

Analysis

## Venture Capital in the New Garage May 2007

Do we still need venture capitalists in the software industry? Sounds like a no-brainer but the question also reflects the disruption that is taking place in enterprise software that was initiated by salesforce.com and accelerated with its unveiling of a company incubator in San Mateo.

For the record, I think there will always be a place for VC's and their money, but it is also true that their position, and possibly their power, may be diminished — or possibly enhanced by the incubator concept.

First, the good news. The introduction of salesforce.com's incubator has finally put a floor under the innovation and entrepreneurship processes. In the years leading up to the bursting of the Internet bubble it was common for entrepreneurs to get funding for ideas that lacked business plans — and maybe even prototypes — with the result that everything came crashing down like a house of cards the first time a breeze came up.

Instead, I suspect that the incubator might become an essential part of the process that leads up to getting funding, analogous to the Bachelor's degree requirements that most graduate schools have. How a new company does in an incubator setting might become a core requirement for anyone who considers investing in a new company.

More importantly, if done correctly, an incubator experience should be able to get first time entrepreneurs some basic business experience that many may lack. So, all in all, I could easily see a time when an incubator experience becomes a standard part of the way that VC's evaluate potential investments. I also think it's possible that VC success rates will improve because many of the mistakes that young companies with inexpe-

rienced management teams fall into could be weeded out earlier.

Nevertheless, to get back to the original question, the full answer is a little different. If an incubator is the only difference in the entrepreneurship process, then it is quite likely that emerging companies will still need VC money because an awful lot of it goes to things that are not strictly related to building a product like rent, marketing and building a sales force.

As it turns out, the incubator concept has been around for a long time and the single important difference here is that in addition to providing all sorts of business nurturing, the incubator in San Mateo tries to standardize products on a platform and tool set that make it possible to standardize the way the applications are eventually marketed and sold. It is this innovation that sets the new incubator apart because it changes the marketing and sales paradigm, removing economic friction and the need for at least some of the capital required to overcome it.

Labor is still one of the biggest parts of a company's outlays and sales burns cash like there's no tomorrow. If you are building a conventional business the cash that drives the sales and marketing team during the ramp-up process has to come from somewhere and that place has traditionally been the venture capital community. The natural question then becomes, what alternatives does an entrepreneur have other than building a sales force? The answer is already in front of us in the form of what salesforce.com calls the AppExchange.

An online commerce device like the AppExchange can do a lot to reduce or eliminate the costs associated with selling software. For example, it greatly reduces the need to build out a sales and marketing component

of a business. It remains to be seen how profits will be affected but it is possible that enterprise software can be just as profitable at a lower price point if costs (e.g. sales overhead) can be driven out of a product's price.

Purists might say that a sales force is required to bring new product ideas into a market but maybe not or at least not so much. Expensive sales and marketing drives up prices and is essential only if there is no other means of penetrating a market. The alternative is to greatly reduce friction caused by sales and marketing to the point that a price is so low that a buyer can afford to try a product and discard it if it fails to meet one or more key needs.

Some people might find this to be wasteful but it is exactly the approach that early adopters have used for decades. In his early books like "Crossing the Chasm," Geoffrey Moore made the point that early adopters tended to be companies with lots of resources that can afford to experiment with innovative products (and possibly throw

them away) and in many cases help the vendor articulate its true value proposition.

The ability to pay for the costs associated with that kind of innovation means early adopters get the first benefits and is one reason they gain great market advantage when they adopt new technologies. Imagine what might happen though if the cost of trying an innovative idea drops. In that scenario, potentially any company could be an early adopter with far reaching impacts on competition.

Inevitably, we come back to the original question — are VC's still necessary? The answer is yes, but this business is changing significantly, even for VC's and it is possible that VC's will need to change their models in the same ways that software companies are in the middle of changing theirs. In the not too distant future, a venture capitalist might look a lot more like salesforce.com than any of the firms on Sand Hill Road.

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