*Mark L. Frigo, Editor*

# A Holistic Approach to Venture Capital Investment Decisions

BY MARK L. FRIGO & JAMES P. SWEENEY

What is the primary challenge facing venture capital firms today? After three years of steady decline from the lofty 1999-2000 levels, venture capital investments exceeded $20 billion in 2004, and concerns are being raised about successful investing. With more than $5 billion raised in the third quarter of 2004 alone, the challenge is the preservation of strong returns in a market awash in cash. This means making the right investment decisions. The current climate calls for a disciplined and holistic approach to linking the strategy of a business to the financial value that it will create.

## The Challenge

The challenge for the venture community is to find the best ways to make the connection between the business strategy of the company and the future financial value it will create. Even the best VC firms will find this to be a daunting task. What's needed is a framework that describes the strategic activities of the most successful companies and makes a distinct connection between their business strategy and financial performance.

This framework would reflect the necessary strategic activities for superior performance. The business would be aligned toward defined financial value maximization goals and a commitment to pursue maximization of shareholder value within the parameters of ethical conduct as defined by the communities in which it operates. It would focus on customer needs, the pathway to value creation, and targeting the right segments with intent to dominate, and it would be willing to cannibalize its offerings when needed. The company would display a balance and synchronization of business competencies, which would include continuous innovation of offerings to fulfill customer needs, operational excellence aligned with business goals, and branding the offering to the right people with the right intent. This business would also utilize a spectrum of partnerships and options to enhance competencies, engage employees to support the right balance of competencies, reengineer the entire value chain when applicable, and, most importantly, practice an ongoing creation and realization of unique Genuine Assets to ensure competitive advantage. These characteristics describe a business adhering to the tenets and foundations of Return Driven Strategy (see sidebar, p.10).

## Connecting Strategy with Results

While traditional investment decisions are driven by quality of the management team and pro forma financials, Return Driven Strategy offers an assessment methodology that is both holistic and dynamic. By applying the tenets and foundations of Return Driven Strategy, the venture community will have a powerful tool with which to evaluate investment decisions. Return Driven Strategy makes the connection between the business strategy and valuation (see Joel Litman and Mark Frigo, "When Strategy and Valuation Meeting: Five Lessons from Return Driven Strategy," *Strategic Finance*, August 2004).

Return Driven Strategy reflects

## About Return Driven Strategy

**Return Driven Strategy** is a framework and set of guidelines for evaluating, developing, and refining executable strategy firmly aligned with the goal of maximizing financial value (see Mark Frigo and Joel Litman, "What Is Return Driven Strategy?" *Strategic Finance*, February 2002). The ongoing academic, clinical, and real-world research and application of the framework have been led by Mark Frigo and Joel Litman over the last several years. Return Driven Strategy is being used successfully by executives in strategic planning retreats, at board meetings, as a platform for balanced scorecard initiatives, and by investment analysts. It has also been used and adopted successfully by privately held companies and nonprofit organizations.

The tenets and foundations of Return Driven Strategy form a hierarchy of interrelated activities that companies must perform to deliver superior financial performance. These tenets summarize the common activities of great company performance and identify flawed strategies or failed direction of marginal performers. Here is a list of the tenets and foundations of Return Driven Strategy:

### THE TENETS OF RETURN DRIVEN STRATEGY

**The Commitment Tenet:**

- Commit to Ethically Maximize Financial Value

**The Goal Tenets:**

- Fulfill Otherwise Unmet Customer Needs; Target and Dominate Increasing Segments

**The Competency Tenets:**

- Plan for Executability, Effectively Deliver Offerings; Innovate Offerings; Brand Offerings

**Supporting Tenets:**

- Partner Strategically; Map and Redesign the Value Chain; Engage Employees and Others; Utilize Options and Portfolio Strategy; Communicate Strategically

### THE FOUNDATIONS OF RETURN DRIVEN STRATEGY

**Genuine Assets:**

- The Building Blocks of Sustainable Competitive Advantage

**Significant Forces of Change:**

- *Vigilance and Agility to Capitalize on Opportunities and Avoid Threats*

**Strategic Valuation and Performance Measurement:**

- A Discipline that Links Strategy to Ultimate Financial Results

the activities of successful companies such as Intel and Cisco, which were funded as start-ups by VC firms. It can be used as a set of guidelines for evaluating business strategy for such ventures as it is applicable to start-ups as entrepreneurial ventures as well as corporate intra-ventures. The economics of start-ups involve massive risk in investment with uncertain promise of returns and with critical up-front stages. The massive high-risk investments accompanied by negative cash flow returns require a disciplined approach for executing business strategy. The risk is compounded by the fact that this time period requires allocation of resources into the building of sustainable Genuine Assets (see Joel Litman, "Genuine Assets: Building Blocks of Strategy and Sustainable Competitive Advantage," *Strategic Finance*, November 2000, and Mark Frigo, "Building the Verbs of Strategy on the Nouns of Business," *Strategic Finance*, April 2003) to provide competitive advantage. This requires a prioritization of which Genuine Assets are most critical to develop at different stages of the business.

### Asking the Right Questions

Evaluating a start-up's strategy and the executability of that strategy involves asking the right questions centered around having the right goals, competencies, and assets.

*The Right Goals:* Does the business have the right goals? A strong focus on targeting and dominating large and high-growth markets by fulfilling unmet customer needs will test the reasonableness of the market segmentation and the target of the product or service. What is the otherwise unmet customer need? How otherwise unmet is the need? What market segments? Are the market segments increasing, decreasing, or stagnant? What is the potential for domination?

*The Right Competencies:* Does the business have the competencies it needs to effectively and efficiently deliver the offerings, continuously innovate its offerings, and brand them?

*The Right Assets:* Does the business have the right assets to create and sustain competitive advantage?

Genuine Assets in the form of people, patents, or branding offer a degree of protection from new entrants and substitute offerings. What are the existing Genuine Assets of the start-up? What "missing" Genuine Assets are most critical to the success of the venture?

### Case Scenario: A CRM Offering

This start-up was a company seeking venture capital to help enter a maturing customer relationship management (CRM) marketplace with the intent to produce an offering with broadly comparable but scaled-down functionality at one-third the price of the current market leader. Here the challenge is addressing some key questions: Can this start-up deliver the offering at the lower price and generate ROI above its cost of capital? Can it deliver sufficient functionality required by enough customers to create the needed revenue and cash flow returns to justify the investment in the business? What unique Genuine Assets does this start-up have that give it a competitive advantage?

### Case Scenario: A Niche Software Offering

This start-up is a software company that sells relationship management software that will link suppliers to distributors and customers. They subdivided or created a niche within a broader market segment using a model based on reduced TCO (total cost of ownership) and ease of use. Here the company is using technology to drive costs and prices down. The question is whether the venture can get to the intersection of sufficient functionality and sufficiently low TCO with enough volume to drive returns in excess of the cost of capital.

### Balancing the Art and Science of Start-Ups

Investment decisions have historically focused on the science of financial analysis and the art of assessing business plans and people. There is no substitute for judgment, and the instincts of venture capitalists borne of time, success, and failure will continue to loom large in investment decisions. But a compelling new framework, Return Driven Strategy, can be a powerful ally of the venture community. When used in partnership with traditional analytics, it can greatly improve precision and clarity in investment decisions facing a venture capital firm. ■

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