

# **Lenses of Investment**

**A guide for investing in software startups**

**Part 1**

**By**

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## **Introduction**

I am often asked by potential investors to opine about new technology startups. The usual question is “What do you think?”

Well, I think about a lot of things when I review the propensity of a successful startup. Their question about my thoughts is just a proxy to the real question - “Should we invest?”

Over the years, I have developed a visual-mental model to assess the likelihood for success, and it is the topic of this paper. There is also an Excel sheet that accompanies this paper, with a model that works like a score card. You can use the model to score a startup and get a sense of how likely are they to succeed.

The paper is divided into two parts:

- 1) The top three due diligence factors and why they matter
- 2) Is the business scalable? –A successful lemonade stand cannot scale to \$1BN in sales

## **The Top Three Due Diligence Factors**

### **First things first – One Idea At A Time**

Any founder and entrepreneur I have ever met had one idea they thought was good enough to pursue commercially.

Ok, that is a lie.

Every founder and entrepreneur I have ever met had *many ideas* they thought were good enough to pursue commercially.

Some founders are simply in love with their ideas. Some are in love with the fact that they thought of the next big idea. The problem is that most founders think they can pursue more than one idea at a time... that is a fatal mistake.

It is hard enough to get one idea through the stages of development into production. It takes a lot to get from a dream/idea stage to a product/service that can be sold. Running in two different directions at the same time is simply not going to work.

The word “idea” could mean that the entrepreneur is thinking about starting two companies at the same time, and sometimes starting two products within the same company – both are equally doomed.

I always check to see if the founder has learned this lesson before and how they plan to focus their efforts. If I hear something like “we invented a new software that eliminates the red-eye in photos... we

are planning to monetize it a few ways... have it as open source software, build a paid SDK for photo enthusiasts, convince the hardware manufacturers to license it, and also build our own camera with it... and we have even more ideas..." – I know they have not realized that this is the path to doom.

A good rule of thumb:

"Having it all doesn't necessarily mean having it all at once."

— Stephanie Luetkehans

**Thus, the first thing I am looking for is: have they learned that pursuing more than one idea at a time is fatal?**

My four years in business school can be summed in six words:

Find A Need And Fill It.

A product must address some need, by some users. The solution to the need has to be positioned correctly to crack the code and generate sales. So, unless the new venture is super-focused on the need, and how to fill it – the efforts will not be focused enough to get money from customers. Once you add more products, markets and use-cases for different users, the level of intensity and focus is reduced further.

It is absolutely ok, that AFTER one product is sold successfully and profitably, that the team chooses what's next? However, doing it at the beginning; thinking you can execute it all flawlessly – is a sign of immaturity.

Andy Grove of Intel captured this lesson with these words:

"Survive, and then thrive."

"The first requisite for success is the ability to apply your physical and mental energies to one problem incessantly without growing weary."

— Thomas Edison

## Second things second – Focus and Patience/Persistence

The second thing I look for is founders with focus and the patience/persistence to wait for it to pay off.

To illustrate, think about the time when you were a kid, and tried to burn something with a magnifying glass... The lazy ones among us tried to burn paper, the over-achievers – ants.



What do you think will happen if the magnifying glass will not perfectly focus the sunlight?

Nothing will happen. Not enough heat to create fire.

What do you think will happen if the magnifying glass is perfectly focused but is constantly moving from one spot to the next?

Nothing will happen. Not enough heat to create fire.

The same concept follows with startups and their founders/inventors/creators/entrepreneurs. If the founder and the founding team cannot focus maniacally on one thing – there will not be enough heat to start a fire. Also, if they are very focused, yet keep moving their focus from one idea to the next and don't have the patience and persistence needed – there will not be enough heat to start a fire.

**Thus, the second thing I am looking for is: have they learned that not maintaining their focus long enough for the market to light up (which requires patience and persistence) is fatal?**

It is absolutely ok and expected, that AFTER the first idea “catches fire” that you THEN pursue the next idea.

## Third things third – Distilling The Essence

Once the founder has discovered a recipe for success, focused the sunrays and kept it focused for enough time... fire will start. Assume that ten customers bought version 1.0 of the product and they are happy with it. Now, you want to sell to thousands more and make sure the product is enterprise grade.

While no one has ever been proud of their version 1.0 product when they look at it after a few years, it is the version that “started it all.”

Any tinkering with the original recipe before it is fully understood is putting the business in danger and is potentially fatal. You cannot scale this business, until you can safely reproduce exactly what you have.

The founder/s has spent countless hours thinking about their business and has innate knowledge of things that are both obvious and not. In many cases the founder is “User #1” of the product, and has a clear vision of what the product needs to do. Distilling the essence is a continuous process of documenting and understanding both the obvious and not. If changes are introduced during the period that a team is taking over – it can lead to honest mistakes that could change the product forever.

Thus, before scaling, the version with the initial essence must be carefully replicated so the transference of knowledge from one mind to many is successful. Otherwise it will be akin to swapping horses in the middle of crossing a river...

**Thus, the third thing I am looking for is: has the team learned they need to pull the essence of the product from the founder/s and replicate it perfectly before scaling?**