The Deal

from "Startup, A Silicon Valley Adventure" by Jerry Kaplan,
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THE MODERN CORPORATION is quite possibly the highest form of human corporation. Specialized resources in the form of labor, raw and finished materials, capital, and knowledge come together in a marvelous process that transforms these components into goods and services of greater value. This miraculous conversion is similar to the process by which dirt, water, sunlight, and a packet of information in the form of a seed are reorganized into a living plant. Like plants, corporations are born, grow, and die, reach out for resources, fend off predators, and compete with others. Businesses evolve over time, as less efficient corporations are replaced by more effective ones, whose successful practices are then emulated by others.

It is against this backdrop that the "startup game" developed. The startup game is an elaborate contest created to accelerate the pace at which corporations evolve, played continuously by an endless parade of hopeful entrepreneurs. It is a carnival game of life, testing the strength, aim and skill of contestants willing to expose themselves, for glory or ridicule, to public scrutiny. The challenge is to find a new or better way to do business; the rewards are increased wealth, enhanced personal reputation, and control over one's own destiny. The startup game is designed to motivate our brightest, most creative, and hardest-working individuals to improve the use of society's resources, increase employment, and provide a broader range of quality goods and services. Here's how the game is played.

It begins with an aspiring entrepreneur who is willing to step right up and be tested. As in many other games, the player starts with an artificial currency in this case the stock of the new venture. The goal is simple: increase the value of the entrepreneur's shares, because when the game is over, these can be cashed in for real money. The trick is to swap some of the stock for three resources ideas, money, and people then use these resources to increase the value of the remaining stock.

The ideas are called intellectual property, which includes the business concept itself and any unique designs, processes, or plans for how to pursue the business. The intellectual property is safeguarded by trade-secret protection programs and by patents and copyrights.

The money comes from investors, usually a venture capital partnership. The venture capitalists, or VCs, get a special form of equity called preferred stock. This stock confers certain rights, known as preferences, such as the right to appoint someone to the board of directors.

People are usually assembled by recruiting friends and associates and by hiring headhunters to find them. These people become the employees, who are paid with a mixture of cash and stock. The cash is enough to cover reasonable living expenses, but is often less than the employees would earn at a stable, going concern. The stock is what they are really working for. It is a part ownership in the venture, a chance to participate in the game and pay for it with their own labor which is why it is often called sweat equity.

The entrepreneur doesn't raise all the required money up front because that would mean selling too much of the stock. Usually, the initial investment is just enough to reach some identifiable milestone. The milestone is chosen to demonstrate to potential future investors that the company's prospects have improved, justifying a higher price for the stock, so that less of it has to be sold. If the money runs out before the milestone is reached, the game is over. In the meantime, other companies may try to steal the ideas, the people, and may even try to run the venture out of money.

Venture capitalists typically look for a reasonable possibility of making five to ten times their original investment within five years. This corresponds to borrowing money at 50 percent per year or more (until recently, such an interest rate would have been considered criminally usurious). This high cost of capital makes the startup game a race against the clock.

The final step in the game is a financing event called an initial public offering, or IPO. The IPO when the company is first listed on a public stock exchange usually makes the transition of the enterprise from a risky venture to a profitable company. Up until this time, it is virtually impossible to dispose of stock and get cash. Soon after the IPO, the entrepreneur is free to sell stock on the open market, as are the inventors and employees. This marks the successful end of the startup game and the creation of a viable company. The entrepreneur can now cash in his stock and go home, take on the less risky job of managing a going concern, or step up and play the game again.