

The Five Fatal Mistakes of Startups

Henry Kressel
&
Norman Winarsky

It's natural to expect that many young companies fail, but what's remarkable is that in an overwhelming number of times, they fail from avoidable mistakes.

Of course sometimes events occur that could never have been predicted—such as the loss of a key founder, or an unexpected government action that eliminates the need for the product—but these events are rare in our experience.

This is a manifesto about the company killers that every CEO needs to avoid.

MISTAKE 1: Failing to Know Your Customer.

When a new product represents a possible breakthrough in value compared to existing ones, determining the proper customer targets can be particularly challenging. Value propositions and business plans, no matter how carefully crafted, make assumptions about customers and their buying behavior. But these assumptions are at best hypotheses. You may have talked with and gained assurance from many customers, but talking isn't sufficient. It is essential that your leadership team has deep domain knowledge and experience with the customer and their ecosystem. One unfortunate example is the fate of an SRI spin-out called PacketHop.

On September 11, 2001, when the Twin Towers were attacked, 343 firefighters died. One reason so many died was that, due to the fire, all communications including the internet had failed between firefighters at the base of the buildings and those who were running up the stairs to save thousands of lives. They never received the call to come back down.

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Researchers at SRI reasoned that they could develop another way of maintaining communications: by creating a wireless network that hopped from handheld device to handheld device as the firefighters were running up the tower. Effectively, a local version of the internet would be running up the stairs with them. That is where the name PacketHop came from.

Much of the technology—known as mobile ad hoc networking—had been developed under government funding for an entirely different purpose, but it would apply here, too. PacketHop had an outstanding team, top investors, and what looked like a large potential public safety market with a major pain point. The value proposition looked irresistible as a foundation for a big company. Unfortunately, the team did not have sufficient domain expertise to deeply understand the buying behavior of the target customer.

The problem? The emergency responders—PacketHop's initial target customers—were naturally conservative and reluctant to move from a well-known brand like Motorola (who was the dominant supplier in this market) to a start-up's product, even if it would be superior. No matter how much value there was in creating this new, seamless, low-cost product, the customers were dedicated to maintaining what had been long-standing customer relationships developed over many years.

Each community, each group of first responders, each town budget official would need to approve the purchase of a product from a new vendor. The sales cycle proved to be so lengthy that go-to-market costs were very high. A few high-profile cities were willing to do proofs-of-concept, but reluctant to buy an entirely new solution.

Beyond these primary problems, the federal government funds allocated to help solve this problem went to the states, and the states funded the communities according to their needs. The need for a new type of communications was often deemed a lower priority than, say, a new fire truck.

Because of the inability to close sales, PacketHop missed its milestones, the venture capitalists were not willing to continue funding, and the company closed.

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MISTAKE 2: Keeping the Wrong CEO

If you're a CEO, you need to understand your own talents and limitations. Some great entrepreneurial CEOs are best suited for early-stage companies, but are not suited to deal with growing list of issues that a growing company has to deal with. The primary point of CEO failure occurs most often in the transition from the freewheeling atmosphere of an early-stage start-up to a larger and more structured organization. Working in a company that feels like one happy family is great, but it has its limits, which are quickly reached with growth when delegation of responsibilities must be done and the CEO role goes from "touching " everything to managing people. Some entrepreneurs are skilled in developing a business vision, but when it comes to execution, they simply do not have the talent (or interest) needed to manage a growing team in the face of growing obstacles.

Unfortunately, CEOs rarely acknowledge their own inability to deal with such events and it's the board of director's role to act: determine the root causes of the problems in the company to address them. If leadership dysfunction is the problem, failure to address it promptly is probably the single most important cause of venture failure.

MISTAKE 3: Mismanaging Finances

Here are some common ways that young ventures waste money:

Hire Staff Prematurely | The most common early over-hiring occurs in the sales operation, when you hire personnel too far in advance of having products to sell. Eventually you will need a strong sales organization, but in the early years you need market development people who have the technical expertise to work with potential customers.

Keep Less than the Best | Most early stage companies don't formally monitor employee performance. But if that informality continues too long as the company grows, less competent people can do serious damage. A formal employee evaluation process is mandatory. However, it does require proper systems, and people trusted with management responsibilities (perhaps for the first time) must be trained.

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Manage Product Development Poorly | Poor coordination between marketing and product development slows product completion and launch. Sometimes the difficulty in getting products to market comes from a belief that “it’s not good enough,” leading to constant (and wasteful) engineering iterations without good reason. Avoid the trap of letting the interests of one or two potential customers drive product development—taking focus away from the broader market opportunity. Falling into such a trap means that the product could end up being a custom solution and nothing else.

The Wrong Corporate Partners | Young companies with exciting new technologies often find many opportunities to work with established corporations. Frequently, major companies approach them, looking to diversity their product portfolios, or just wanting to learn about the new technology. Such partnerships sometimes offer potentially valuable marketing or manufacturing relationships—but the cost can be much too great—with extensive interaction that requires a great deal of executive attention. This attention is frequently at the expense of more valuable activities. Overdependence on such partnerships can both distract the company from its original vision, as well as create dependent on a single customer—never good situations. Unfortunately, many young companies view such partnerships as a short cut to building a successful company—at the expense of more productive market development.

Erroneous Cost Accounting of Products | Understanding what products actually cost is never easy. For example, young companies can confuse product development costs with marketing costs. One example is a software company that came to us seeking funding. The company had excellent products. It was striking, however, that it was unable to be profitable even as its revenues grew by 30 percent per year.

The reason, we discovered, was erroneous accounting. When we looked closely, they featured a 80% gross profit margin, but the actual product costs were really 110 percent of the sale price. This is because each sale involved a huge amount of customized engineering and services. These costs were hidden under the heading of “marketing” or R&D costs and were reported as such to the board of directors. The company had an unsustainable business model because products were being mispriced.

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MISTAKE 4: Being Overconfident

If you think things are going great, why bother to change? Early, rapid success is a good thing, but not if it leads to neglect of the competition or ignoring changing market needs. Overconfident companies may avoid developing new products for fear that they will reduce sales of existing products—and because sales management says that no new products are needed. This is a recipe for going out of business. The solution? Stay paranoid! Perpetual paranoia needs to dominate a business as it runs harder and harder to gain its market position.

MISTAKE 5: Failing to Anticipate Industry Developments

A business cannot escape the impact the environment or historical trends. But what it can do is develop contingency plans early enough that the future of the business is not at risk. Examples of these trends include the commoditization of products over time, the consolidation of vendors and customers, the growing importance of industry product and service standards and, of course, the impact of new technologies that may be nascent when the venture is launched but could become giant factors faster than anticipated.

Products Become Commodities Creating Intense Price Pressure | Businesses often assume that product cost reductions are predictable and will protect the company against aggressive competitors. But what happens when cost reductions don't materialize or competitors emerge with lower-cost factories or sponsors (such as governmental agencies) willing to subsidize loss-making factories?

Rapid Industry Consolidation Threatens Niche Companies | The history of technology companies is that of relentless consolidation, driven by the high cost of developing new products of ever greater sophistication along with the need for broad marketing. You must grow with the market opportunity that was the basis of your venture. Some companies fail to understand the market dynamics and end up stranded with shrinking revenues when more aggressive competitors copy their original value proposition but do it more cheaply and perhaps better.

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Industry Standards Obsolete Products | Major changes in industry product or service standards can destroy a company. Products can be obsoleted overnight when new standards are mandated and the company does not have the time or resources to meet them. It's essential to anticipate such changes and be prepared to deal with them with adequate capital and skills.

Failure to React to New Technologies | Many businesses fail to adapt rapidly enough to new technologies. This process can be painful because new technologies can obsolete the existing product portfolio. Here is where the most brilliant and courageous management is needed. One example of a company that successfully transformed itself when faced with a fundamental technology introduction is BEA Systems. The company was originally launched to provide novel software to enable reliable computer operations networked over private corporate data networks. It was successful with this model, and even went public.

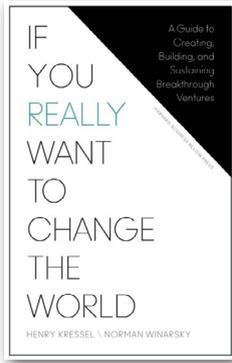
But the management recognized that there was disruptive changes on the horizon. The internet was becoming critical for data communications, and they needed to transform their products. The company management acquired a start-up with the required technology, and became a leading software company offering products based on Internet communications. Oracle Corporation eventually acquired BEA for several billion dollars. Had it failed to transform itself, it would have been a niche player of limited value with poor future prospects.

Conclusion

You position yourself for success when you have skillfully avoided the five fatal mistakes. Leading a venture will constantly challenge you in unpredictable ways, but what people sometimes call good luck in building successful businesses is rather success based on a series of wise decisions, leaving room for serendipity to make its contribution.

We hope this manifesto will help you make these wise decisions as well. 🙏

Info



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ABOUT THE AUTHORS | **Henry Kressel** is special limited partner at Warburg Pincus, a leading global private equity firm where he previously served as a senior partner and managing director for more than thirty years. During his tenure, he successfully led and managed investments that generated many billions of dollars in enterprise value. **Norman Winarsky** is past president of SRI Ventures at SRI International, a world-renowned research institute. He was a founder of SRI's venture strategy and process, which has resulted in more than sixty ventures worth over \$20 billion.

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