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WHY YOUR COMPANY SHOULD (PROBABLY) BOOTSTRAP

In my work, I see a lot of companies looking for investment. At the Angel Investor Forum (AIF), of which I'm president, we screen a few hundred companies per year, ask a couple dozen to present and actively pursue diligence on about 10. Plus, I mentor or judge at a couple of startup weekends each year and go to five or six accelerator demo days.

But I also have my foot in another camp. I've been an entrepreneur since 1979 starting and running companies that I own. You've never heard of any of these companies – they've all been bootstrapped. They are companies that I grew and profited from with no outside funding. Since 1994 I've been consulting for people who run such companies. The difference between bootstrapped companies and those with outside investment is stark.

The entrepreneurial world is changing

The problem I see is that everyone thinks starting a company and raising money go hand in hand. They don't, but you'd never know it from reading the press. But there was no venture capital industry before the late 1940s – and some pretty big companies were started back then. Many are still around, like IBM, AT&T, GM, Xerox. Even into the 1970s and 1980s, when companies like Microsoft, Oracle and Dell were started, they didn't go after outside investment first. They went after customers first. It might surprise you to learn that in the past 50 years, half the companies that have gone public did it without taking any money from venture capital firms or angel investors.

Only in the past 20 years or so has raising money become the first thing entrepreneurs think of. But in the past few months, people are starting to see the error of that approach. Don't get me wrong – there's a place for angels and VCs in the entrepreneurial ecosystem. I'll get to that in a minute. But here's what people are missing.

The kind of investment that's right for your company is not up to you – any more than the size of your shoes is a fashion choice. You can choose the style of your shoes, but not the size.

I hear from entrepreneurs all the time about why they need money. They'll grow faster, hire more sales people, add new features, etc. But investors don't invest to grow your company. They invest to get a return on their investment. If people sold products the way they ask for investment, they'd be saying, "You should buy my stuff so I'll be able to upgrade my Internet service to a faster line." That's not a very good sales pitch.

It doesn't matter to an investor whether investment will make your company better – it matters whether your company makes a good return on his or her investment. In my work I see a lot of really good companies that are lousy investments.

A good company is not the same as a good investment

This idea is starting to gain popularity. Have you heard about the Series A crunch? Companies that got some early seed funding find they can't get funded when they need to raise $1 million or more. Maybe they should have gotten their seed funding from selling their product to customers rather than selling their concept to investors.

Did you read this profile of two companies in the same industry? RJMetrics got started with $10,000 of bootstrapping money and got its first customer in three months. GoodData went for funding first and has now raised $75 million. The founders of RJMetrics own 80% of their company. Not so for the founders of the GoodData. And here's the money quote:

If RJMetrics were to sell for, say, $50 million, the founders would be set for life financially. If GoodData were to sell for $50 million, it would be a disaster.

A recent copy of *Inc.* magazine has an article about a company (ESRI) with almost $1 billion in revenue that has grown for 43 years without a layoff or downsizing. Here's what Jack Dangermond, co-founder, says:

One thing that has made us so successful is that we've never taken outside investment. That means we can concentrate on what our customers want – not what the stockholders or VCs want. That's a strategic advantage.

In the past dozen years the cost of starting many types of companies has plummeted due to cloud computing, hardware getting cheaper, open source software being more powerful. All of these reduce the cost and risk of getting a product to market.

Add to that the newly discovered concepts of learning entrepreneurship. The phrase "business model" is not just a change in terminology replacing business plans and competitions. It is in fact a new way to start a company with less risk. Customer development, lean startups, business model canvases – these are more than buzzwords: they are all new ways to help entrepreneurs earn their craft faster and better, so they can start companies more rapidly, with less capital and with less risk.

According to Chris Dixon (himself a VC with Andreeson Horowitz), *There are lots of tech companies that are very successful but don't fit the VC model. If they don't raise VC, the founders can make money, create jobs, and work on something they love. If they raise VC, a wide range of outcomes that would otherwise be good become bad.*

The numbers support this concept. At least 500,000 companies get started every year in the United States. Many people are surprised to learn the VCs fund only about 3,000, and angels probably fund another 60,000. These numbers are approximate, but the order of magnitude is right. That leaves a lot of companies to bootstrap. Why? Not because they can't find investors, but because their model isn't right for equity investment.

What is the right model for raising equity investment?

You'll know you are using the right model when you can generate the kind of returns investors need. At minimum that means being able to sell your company and returning to investors 10 times their money in five to seven years, or three times their money in two to three years. Minimum. That generally happens when one of the following is true:

- You have a market that's large enough to create a billion-dollar company.

- Your market is large AND is such that there will only be one key player (like eBay), so you have to grow very fast to eliminate all the competition.
- You have invented some technology that's protectable and desirable to an acquirer for strategic reasons.
- You've grown a company fast enough to prove the business model, but there's a huge untapped market that your acquirer has the resources to exploit.

These returns generally don't happen when several competitors are pursuing the same idea, when your technology can be easily replicated, or when your success depends on the whims of fashion. In those cases you can often run a profitable bootstrapped business by executing well, but it's much harder to have an exit that gives investors the returns they want.

What's different about running a bootstrapped company?

The biggest difference is that a bootstrapped company focuses on selling products or services to customers. For a company with equity investors, that's only the first step. An invested company focuses on selling the company. This difference drives all the other differences.

An invested company focuses on fast growth. You have to be bigger than the competition to get acquired. A bootstrapped company focuses on getting cash in the door faster. So it needs sales. Usually this means it grows slower. Often it can pay much more attention to customers than to competitors.

A company looking for equity investment spends a lot of time going after investors for cash to grow. A bootstrapped company gets cash primarily from customers – so it needs to make sales right away. Often that cash comes from an alternative sale. For example, you might sell consulting services to bring in money that will fund the development of your product. Investors frown on this because it takes focus away from your key objectives.

Bootstrapped companies try to keep their expenses variable so they minimize cash outlay while they grow. They do this even if they might save money by spending more up front. This may mean leasing equipment rather than buying, paying more in commission for sales because it means less in salary, or hiring part-timers and contractors even if a full-time employee would be more productive.

A strong ecosystem emerges when there are companies at every level and scale: those that should be funded by angels and VCs and those that should bootstrap. But equally important is that entrepreneurs learn what it takes to make a strong company and learn which type of funding is right.

By John Seiffer

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