Murdoch's News Corporation founded a venture capital company and underwrote it with $300 million to make Internet investments.[136]

The majority of incubators and venture capital firms founded by major corporations during a boom phase are shut down again when the markets cool off. Even if complaints about the short-term orientation of major corporations appear justified in light of their

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[136] Cf. Siklos 1999, 72.

cyclicality, we must not forget that the founding of these businesses figured importantly in creating legitimacy. Founding incubators and venture capital firms can be used to signal the capital market that one has very close ties to a new technology and is on the verge of transferring the charm of a start-up to one's own corporate operations. During an economic downswing this form of ensuring legitimacy is no longer necessary, and the capital markets tend to take a positive view of shutting down incubators and venture capital arms as positive adjustments to new market conditions.

((U3))Spinning Off Attractive Corporate Divisions

In addition to acquiring growth companies and establishing their own incubators and venture capital arms, major corporations have the possibility of profiting from a market boom by spinning off corporate units which the capital market deems attractive. At the height of a stock market boom, the object is to pocket equally high prices from investors for corporate subsidiaries which are active in similar business sectors as the growth companies which the capital market considers sexy.

This enables corporations to isolate risky divisions from their core business without losing control over the subsidiaries they have spun off. For example, when Siemens successfully took its two chip subsidiaries Infineon and Epcos public, the result was not only a deluge of money for the electronics concern but also an opportunity to separate out business areas which are traditionally subject to substantial fluctuation. The microchip business is highly cyclical and can cause a corporation’s chip sector to report losses of €1 billion one year and profits of the same amount in subsequent years. By taking the chip-making divisions private this risk can be at least partially deflected from the corporation to shareholders on the exchanges. As the 20th century drew to a close, Deutsche Telekom, Telecom Italia, British Telecommunications, the Dutch KPN Telcom and France Telecom all tried to raise capital by taking their Internet and mobile communications divisions public and thereby putting money in the till of the highly indebted corporations.

Since the parent companies generally retain majority ownership of the subsidiaries they spin off, the IPO of an attractive daughter company also has the pleasant effect of raising the stock price of the parent. As an example, when the Spanish telecommunications firm Telefónica took its Terra subsidiary public, and Terra’s stock price more than tripled on the first day of trading, the stock of the parent corporation rose concurrently just under 50 percent in the week of the IPO.[137]

An important ancillary effect is that the compensation of managers and engineers in the spin-offs – due to their high stock market appeal – can be adjusted to levels common in venture capital-financed growth outfits. Thus, one of the reasons Siemens spun off Infineon was the opportunity to lock in highly-qualified chip development and production personnel through attractive stock packages and stanch the brain drain in the direction of venture capital-financed growth companies. At the height of the Internet boom the Disney concern was also forced to generate “Web currency” because a good dozen of its senior executives had already defected to young Internet start-ups.[138]

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[137] Cf. Matlack 1999, 18f.

[138] Regarding Siemens see Ewing, Echikson and Baker 1999, 68; on Disney see Siklos 1999, 73.

((U3))When Major Corporations Participate in the Venture Capital Business

Ultimately, when major corporations spin off units they consider attractive to the capital market, acquire growth companies and establish their own venture capital operations, they become active participants in the venture capital industry.

This involves them in the high-risk games played in the capital market, however, and they cannot be certain that they will succeed in transitioning back to a more product market-oriented strategy in the future. The downfall of corporations such as Enron and WorldCom are the best-known examples of the risks inherent in such strategies for major corporations.

((U2))3. The Question of Timing

The success stories of venture capital financers involve such (former) global corporations as computer manufacturer Digital Equipment, Compaq, Tandem and Apple, chip manufacturers Intel or AMD, software developers Visicorp or Lotus, network companies such as Cisco, biotech companies such as Genentech or Biogen and online outfits like eBay or Amazon.com. The rise of these firms from small garage companies to global corporations with dominant market positions makes it immediately obvious why venture capital financing not only produces hundredfold returns on the money investors put up, but also benefits the national economy.

How do these successful companies differ from exit capitalism’s innumerable but often mostly forgotten flops? What makes Compaq and Apple different from failed venture capital-financed computer makers Osborne Computer or GO? Why are eBay or Amazon different from their competitors Boo.com, Webvan or Beenz which failed so miserably?

The standard explanations for the failure of venture capital-financed companies point to faulty assessment of the product market, management error or problems encountered in the growth process. But even in their best years companies like Digital Equipment, Compaq, Apple, Genentech, eBay or Amazon.com served up (in retrospect) remarkable misjudgments of the market, serious management errors and extreme growth problems. Thanks to their successes, though, their bad judgment, errors and troubles have not become lodged in our memory. In exit capitalism, what appears to have a far more devastating effect than the above-mentioned mistakes and misfortunes is that companies seek refinancing with venture capital at the wrong time.

((U3))The Wager in Exit Capitalism

Venture capital-financed companies wager, so to speak, that they will be able to refinance themselves through the capital market until they reach profitability. In hype phases the object for growth companies is to stretch the process of “giving away” shares as long as possible and adeptly to interweave raising new money in the capital market with writing a growth story. Every dollar raised in the capital market is incorporated into the company's ongoing growth story and used to boost the price of its stock. As we have shown, when the value of a company’s own currency, its stock, has risen, the company can subsequently raise money in the capital market under even more favorable terms, and thereby further embellish its success story.

Among the more recent outstanding examples of this mechanism are Amazon and AOL. After receiving venture capital seed money, Amazon launched a successful IPO, issued new shares and floated bonds for sale, thereby raising enough money that the company could consistently post losses for six years. Amazon was able to cover cumulative corporate losses of $2 billion through high ongoing refinancing from the capital market. AOL, likewise, made not one cent of profit from its founding in 1985 until 1996. AOL's comparatively low receipts from advertising and user fees were far from balancing its high losses resulting from investments in program development, computer servers and marketing campaigns, which were covered by ongoing infusions from the capital market. The skill of AOL management lay in its adept use of the company's growth story, never allowing the flow of money from the capital market to dry up until, in mid-1990s, the company was self-supporting.[139]

Venture capital-financed companies which cleverly surf the waves of the capital market have an advantage over firms that are growing slowly under their own steam. In a strong bull market a company which is expanding cautiously has a problem because it creates the impression that it will not be able to fulfill growth expectations. During a company's early financing stages additional infusions from venture capital investors will threaten to evaporate if the company cannot maintain the appearance through rapid growth that it will soon be listed on the exchange. Start-ups which are unable to climb quickly in the stock indexes following an IPO arouse only little investor interest. Their shares plod along and issuing new stock on

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[139] Regarding Amazon cf. Feng et al. 2001, 17; on AOL cf. Hof 2000, EB 50. No claim is made that the model will prove succesful in the long term and that Amazon and AOL will survive in years ahead.

the exchange is not a particularly lucrative prospect. Further growth cannot be financed and the threat of a takeover by a larger competitor looms.

When signs emerge that continuing infusions from the capital market are dropping off, a company must already be able to hold its head above water as well as possible on its own. Ideally, a venture capital-financed growth company will have staggered the issuance of its stock in the capital market so skillfully that it will be successful in the product market after several years and no longer depend on additional infusions of capital. Companies like Digital Equipment in the mini-computer industry, Fairchild or Intel in semiconductors, Apple or Compaq in the PC market, or Sun Microsystems in the networking sector made the transition from capital market-financing to financing through product sales in an exemplary fashion, and therefore remained unaffected when the capital market collapsed.

((U3)) Failure During a Capital Market Collapse

Companies which are not yet profitable in their business operations or have not used their expansion policies to acquire other profitable companies, run into difficulties when the capital markets go into decline. When an industry is “finished,” venture capitalists see no further opportunities to unload their shares in such companies at attractive prices. The industry is no longer “sexy” enough to warrant an IPO or a takeover by another company.

Growth companies are so dependent on the capital market, and developments in the capital market are, in turn, so beyond the influence of individual growth companies, that there is little room to maneuver when the capital market starts to founder. A growth model which is contingent on raising additional capital in the market for another one, two or three years, is no longer viable once the capital market turns down.. Companies lose their footing from one day to the next.

Ultimately, the primary causes of many company failures in exit capitalism are not due to management problems, to entering a product market too late, or to the inability to resolve organizational difficulties. Rather, the failures are caused by poor timing of capital market politics which prevents companies from exploiting capital market hype to secure the backing they need to expand.

One of the older examples can be seen in Osborne computer, which was founded in 1980. In 1981 the company introduced the first mass-market portable PC resulting in substantial cash flow for the first year. But in spite of this the company had to file for bankruptcy three years after it was founded. It had failed to raise enough capital to bring its new products to market and stand up to competitors like IBM. Among other things, a short-term bear market in stocks repeatedly forced Osborne to postpone the IPO it needed to secure subsequent financing. By the time the financing window had reopened, the company was already bankrupt. GO Computer Corporation, the first manufacturer of handheld computers, was unable to raise additional funds due to a tight capital market environment and therefore had to close its doors. Had GO Computer been able to launch an IPO, perhaps the handheld computer market would not have dominated by latecomer Palm but GO itself. The bankruptcy of online pet food retailer Pets.com – by far the favorite whipping boy of Internet business critics, second only to Boo.com – cannot be explained exclusively through a poorly conceived business model or botched business operations. An explanation of the company’s failure must also consider that Pets.com, even though it had mounted a successful IPO, could not place any further stock on the stock exchange because share prices of Internet companies were plunging.[140]

The failure of these companies says nothing about their medium-term potential to reach profitability. Who would assert that Osborne Computer, the firm responsible for the first spectacular business failure in the PC industry, would not have had the potential to reach profitability and carry on, given two or three years of additional capital market financing? Who can be certain that several million dollars of interim financing would not have been enough to allow GO, the first manufacturer of handheld computers, to make its successful imitator Palm look old? Who can be absolutely certain that Boo.com would not have dominated the online apparel business if, at the height of the Internet boom, it had still managed to raise additional capital in the stock market?

To overstate the point, the reasons many growth companies collapse in the capital market are not related to the product market. Rather, their economic demise is the result of falling stock prices. Or, stated even more provocatively, companies do not founder in the capital market because they're bad companies, they appear to be bad because their stock prices are plummeting.

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[140] Regarding Osborne Computer cf. Mandel 2000, 73; on GO cf. Kaplan 1995; on Pets.com cf. Southwick 2001, 199.

((U1))VIII

((U1)) The Greatest Money Burning in History, or Normality in Exit Capitalism

“The New Economy sets enormous energy free. It is the best proof that capitalism still works.”

Stephan Schambach, founder and chairman of Intershop, at the height of the Internet boom

When financing for an industry is grinding to a halt, taking a look at what was written about it at the height of the business cycle can be interesting. The euphoric proclamations about a technology ushering in a “new era,” the resolution of conflicts between labor and capital and its “liberating potential” for employees – it all sounds so hollow in the face of daily bankruptcy filings by venture capital-financed companies, 1/4 to 1/5 of the staff in the remaining firms laid off, and the commentaries concerning the latest ill tidings posted at Web sites such as www.fuckedcompany.com, www.dotcomtod or www.netslaves.com. When the employees of already bankrupt companies paste their business cards on a “wall of blame” at pink slip parties (named after the color of the envelopes, in which termination notices are sent in the U.S.) the heady statements published in management books during the boom look like nothing more than the makings of the next collages of disgrace.

Descriptions of the “brave new world of work,” the “new rules of economics,” or the appeal of “rapid expansion” seem like entertaining although extremely outmoded caricatures, which are now hardy apply. The management literature written at the height of the technology boom and the euphoric statements by top executives are not aimed at providing a precise explanation of how the boom works, but strive instead to set a seal of approval on the boom through ringing endorsements.

The decisive factor is how experiences gained during the boom days are processed in the aftermath. The manner in which businesspeople, journalists and academicians comment on the bankruptcies is crucial in determining whether the body of knowledge on the venture capital business is augmented or not. The manner in which the “failure diagnosis” is conducted during a downswing determines whether the usual procedures will simply be replicated in the next upswing or whether a learning process takes place.

This summary chapter argues that the method of tracing responsibility for company failures to personnel error obscures that upswings and downswings are just as much a part of exit capitalism as winning and losing elections are in a democracy. The venture capital business is subject to cycles. They may vary in intensity but as long as company shares are traded in speculative markets they can never be avoided.

((U2))1. Con-men, Crooks and Coke-Heads: Rash Explanations for the Failure of Growth Companies

“For they know not what they do.” This sentence summarizes one of the main reasons why companies fail. Foodstep founder Robert Bauer, for example, describes the days of the Internet boom as “the biggest money burning in history.” Martin Andersen of SuperWebOffice contends that it will be a long time before another such phase occurs. According to Andersen, $4.3 billion went up in smoke. The euphoria, the experimentation, the highs and lows, the tension, the shimmering air – in Andersen’s opinion all of these factors contributed to management not always thinking clearly. Greg Galanos of Mobius Venture Capital compares the frothy years at the end of the 20th century with the final years of the Roman Empire, during which strange and utterly dysfunctional business models also emerged.[141]

A special partiality can be seen for placing blame on employee error. Lutz Krafft of the e-startup.org research network explained that the start-ups made every mistake in the book, from incomplete business concepts, miserable customer service, a lack of liquidity control, to hasty investments in other companies and headlong, unsound growth. Companies such as the U.S. online toy retailer eToys or the European Internet buying club Letsbuyit.com were criticized for spending over $100 million on marketing before they had even set up a proper distribution system. Venture capital was used to create a flash in the pan, the complaint runs, without management having developed businesses of any substance.[142]

According to criticism voiced frequently in the media after the market’s enthusiasm has cooled, new technologies had seduced people into the boldest of hopes and at least

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[141] Cf. Levy 2002, 58.

[142] Regrading Krafft cf. Littger 2001, 2; on eToys and Letsbuyit.com cf. Hochstätter 2001, 42.

temporarily robbed them first of their sanity and then of their money. There was talk of "manager megalomania" and a "stock market madness" which had befallen the executives of venture capital-financed companies, a madness which suspended the principles of economics. A cartel of prophets of fortune enjoyed the public's complete confidence and successfully stage-produced a kind of parallel universe in which they mutually outdid each other in generating insane projections and fuelling the madness.

Georg Dorn, an organizational developer at E-Yello, traced the failure of his company to the personality structure of its board members, who vacillated between genius and insanity and lacked of any reasonable attitude toward money. When the Internet boom was over, Albrecht Hertz-Eichenrode, chairman of venture capital firm Hannover Finanz and board member of the German Venture Capital Association, explained that too much entrepreneurial élan combined with too little road grip had often "fried the brains" of company founders.[143]

Over and above an excess of entrepreneurial élan, the brain frying is often traced to drug abuse during hype phases. When explanations are sought for the demise of an entire industry, more detached observers recall the tranquillized working atmosphere in growth companies and the liberal use of cocaine at wild parties, and speculate about the long-term aftereffects of such debauchery. Even during Silicon Valley's cyclical crises in the 1970s and 1980s, the area already enjoyed a reputation as one of the biggest cocaine markets in the United States. As the New Economy disintegrated, the opinion was repeatedly heard that the

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[143] Cf. Hertz-Eichenrode 2002. Dorn is an anonymized source.

three Cs, caviar, champagne and cocaine, had contributed to putting businesses on the skids.[144]

((U3)) The “Devastating Role” of Greed

“Entrepreneurial madness,” it is claimed, could only have developed in an environment where everyone was a slave to greed. Venture capital specialist W. Keith Schlitt complained that during the PC boom in the early 1980s many people had not genuinely set their sights on building companies but only on making a fast buck.[145] In the wake of the Internet bubble similar comments were heard. Small investors had often placed bets on next to nothing, simply because there were enough other people with the same ideas. Driven by the hope of fast money, small investors who had no idea what an integrated circuit is, bet money on minicomputer, PC and Internet companies. During the downturn the media blustered about the greed and ignorance of small investors – as if venture capital firms, banks or funds basically stood to earn nothing on an IPO, and analysts always consulted scholarly tomes before issuing buy recommendations.[146]

Attempts are launched to support such assessments by casting the boom phase in question as “the perfect example of all speculative bubbles” and by comparing the rise and

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[144] For the early stages of drug abuse cf. Malone 1985, 398ff; on the three “Cs” cf. Doward 2001.

[145] Cf. Schilit 1991, 127.

[146] Cf. *Gegenstandpunkt* 2000, 91.

fall of venture capital-financed companies with the major speculative bubbles of centuries past. Similar to “Tulipmania” in 17th-century Holland, the PC and Internet booms saw people investing in products which represented no added value. Companies like Webvan, Boo.com or Kabel New Media are compared to a company in England during the early 18th century, which billed itself as a society for the purpose of accomplishing something extraordinarily useful – although nobody knew what. Repeated references are made to the 1841 book *Extraordinary Popular Delusions and the Madness of Crowds* by British author Charles Mackay, in which speculative investors are treated in the same context as spiritual healers, alchemists and fortune-tellers. Just as during the founder boom which began in Germany in 1871, money was invested in companies which promised nothing other than having an utterly marvelous product under development which they could not as yet divulge in greater detail. Just as during the “turn-of-the-century fever” in 1900 and 1901, the commonly held belief was that recent technologies would create an entirely new economic order, new life styles and patterns of consumption, and invalidate the recognized laws of economics. Just as during the boom and subsequent stock market crash in the late 1920s, shoe-shine boys, house wives and taxi drivers hoped to make a fast buck by investing their savings in high-risk stocks.[147]

((U3)) Beyond Personification: The Structures of Venture Capital Financing

[147] For example cf. Henwood 2001.

All of the explanations pertaining to naiveté, lack of experience, drug abuse, ignorance and greed focus on human error. They suggest that everything would have been different (and better) if only: management had been more experienced; megalomania had been less rampant; better oversight had foiled the criminal intentions of crooks; the management of multimedia agencies had stayed with cigarettes, Coca-Cola and beer instead of cocaine; venture capitalists had selected their companies more carefully; and avaricious investors hadn't caused such a flash in the pan. In principle, supposedly, everything was OK. The technologies were promising, there was a big new market and the business ideas were basically sound. It was just the individuals themselves who had sent the whole deal up in smoke.

During downswings, tracing the causes of company failures to human inadequacy fulfills an important function. It holds out the hope that everything can be brought under control if only the people involved learn from their mistakes and pay attention to the “normal” principles of a market economy. If one could just eliminate the “black sheep” which had given the industry a bad name, everything would be entirely different. Once stock market regulations were tightened, and the con-men at Enron, WorldCom or EM.TV could no longer pull off their swindles, everything would get back on track.

But such comments overlook that success and failure in exit capitalism are not determined primarily by lack of experience, megalomania, greed or run-away cocaine consumption, but rather by the cycles according to which venture capitalism itself unfolds.

((U2))2. The Lemming Mentality, or The Wave Form of Exit Capitalism

Contrary to popular belief it is extremely difficult to obtain venture capital financing in a brand new industry. Venture capital investors are uncertain whether a new, interesting business sector is truly developing – not only in their own minds but in the minds of their colleagues as well. When the first minicomputers, hard drives, graphic cards, CD-ROMs or Internet search engines were financed, for example, the money flowed very slowly. Although such early entries put investors in the vanguard of an industry, there was also concern that neither the technology nor the shares of the companies would find a market.

Only when a consensus seems to have formed among venture capitalists that a “hot” new technology has arrived, does a run on companies in the sector ensue.

((U3)) The Formation of a New Sector: The Logic of Imitation

What initially sparks a run on a new technology sector is often the successful IPO of one of its companies. Thus, the highly successful initial public offering of Apple Computer in the early 1980s channeled $110 million into the company treasury and rewarded early investors with manifold returns on their investments. As a result the number of IPOs quadrupled over the next three years and vast amounts of venture capital flowed into the PC industry. A further explosion of IPOs on the NASDAQ followed with the biotechnology boom in the early 1980s. The successful public offering of Genentech resulted in hundreds of biotechnology firms receiving venture capital in the following year and then striving to go public. In the mid-1990s the Netscape IPO primed the pump for the Internet.[148]

When venture capitalists recognize the promise of a new technology, business sector or industry, there is a near-explosive increase in venture capital financing which forces its way into the field. According to venture capital investor Frank Schon, once a new industry has been identified and a consensus emerges regarding the industry's potential, then not just *one* but *legions* of venture capitalists begin to funnel money into the new technology. Vonod Khosla of venture capital company Kleiner Perkins refers to a cycle of greed, in which each venture capitalist strives to claim a piece of what ever technology happens to be booming.[149]

During such periods a vast amount of capital is made available, and even the mediocre ideas of middling entrepreneurs, who are off to a relatively late start, find opportunities to obtain financing. So-called “me-too” companies emerge, trying to elbow their way into a sector as the 4th, 5th or even 20th entry. When the first computer drive companies were founded and backed by venture capitalists, other company founders came forward hollering, “Me too!” and attempted to set up competing companies. In the late 1970s and early 1980s venture capitalists backed 43 disk drive companies in the USA, of which the 12 publicly traded companies alone had a market value of $5.4 billion at the crest of the wave.[150] When it came to developing business models in the Internet sector, often only months elapsed before 10 new companies had sprung up, also selling toys online or offering tools for the do-it-

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[148] Regarding Apple cf. Schilit 1991, 126; for Genentech cf. Wilson 1985, 8; see also Robbins-Roth 2000, 13ff.

[149] Cf. Southwick 2001, 59.

[150] Cf. Gompers 1992, 14

yourself homepage designer. In the online retail toy sector it took no more than a few months for over 30 firms to the swell the crowd, courting children – or, better said, their parents – with names like eToys, Alltoys, PrimusToys, Mytoys or Toyzone.

What makes it worthwhile for venture capital investors to finance such latecomers or wannabes? Venture capitalists are primarily interested in the question, “Will the company I finance provide a profitable exit or not?” This is the pivotal question. Putting money into the 5th disk drive manufacturer, the 10th CD-ROM outfit, the 25th online frozen food retailer or the 4th developer of a new heart medication can make more sense for a venture capitalist than backing a company in an industry which isn't “hot” yet. If the industry isn’t hot, it will be difficult to find an exit via a corporate buyout, an IPO or a management buyback within the next four to five years.

In exit capitalism this strategy can pay off because other investors are likewise basing their decisions primarily on whether the business models in a certain market are considered “hot.” The overwhelming supply of financial resources available to a growth sector allows even run-of-the-mill companies to obtain venture capital financing and launch an IPO. By way of an explanation, George Middlemas, an investment manager at Citicorp Venture Fund, points out that boom sectors tend to be forgiving. In a market growing by 30 percent a year, a venture capital-financed company could make a series of mistakes and still wind up in first place, whereas in a slow growth market a single mistake can lead to a company's downfall. Business consultant Bob Zider explains that there is no basis for the popular myth that venture capitalists invest in “good ideas.” Rather, they invest in “good industries,” i.e. those that are growing faster than the others and in which, as a consequence, even less competitive companies will be able to survive – and can therefore be sold.[151]

As long as a high degree of uncertainty causes decision makers to orient themselves according to the decisions of others, and references to the decisions of others are repeatedly confirmed through lucrative exits, such lemming-like behavior can be economically successful.

((U3))Withdrawing from a Sector in Panic

What makes venture capitalists stop investing in a sector? Based on the bankruptcy of a prominent company, fundamental technological development difficulties or repeated failure to achieve market projections, doubts arise whether the sector's potential justifies the resources flowing into it. Share prices in the sector are viewed as overvalued. Frank Schon of Goal Venture reports that in the post-boom period venture capitalists are sometimes heard to say that a sector had been running pretty well in the beginning, until there was simply too much money invested in it.

This was the case in the early 1970s, when the stock of companies which had been taken public during the boom suffered a massive decline. Following a stock market boom in the late 1960s and early 1970s, and initial, cautious investment in the form of venture capital, the oil price shock and a sluggish stock market caused exit opportunities to evaporate quickly.

[151] Cf. Zider 1998, 133; see also Schilit 1991, 96; regarding Middlemas cf. Perez 1986, 116.

Dick Kramlich, one of the first venture capital investors in Silicon Valley and occasional partner of venture capital legend Arthur Rock, recalls that the stock market was moribund and Silicon Valley looked more like “Death Valley,” with no oasis in sight for venture capitalists. This also applied in the aftermath of the PC boom. No later than the bankruptcy of Osborne computer, doubts arose whether a company success story like Apple could ever be repeated. Tad LaFountain, an analyst with Needham, remembers a meeting between analysts and later Intel chairman Andy Grove in the year Osborne filed for bankruptcy. Grove pointed out that 20 PC manufacturers had each considered a 20 percent market share for themselves as realistic and geared their business strategies to that goal. You could do the arithmetic all day, Grove said, but the equations of those firms would never balance. During the hard drive boom in the early 1980s, which was in turn driven by the boom in the personal computer industry, more than 50 venture capital-financed companies sprang up in this sector. Following a stock market boom in 1983, in which more IPOs were launched than in any previous year since the late 1960s, increasing doubts arose whether all of the hard drive companies could remain viable, and venture capitalists quickly withdrew their money. As soon as they realized that personal computers could run more programs than just games like PacMan and Pong, vast amounts of venture capital flowed into the software sector. After numerous software companies went public, successfully producing a short speculative rally on the NASDAQ, uncertainties arose whether the companies’ operating profits justified their high valuations by venture capitalists and the stock markets. Once again, venture capital was quickly withdrawn. The same thing happened after the bankruptcy of the Internet company Boo.com, raising virulent doubts about the business models of online companies.[152]

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[152] Regarding Kramlich cf. Southwick 2001, 54; on Grove cf. Dignan 2001; on the PC boom see Cook 2001; on

When such uncertainty takes hold of a sector, it leads to headlong retreat. The venture capital greed cycle is engulfed by a wave of fear. U.S. venture capitalist Lorri Rafield explains that when uncertainty rears its head, all investors suddenly become extremely timorous at the same time, and everyone prefers not to make deals of any kind. If venture capitalists, institutional investors and analysts asked a company, “How many new hires can you handle this quarter?” at the last shareholders meeting, now their interest suddenly focuses on one question alone: “How profitable are you?” And the equity owners are hoping they will be able to unload their investments today rather than tomorrow.[153]

Venture capitalists withdraw from an industry like lemmings. From their perspective a take-the-money-and-run attitude makes strategic sense. At the first sign of flight from an industry, capital quickly retreats from the previous growth sector where, for a while at least, almost any idea was financed. As a result, opportunities to unload shares deteriorate for investors who are still in the market, and everyone tries to sell at a price he or she can find reasonably justifiable. At this point a certain sector is dead for venture capitalists for a number of years to come.

((U3)) The Selection Process

hard drive companies see Sahlman and Stevenson 1985.

[153] Cf. Abate 2001.

The withdrawal of capital from one minute to the next puts companies under enormous pressure, resulting in a radical selection process. In the minicomputer industry for example, which experienced a small boom in the late 1960s, companies began to shut down after the capital markets collapsed. Of the several hundred PC companies to obtain venture capital financing at the beginning of the 1980s, only a fraction survived. A correspondingly large number of hard drive, disk drive and memory chip manufacturers also folded. At the beginning of the 21st century the stock market collapse led to high mortality among Internet companies. Whereas at the height of the boom 50 or more companies were romping worldwide in niche markets such as the sale of animal feed over the Internet, search engines or business-to-business platforms for agricultural goods, only very few survived once the stream of venture capital ran dry.

The selection process during an economic downcycle can actually be seen as a precondition for the creation of new industries. In the U.S. venture capital stronghold of Menlo Park in Silicon Valley, Paul Saffo, director of the Institute for the Future, explains that the collapse of the dotcom industry was indeed a disaster for Wall Street. For Silicon Valley and other high-tech regions, however, it represented a welcome end to an abnormal situation. Just as the ecology on the hills surrounding Silicon Valley is based on the occasional wildfire burning out old-growth and creating room for new life, the business world also needs a way of cleaning itself out. This is the only way, in Saffo's opinion, to prevent a sterile monoculture and to eliminate the unwelcome byproducts of success, namely too many people, too many expensive homes, too much traffic, too little office space and too much money searching for a handful of start-ups.[154]

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[154] Cf. Saffo 2002.

((U3))The “Investment Pressure” on Venture Capitalists

When a growth industry has exhausted itself, the turfs have been claimed, and the general consensus is that the sector deserves no further venture capital financing, venture capitalists face a problem; they must reinvest their money. Robert Bauer of Foodstep uses the term “investment pressure” to describe the situation venture capitalists encounter after an investment wave has subsided. Government agencies know the problem as “pressure to expend funds.” It occurs at the end of a project budget or the fiscal year.

This pressure to invest or to expend funds arises because venture capital financing is not a spontaneous form of investing, but has emerged as a business sector of its own since the Second World War. Small investors who have been disappointed by the stock market can escape investment pressure by ceasing to deal with risky companies and instead buying government bonds or certificates of deposit, or increasing their spending on luxury goods. But venture capital firms don't have those options. Their investors would never agree to depositing money in a bank and collecting four or five percent interest.

The situation is particularly precarious for venture capitalists when they have raised money from investors at the height of a major boom, but are not in a position to invest it according to plan because the exit windows in a certain industry have suddenly closed. This investment pressure emerged in an aggravated form for the first time in the 1980s following the personal computer boom. After the sensational success of the Apple IPO and the exponential increase in IPOs on the NASDAQ, the coffers of venture capital firms were brimming. Once doubts emerged about the PC industry in 1984, however, taking firms public in this sector was out of the question for two years. In the aftermath of the stock market crash on October 19, 1987, the IPO window also closed, thereby barring venture capitalists from key exit opportunities for some time. Even though a shopping spree by Japanese companies in the USA during the late 1980s opened a new exit window for venture capitalists, they still had difficulty on the investment side of the equation.[155] A similar situation arose during the last two years of the 20th century, when venture capital firms had little trouble raising money from investors but suddenly saw their exit opportunities evaporate when the stock market collapsed. Two years after the Internet bubble burst analyst Jesse Reyes of equity research firm Venture Economics estimated that U.S. venture capital firms alone were sitting on $100 billion which they “had to” invest.[156]

The collapse which follows a major boom phase results, after a lag of one or two years, in less money flowing into venture capital funds. Thus, in the year after the stock market collapse in October, 1987, U.S. venture capitalists raised 20 percent less capital from investors. Many venture capital firms founded during the boom went bankrupt and dropped out of the picture as suppliers of venture capital. After the Internet bubble burst in the year 2000, the venture capital scene experienced a phase which can only be characterized as a deep depression. Whereas venture capital firms at the height of the Internet euphoria were able to raise over $30 billion in one quarter in the USA alone, the amount accumulated over a single

[155] Cf. Schilit 1991, 96; Pfirrmann, Wupperfeld and Lerner 1997, 40.

[156] Cf. Yu 2002, 30; Khosla 2002, 10ff; see also NVCA 2002; for basic information see Doerflinger and Rivkin 1987: 46.

quarter two years hence had fallen to $2.2 billion, a six-year low for the venture capital industry.[157]

But the low level of inflows did not fundamentally reduce the investment pressure on venture capital firms. The millions, the billions of dollars had to be invested. On the founder scene people were saying that “venture capitalists are both rich and scared.” Venture capitalists react to the problems of investment pressure or the pressure to expend funds by frantically seeking new industries. In casual forums, at conferences and partner meetings, “What are the markets of the future?” ranks high on the list of heated discussion topics. Instead of entering joint ventures, making deals or bragging about one's exits, the conversation turns to what the next hot industries will be. There is conjecturing about the latest trend: Would that be nanotechnology or virtual computers? Should we take a stab at genetics? Will robotics figure in somehow or might we even see a combination of bio-and information technology?

We may regret such sector hopping but this very behavior probably accounts for the innovative effect of the venture capital industry. Only the investment pressure resulting from an economic downswing enables brand new technologies to find investment-ready financers in the first place. When banks, insurance companies, pension funds, foundations and individual investors pressure venture capital firms to finally invest the resources they have made available, the basis is created for venture capital to flood into a new technology, if it is deemed promising.

[157] Regarding the period after 1987 cf. Schilit 1991, 53; for the period after 2000 cf. Yu 2002, 30.

((U3)) After the Boom Is before the Boom

If we choose even to mention the major concept of a "speculative bubble," then venture capital amounts to nothing more than a cyclical business with the "speculative bubbles" which arise in growth markets. In the mid-1980s journalist Michael S. Malone compared venture capitalists to surfers lying in the water waiting for the next big wave. As soon as a wave approaches, normally several dozen firms start paddling hard so they catch the crest of the wave. But only a few are fast enough to do it well. The others remain behind, frustrated, and either wait for the next wave, or leave the water altogether.[158]

We must not fail to take into account, however, that over the history of exit capitalism the waves were able to grow ever greater. Whereas venture capital financing in the early days focused on research dependent, scientific developments in the high-tech and biotech fields, during the Internet boom venture capital forced its way into every sector, from arts and crafts to watches, book sales and travel. Venture capitalist Ann Winblad explains that venture capitalists traditionally invested in high-tech sectors which provided services to other industries. Using the Internet, venture capital firms then began to compete with companies in the end-user sector which previously had been merely the recipients of services provided by venture capital-financed companies. Winblad says that she would never have thought of financing companies in banking or transportation, not to mention the domestic animal business, but that the Internet had made it possible.[159]

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[158] Cf. Malone 1985, 350.

[159] Cf. Southwick 2001, 28.

Many business models during the Internet boom were based on relatively simple technology, which resulted in a dramatic widening of the range of individuals running venture capital-financed companies. In principle, anyone who could cobble together a modest Web page using the Java programming language, had the opportunity to develop a business idea and compete for venture capital financing. The technological underpinnings were so easy to grasp that business consultants with only two or three years of professional experience, or even management students, could implement a business concept and not worry about being unequal to the technological complexity.

The entry of venture capital financing into the online business sector raised the entry and exit speed of venture capitalists to the next higher level. Whereas investments in both the high-tech and biotech sectors generally involved commitments over a somewhat longer period, and venture capitalists were involved in building up companies for several years, the length of time between investment and exit in the Internet industry amounted in some cases to no more than a year or two. Developing new computer hardware, not to mention genetically engineered pharmaceuticals, often required several years. But in the Internet business, especially the business-to-consumer and business-to-business ends of it, programming a Web portal in six months and setting one's sights on an IPO after another twelve was entirely within the realm of possibility.

Both the scope as well as the speed of the Internet boom caused a stronger and wider downswing in the venture capital business than during the “normal” venture capital cycles in the minicomputer, PC, software or biotech sectors. Affected by the downswing were not only the online companies and the venture capital firms which had focused on the Internet – and had profited especially from the boom – but also all the other companies which had ridden the capital market wave at the end of the 20th century. Even growth company exchanges like

NASDAQ Japan or the German Neuer Markt, which were created as part of the Internet euphoria and had instituted no strict quality controls for the companies they listed, were engulfed by the downswing and went out of business.

But even the worst of economic downswings will not prevent the next boom. Maybe the next boom will take just as long to materialize as during the “drought” following the “golden age” at the end of the 1960s. Perhaps it won't be as pronounced as the Internet boom. Perhaps the next boom will involve substantially more complicated technologies. Many investors had negative experiences with the relatively simple technology of the Internet. During the next boom no one may want to become involved with a sector where every college student can open a “me too” business. But as long as speculative stock trading remains possible, the next boom phase is sure to come.

((U2))3. The Cycles of Exit Capitalism

Speculation became an integral part of capitalism when trading shares of business ventures was introduced. In Holland beginning at the middle of the 15th century it was not only possible to purchase shares in a venture but also to trade them on a fairly large scale. Dutch merchants used centrally located hotels, taverns or markets as places to exchange shares in expeditions to distant Asia or later to America. Thus, a Dutch businessman could cash out of his original investment in an overseas trading venture even before the ship put into a Dutch harbor laden with spices, fabrics or gold. Since the first trading locales were no more than converted hostelries, the first true exchange building was opened in Antwerp in 1531. Now merchants were no longer forced to transact their business in dives or even in the open air.

The history of the great speculative bubbles since the 15th century is a tale of gamblers in the stock market observing each other with ever-closer scrutiny and making ever-greater investments based on the potential future behavior of other investors. A few examples can be seen in the “Tulipmania” between 1634 and 1637, where astronomical prices were paid for tulip bulbs, the “South Sea Bubble” from 1719 to 1720, which led to a major wave of speculation in France, or the “Founder Boom” in Germany in the early 1870s, where any business concept, no matter how abstract, could obtain financing.[160]

But such speculative bubbles would not yet qualify as exit capitalism per se. Only the emergence of venture capital financing as a profession made trading company stock and speculating on developments in the future into more than mere exceptions to the rule and transformed them into the basis for an independent business model. The short-term exit orientation which emerged during certain phases of major speculative bubbles during the Early Modern and Modern Age only became the norm with the institutionalization of venture capital financing.

In exit capitalism the exit mentality does not remain limited to venture capitalists but is also adopted by founders, executives and employees. To the extent that they become shareholders of a venture capital-financed company based on their contribution of labor, entering and exiting companies in rapid succession also plays an increasingly dominant role for them.

It would certainly be a mistake to proclaim exit capitalism as a fundamental transformation of the capitalist economic system. Value is still created through the exertion of

[160] For a discussion of the economic reality of investor decisions cf. Garber 2000.

labor, and there is little evidence that the exit mentality could become the driving force behind traditional exchange-listed companies or those which are financed through the founder's equity capital. But no later than the Internet boom, it became obvious that during the hype phases of exit capitalism traditional capitalist companies come under pressure and may be forced to adopt the strategies of venture capital-financed companies.

Exit capitalism cannot be viewed as a pathological outgrowth of capitalism. It falls within the normal range of capitalist business transactions. What occurred during the Internet bubble and the concluding years of the 20th century was not pathology but the direct result of an economic system based increasingly on the tradability of company shares.

We may refer to such highly speculative stock transactions as "casino capitalism," a "chain letter economy" or a "bubble economy." But ultimately, it is the hope of venture capital investors to be able to sell the company shares they own at a high exit profit in an overheating venture capital spiral, which makes risky investments in new technologies possible in the first place. Only the involvement of the venture capital business in "casino capitalism," a "chain letter economy" or a "bubble economy" causes such massive amounts of capital to flow into the development and commercialization of new technologies.

Those who point to the irrationalities of such speculative bubbles and exaggerated, euphoric cycles and say "No" would, to be consistent, also have to say "No" to venture capital financing and ultimately to trading company stock. But since stock trading is one of the pillars upon which capitalism rests, a "No" to venture capital financing would be tantamount to a "No" to capitalism itself. Those who complain, during exit capitalism's downcycles, of the irrationality, pathology and madness of the markets certainly would never intend their "No" to be construed in that manner.

((U1)) Appendix

((U2)) Methodological Considerations

I have subjected the empirical material used in this book to a qualitative analysis. At first glance, the qualitative analysis of conversations with experts, published interviews and articles seems to contrast with the methodology of both contingency theory-oriented organizational sociology as well as the science of economics and its interest in comprehensive trends. My goal in writing this book was to use the qualitative material to generate plausible hypotheses, which can only be supported or refuted in a second step which involves quantitative analysis. For this reason, I do not use the empirical material presented here to establish causal relationships, but to develop, illustrate and support the plausibility my argumentation claims.

In addition to country case studies on venture capital financing in the USA (by Alexander Schulze-Fielitz), Great Britain (by Ursula Mühle), France (by Friederike Schwarzer), Germany (by Norbert Huchler) and Israel (by Gali Reich) as well as the historical case study of the cyclicality of venture capital financing (by Marianne Schröder), which was particularly important to me, this book rests on three empirical pillars.

The first pillar is the analysis of books, interviews and monographs about venture capital financing in U.S., British and German periodicals. This material is used to reconstruct public discourse between companies, venture capital investors, analysts and journalists over the formation, significance and strategy of growth companies. Since the interviews and articles I examined are already a matter of public record, I did not anonymize the company names. Using published sources raises a methodological problem; it is difficult to determine the degree to which information was already generated with subsequent publication in mind, thereby limiting the usability of the statements. To counteract this, source material in the public domain was contrasted and supplemented with empirical information collected from venture capitalists through my own efforts.

Therefore, the second pillar the present book rests upon is a study conducted within the framework of a research project shortly after the Internet bubble had burst. Expert interviews were conducted with the CEOs and employees of nine venture capital firms. Interviewees were assured anonymity both for their companies and themselves as a means of precluding responses based solely on public relations considerations. The statements by employees of the fictitious venture capital firms Goal Venture, Ad Venture, Venture World, Natha.com, Grquick.com and MACV are drawn from this research.

The third pillar is a study of seven companies which were financed by venture capital investment. These firms had either already launched a successful IPO or their company strategy was focused on taking the company public on a growth company stock exchange within two or three years of the first round of venture capital financing. A total of 20 expert interviews were conducted with employees of the seven companies. Additional published and unpublished company data was also examined. The study focused particularly on reconstructing the "inner life" of these venture capital-financed companies and served primarily as the basis for Chapter V. To ensure the anonymity of both company and employee, information which was not central to the line of thought was partially changed (different products, financers and attributions to interviewees). The interview sequences with employees of the fictitious companies Foodstep, Informationhighway, E-Yello, Netdollar and SuperWebOffice were drawn from this study.

In the present book I have dispensed with classifying individual lines of reasoning according to explicit categories of organizational theory. References to current discourse on neoinstitutional, micropolitical and systems theories are pointed out in individual articles, in which I also provide additional empirical evidence for the plausibility of my arguments (see references).

This book must leave many questions about exit capitalism unanswered. What is the relationship between capital and product markets during upcycles and downcycles on the exchange? Precisely what is the effect on major corporations of the various phases of the exit mentality? To what extent do venture capital-financed companies act as models when major corporations increasingly adopt a capital market orientation during periods of stock market hype? How does the exit mentality affect the relationship between investors in venture capital funds and the venture capital firms themselves, and between venture capital firms and the companies they finance? (It is correct that much has already been written on this subject from the vantage points of principal agent theory, transaction cost theory or property rights theory. But such theoretical biases cause many aspects to be overlooked.) In what respects do the various cyclical upswings and downswings in the venture capital business differ, and what is the role of the boom phase connected with Internet technology?

My hope is that this book will provide a theoretical framework within which these questions can be examined further.

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