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Myth Busting: Betting on the Horse

by Louis M. Scarmoutzos, PhD

Reprinted with permission from BioExecutive International 2(5):16-17 (May 2006)

A recent study shows that VC investors, contrary to popular myth, don't necessarily bet on the jockey rather than the horse.

I recently attended yet another venture forum. These forums are becoming increasingly prolific and widespread. In case you haven't attended one of these events, you should. Not only are they interesting but they can be very useful to small companies, startups and new enterprises looking to raise much needed capital from the private equity and venture capital community. From the venture capitalist's and private equity investor's vantage point, the forums often provide a good source of new investment ideas. As one investor I know puts it "...it makes my job a lot easier—rather than searching the globe for new ideas, all I have to is look under one rock."

Venture forums usually include a relatively large gathering of small companies and startups looking for equity funding or partnering opportunities. The companies usually give a short presentation to a targeted audience made up primarily of VCs, angel investors and related private equity investors. Often there are panelists or speakers who provide an overview of the current investment or partnering climate as well as additional seminars that provide instruction on such topics as entrepreneurism, the funding process and related new venture activities. The forums are often good events to attend for the budding scientist-entrepreneur, engineer-entrepreneur and founders of the new venture.

I usually attend several such forums annually because I work with dozens of startups and small biotech companies in helping prepare them for a funding, partnering or related milestone event. Inevitably, one of the speakers presents a slide with a jockey and horse and relays that venture capitalists (VCs) "…bet on the jockey and not the horse." In the unlikely event that you have not heard this phrase before, it relates to the (supposed) fact that VCs bet on the jockey (senior management) and not the horse (the business/market) when making their investment selections.

I can't tell you how many times I have heard that phrase. I have never been comfortable with the colorful metaphor, particularly as it relates to biotech companies. It contrasts with my personal observations that intellectual property, market characteristics and unique products, in other words non-human assets, are often key indicators of a biotech company's success in finding funding. Yet, not being a VC or investment analyst, I usually just grin and bear it, no matter how grizzly it appears to me.

Regular columnist Louis M. Scarmoutzos, PhD, or "Dr Lou" as his colleagues and friends fondly call him, is President and Founder of MVS Solutions, Inc—a management, enterprise and technology consulting firm located in Massachusetts and New Hampshire. Dr. Lou can be reached at LScarmoutzos@MVSSolutions.com or at +1.617.283.2182. Information regarding MVS Solutions Inc is available online under mvssolutions.com.

As companies evolved from a startup to a public company, the uniqueness of the company, including non-human assets, customers, and competitors remained relatively constant; however the human capital of the companies studied changed substantially.

In fact, if you talk to VCs, most of them will tell you that their investment selection process takes into account a multitude of factors including the business model, management, intellectual property, products, market characteristics and competition, to name a few. And on balance, many VCs may tell you that they may more heavily weigh the "jockey" over the "horse" in their final investment selection.

And yet, rarely do I attend one of these forums or related events when someone doesn't explicitly state or utter that VC and private equity investors "…bet on the jockey and not the horse."

I recently came across the first fact-based study, to the best of my knowledge, that may directly debunk this popular myth. A recent paper by Kaplan et al at the University of Chicago Graduate School of Business (UCGSB) studied about 50 venture capital financed companies. About one third of the companies studied were biotech companies. The study found that as companies evolved from a startup to a public company, the uniqueness of the company, including non-human assets, customers, and competitors remained relatively constant; however, the human capital of the companies studied changed substantially.

Although a relatively small number of companies were included in the UCGSB study, the statistical study goes on to show the importance of proprietary intellectual property, patents, and physical assets and their increasing importance over time.

Kaplan et al further state, "The glue holding the firm together at a very early stage is composed of the patents, the stores, and the processes. Except perhaps for raw start-ups, VCs should bet on the horse. We see the jockeys changing, but we don't see the horse changing."

The UCGSB study suggests it is the business that is most important for a new company's success, even from a very early stage in its evolution. The authors of the study stress that their results should not be interpreted as saying that specific human capital is unnecessary or unimportant. On the contrary, human capital is important; however, the specific individual and his or her particular expertise appear to be less important than other factors.

The results of the UCGSB study jibes well with my own personal observations. Other notable findings from the UCGSB study include:

- Near complete stability of a company's business model from startup to public company.
- Business ideas for biotech companies are more likely to be based on academic research while non-biotech companies are most likely to be based on ideas from previous jobs.
- Intellectual property, whether patented or not, was found to be significantly more important to a company than its physical assets.
- From startup to public company, the focus was on internal growth (producing new or upgraded products, adding customers via gaining market penetration or market leadership).
- Over three fourths of the companies listed a chief scientist, chief technical officer, or chief engineer as a key executive.
- VCs were regularly able to find replacements for the management team when and where appropriate for the business.
- In no case did VCs invest in good managers and significantly alter the company's business.
- The turnover of top executives was more common after the company went public.
- Despite being unprofitable, the company's market capitalization increased roughly tenfold from the startup to IPO phase.

What does all this mean for today's aspiring biotech entrepreneur and startup company? Focus on the business: grow your markets, products, customers, intellectual property, and so on. By doing so, you will be rewarded. The Kaplan study goes on to show that the founders and senior management are indeed handsomely rewarded for all their hard work and efforts. Using the first trading day's closing price, Kaplan et al show that the founders and senior management gain about $10 million to $30 million, on average, for their contribution to the company's success and growth.

References

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