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## The Shared Courage to Face the Gap

*A contribution to dating the first heartbeat of a company.*

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### Overture

During my musical training, I led the typical nomadic existence of a student, living here today and there tomorrow. Once I lived in a large high-rise block from the 1960s with thin walls. I could not have any consideration for those thin walls and played my bassoon at all hours approved by the house rules. Before long, I received a visit from the old lady upstairs, who complained about the noise from my 'trumpet'. And as if that were not already insulting enough, she topped it off with the accusation that she had already had to turn up her television because of me. That was how I first encountered the phenomenon of external effects, long before I had even begun studying economics.

In order not to damage the old lady's hearing any further, I summoned all my courage and played the bassoon in the public park near the high-rise until my next move. It happened from time to time that passersby enjoyed my playing and threw coins into my bassoon case. I was glad about the money, as it enabled me to buy new reeds and thus continue to produce and improve my music. And it must be said that bassoon playing became quite lucrative in this way.

So, quite unexpectedly, my bassoon music had drawn me into an exchange relationship with my surroundings, with a flow of goods (the reeds as input, my blowing and fingering as throughput/production, and the music as output) and a flow of finance (cash flew into the bassoon case). With my bassoon I was at the centre of a network of contractual arrangements — including a supplier agreement with the reed maker, a service contract with Püchner Woodwind Instruments, a training agreement with my bassoon teacher, and finally a customer relationship with the listener. Just as is typical of a company.

Had something come into being here that one might commonly call a company? I want to answer this question for two different cases, which are described in the first and second main themes below.

## First Main Theme

The coins were at best to be understood as a stipend. So I took them without thinking further about it.

It was clear to me that the money in my bassoon case had to be connected to my bassoon playing. But I neither could nor wanted to know exactly how. My sole concern was the refinement of my musical skills — the whole thing was a hobby, not a business.

If that is how things unfolded, then in the case of the First Main Theme no company came into being. Even if I had been committed to the economic principle (I was trying to become as good as possible at the bassoon with my limited time budget) and even earned money with my service, I lacked one important quality: the search for the gap. That is what distinguishes all entrepreneurs, whether a small start-up founder without any capital requirement or technology, or a high-tech entrepreneur with patents and millions in venture capital.<sup>1</sup>

## The Creation

Albach sees in the entrepreneurial spirit the ability to search for new opportunities for shaping the future of people within one's own company and among one's suppliers and customers. Baecker describes the entrepreneur as a 'reader' of our way of life. He reads it in order to find opportunities for new products. By diagnosing our society — which we have largely forgotten how to read ourselves — the entrepreneur can unleash the necessary product imagination to create new situations through products, from which other situations or the old status quo can be viewed. To illustrate this, let us take up the story of the monkeys in the cage.

The entrepreneur is the new monkey in the monkey cage, in the middle of which stands a tree with magnificent bananas hanging from its branches. An electric wire at the tree trunk gives every monkey that climbs it an electric shock. The existing population had to learn painfully that the bananas are out of reach and warns all newcomers. While the 'sensible' newcomer follows the advice of the old-timers, the entrepreneurially-minded monkey listens to his colleagues' warnings but is unwilling to forgo his own examination of the situation, for he knows from experience that circumstances can change. He climbs the tree and discovers that the current has been switched off and can eat the bananas without a shock.<sup>2</sup>

The entrepreneurial monkey first looks carefully at the circumstances and examines the assumptions on which they rest. He does not let himself be led astray by those who claim to have already made up their minds. He learns highly selectively, forgets many things immediately and some things never, handles his attention sparingly but with great sensitivity, while searching for the gap. Once he has found one and commits everything necessary to push into it, we call it an innovation. This approach is observable not only among company founders but also in established companies. When one considers that Siemens generates 70% of its revenue from products less than five years old, we can hardly do without this approach even in established companies. Companies without innovations may fall behind in competition; company founders without innovations never arise in the first place.

Albach argues against the separate consideration of the person of the entrepreneur in theory. So that the entrepreneurial element does not fall by the wayside, he proposes that the 'entrepreneurial' should be built into the theory of the firm as an integral component in a so-called 'innovation function'. In the General Theory of the Firm, the concern is ultimately not with persons but with functions.

<sup>2</sup> *This parable is taken from Dirk Baecker's essay.*

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That may be understandable for the 'entrepreneurial' element in existing companies. In the case of the company founder, however, the question must be asked: where does the company come from in the first place? If the company only comes into existence through innovation, then the company's innovation function cannot yet exist, because that would require a company to already be in place. The person of the entrepreneur does not exist in Albach's theory. This is paradoxical and stands in the tradition of business administration in neglecting the emergence of companies.

However, Albach is right that in the description of the 'entrepreneurial', there are several people involved in the innovation process in various ways — not just the lone entrepreneur.

'The entrepreneur' is therefore used here only as a 'pars pro toto'. Equally implied is the female entrepreneur, and beyond that, entrepreneurs of all kinds. The search for the gap is neither gender-specific nor does it have to be carried out alone. The idea may arise in a shared conversation or may even be brought to the founder, who then examines it or sets about its implementation.

Not every innovation is crowned with success. Most company founders fail. When we say that every successful founding of a company presupposes an innovation, it does not mean that all innovations lead to successful companies. Whether the founder has correctly identified the gap can sometimes only be determined in hindsight.

## **The Resonance**

What I lacked with the bassoon was not the eye for the gap, but at least the drive to search for it. For those who might find this unrealistic, let us cite as an example a research institute that sells products as a by-product of its research, without wishing to cultivate this market. There is no motivation for a spin-off. What it receives has for the institute the same quality as grants from the German Research Foundation.

It is undoubtedly a research operation. With regard to the market for the products it sells, the research institute does not act as a company. The revenues are, for the research operation, (positive) external effects.

Or in terms of systems theory: it is the distinction of the science system (true/false) that is relevant for the researchers; the payments from the sold products are not directly understood but rather generate resonance as an environmental event. In order to interpret them entrepreneurially, the system would have to use the code of the economy (pay/not pay).

Similarly, with my bassoon, I cannot move from the cultural cycle into the economic cycle. Even if the musician would deny that he is leaving the artistic cycle and commercialising his music, he at least has a concert promoter or a manager who markets his music. My distinction was beautiful/not beautiful and not lucrative/not lucrative.

Asked why more companies do not spin out of his research centre, the spin-off officer said: 'Our researchers simply have it too good here.' Necessity makes people inventive — not only in the sense that solving a problem is necessary, but also that one's own situation is experienced as a necessity. Even if that is just the boss one cannot stand any more. In that sense, hated bosses and bullying colleagues are among the most important drivers of new business creation in this country.

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At this point, the funding opportunities offered by some German federal states must also be questioned — those that fully finance a founder from the idea fund to the founder-job and thereby turn him into a funding addict in the subsidy cycle (project report in exchange for funding amount), without ever releasing him into the economic cycle. The search for the gap within the funding thicket then becomes more important for the emergence and survival of the organisation than the search for the gap in the market.

If the research team has devoted itself to basic research, then the sale of products cannot be equated with entrepreneurially driven marketing, but rather with an alternative disposal of the waste generated in the process of gaining insights. This is admittedly a largely hypothetical case, but it is possible in fields remote from commerce (and many innovations do emerge from such fields) and therefore must be answered within the scope of the question at hand.

The gap must not only be identified — one must also push into it. Otherwise it remains a mere thought experiment. Identifying the gap is a conscious process. This can happen through targeted market research or even by chance (as with me and my bassoon). During clinical trials of a blood pressure drug, the male participants reported persistent erections as a side effect. The Pfizer managers turned the side effect into the main effect and brought the potency drug *Viagra* to market. As soon as the entrepreneur realises that he is already successfully offering a product on the market and reconstructs the gap that had opened up for him, the company exists. What the management function of planning may miss should at the latest become apparent in the control function. A hypothetical case, but one that should also be answered here.

If the actor does not want to open up a gap, then there is also no company. A far greater hurdle than the will is, for most people, the ability to identify a gap. The statement is ubiquitous: 'I would love to set up on my own. But I just can't think of a good idea.'

While we hold the search for the gap to be a necessary but not sufficient element for the first heartbeat of a company, let us turn to the second main theme of the bassoon example.

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## Second Main Theme

With the jingling in my case, I immediately recognised the market potential of my bassoon playing and blew louder and more virtuosically to attract more people, and from then on sought out places with high footfall and a classical-music-affine clientele. I saw a gap for bassoon music in public places that I wanted to fill permanently. A one-off concert would have been a project, not yet a company.

In this example, discovering the gap coincides with the commencement of business operations. The first heartbeat of my company can therefore be dated without doubt to this point in time.

The company came into being with a contract. Music was exchanged for money. A case that occurs thousands of times every day in German pedestrian zones. Based on the underlying legal and procedural definitions, agreement already existed at a preliminary level. In this case, however, the exchange was based on a misunderstanding: the bassoon case lying in front of me was interpreted by the passerby as an invitation to a transaction. In the Second Main Theme, I immediately corrected this misunderstanding by knowingly accepting the money. It is certainly a special case when the commencement of a service relationship with customers coincides with the moment the business idea is formed.

The example is chosen deliberately: even the conscious placing of the bassoon case would have been attributable to preparatory activity for company formation and would therefore have confused us in the desired dating of the first heartbeat.<sup>3</sup>

<sup>3</sup> *This approach follows the tradition of the didactics of US textbooks, which explain economic relationships through initial simplification followed by the sequential introduction of additional parameters, e.g. from Robinson Crusoe to the modern economy (typical acknowledgement of a new chapter: 'And we see that our model still fits').*

## Variation of the Second Main Theme

Now let us take the simple melody and vary it: if the market entry sounds the first note, then the preparation of the sheet music is a proposal we will now examine more closely.

Empirical studies show that market entry and company founding are preceded by a longer period of idea formulation and preparation. The gap may have been identified, but the push into it is still to come. We can now roughly narrow down the first heartbeat to this period. This period lasts on average 1.5 years.

For geologists<sup>4</sup> and archaeologists, this is certainly a satisfying result — but not for economists, when one considers that only very few companies survive the first two years and an organisation becomes on average 30 years old. For the person who must identify the gap, the lead time before the actual market entry creates a twofold problem: he may have to recognise the gap even before it exists. The entrepreneurial monkey in the cage must already set out when the wire is still live (or when the banana is still green). It is crucial that the gap is there when the monkey arrives. All the more difficult it is for him to convince the other

monkeys of the gap when it does not yet exist.

## **Polyphony**

In answering the question of the first heartbeat, we are aided by a characteristic of advanced economies: the division of labour. That is, the entrepreneur depends on cooperation with other market participants.<sup>5</sup> Obviously with those who consume his services, but before that with technically skilled people on the team, with suppliers or cooperation partners. This allows us to...

<sup>4</sup> *My father is a geologist and says on such occasions: 'I think in millions of years.'*

<sup>5</sup> *We leave the case of self-sufficiency aside here.*

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...simulate the first heartbeat of the company — we discuss this further below.

On the path from idea to company, the entrepreneur must convince third parties to contribute to the planned company. The actors do not do this out of altruistic motives; they pursue their own advantage. If the entrepreneur has the luck and the talent for persuasion, he will succeed in making the gap visible to others as well. It is in the nature of the matter that starting a new company entails high risks. Failure is implied. The entrepreneur does not seek out risks, however; he accepts them up to a certain degree if they are in a justifiable ratio to the resulting opportunities.<sup>6</sup>

The contracts the entrepreneur concludes with the other actors must not only coordinate the behaviour of the contracting parties — the contract must also motivate the partners to act accordingly. These two problem aspects must be resolved simultaneously by the entrepreneur.

Markets react with hostility to innovation. They are in equilibrium before the entrepreneur intervenes; market participants shy away from innovations because they throw the expectations and choices of participants into disorder. The market reacts with resistance because innovation disrupts the equilibrium of the status quo.

The entrepreneur or innovator must now find contractual agreements with the other market participants that not only coordinate but also motivate them to participate in the implementation of the innovation.

A contract in the economic sense is any binding explicit or implicit agreement on the exchange of goods or services between people who consent to this agreement because they expect to benefit from it. The subject matter of contracts is the assignment of property rights.

<sup>6</sup> *If he did not act in this sense, he would not be an entrepreneur but a reckless gambler.*

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It is not always as simple as the exchange in the bassoon example. Often a longer negotiation process precedes the agreement (or the non-agreement).

The entrepreneur is the innovator in a networked economy. In view of these risks, other actors enter into a relationship with the entrepreneur: team members, employees, investors, banks, funding agencies, suppliers, landlords, pilot customers.

In pursuit of individual goals, actors come together to increase total output through joint work — in various organisational forms, in the market or in a hierarchy, or in various forms of control and cooperation in between.

With the contract-oriented view that we apply to the emergence of a company, we follow the approach of Alchian/Demsetz, who describe a company as a nexus of contracts concluded between individuals and a legal fiction, the company. If all these individuals were to conclude contracts directly with one another, this would require a complex structure of multilateral contracts.

Before the first heartbeat, however, the company does not yet exist. Whether a company emerges therefore depends not only on the conclusion of contracts with the aforementioned actors, but also on the emergence of a bilateral structure in which the contracts converge at a central reference point. This determines whether the idea and personality of the entrepreneur can be transformed into a viable company. Both aspects are equally central.

If the company is the centre of a network of contractual relationships, then the entrepreneur is the puppet master who holds the strings and draws them as a network around the emerging company.

## **Metamorphoses**

The entrepreneur emerges, in Frank's systems-theoretic analysis of the pre-founding process, through participation in founding-related communication — i.e. the researchers discover the market gap. Through the entry logic, a selective access to founding-relevant information is formed. The company does not yet exist.

An idea does not yet make a company. Even if the idea is the seed of every company, it would certainly not be practicable to call an idea a company already. One would be calling the seed an organism and thereby overtaxing the cell and our imagination. The question of dating the first heartbeat is understood here as one of definition, which should be as explanatory and problem-oriented as possible in scientific and practical applications, and should simplify the handling of company formations.

In this context, let us cite the insight of an entrepreneur who had the following experience: he had an idea, patented it and went to Siemens with it to sell or license it. They turned him down with the comment: 'We have plenty of ideas.' So he had to take the initiative and develop from the idea a company that is now at the centre of a bilateral network of contracts that includes Siemens. A simple licensing of the idea to Siemens would not have triggered the first heartbeat of a company, because a decisive feature — namely the company as a nexus of contracts — would have been absent.

For this reason, the spin-off officer of a university is in many cases more important to company creation than a patent exploitation office. Ideas must be refined by entrepreneurs into companies. It is only through proximity to the market that they unfold their enormous potential for growth and employment.

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The described division of labour makes it necessary to render the emerging company capable of action both externally and internally, in order to be able to acquire resources (capital, customers, employees). Trust and legitimacy are important prerequisites for the procurement of resources.

Entrepreneurs must initially derive trust in their venture from their own person. Investors invest in teams and less in the company. Industry and management experience of the founder is of particular importance at this stage — for the first colleagues, the first investors or the first customers. 'Trust is the beginning of everything.'

Institutional investors face the dilemma of having to justify their investment decisions rationally. With seed and pre-seed investments, reliable information about the emerging company is scarce. This is where business angels come in, investing their own money and deciding from gut instinct — they are, after all, accountable at most to their spouse. From a conversation between a business angel and an entrepreneur: 'I don't understand what you do, but I trust you.' No investment manager could propose an investment to a committee on this basis. Because of this personal component, in-person events with presentations by entrepreneur teams are very popular with business angels. They prefer to look the entrepreneur in the eye rather than take the company's business plan in hand. Since a North German business angel network began having capital-seeking entrepreneurs present to its business angel circle, the ratio of deals presented to investments has increased dramatically (to 50%).

As the founding process advances, the emerging company (through characteristics such as size, location, potential customers) increasingly functions as a reference point, and personal characteristics of the founder recede as a basis for stakeholder decisions. The entrepreneur...

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...attempts to eliminate the Liability of Newness. The switch is flipped when stakeholders see the company and not the entrepreneur as the reference point.

Recently someone from my industry asked me: 'Are you still at CatCap?'<sup>7</sup> That surprised me and I realised: my baby had become independent. The reference point was no longer me, but the company. I had somehow missed the first heartbeat in that relationship.

It is no different with other companies: the driver drives a Mercedes from Daimler (exception: the person from Baden drives a Benz), the master craftsman works at Daimler, the suppliers are called Daimler suppliers, and the shareholders hold Daimler Benz — now DaimlerChrysler — shares. The company is the reference point. Daimler and Benz have long been dead — the company continues as a legal fiction with the names of the founders.

Daimler and Benz were the entrepreneurs who in 1886, independently of each other, saw the gap for the automobile. They too were already dependent on cooperation with other market participants. Gottlieb Daimler ordered a carriage from the coachbuilder Wilhelm Wimpff & Sohn in Stuttgart and had it fitted with a high-speed motor. In so doing he built his first four-wheeled automobile. Daimler had thereby concluded with Wimpff & Sohn a supplier agreement that fitted into the nexus of contracts that constituted the company Daimler. We therefore want to hold onto contracts for dating the first heartbeat, because those we can look at.

<sup>7</sup> *Name of the company of which I am founder and managing director.*

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The originator of the idea, due to the Liability of Newness, must contend with two inherently founding-related facts: information asymmetry on the one hand (the entrepreneur possesses information relevant to the subject of the contract that is hidden from the potential partner) and uncertainty, i.e. the lack of information about future market developments, on the other. Contracts concluded with the wrong partner can lead to efficiency catastrophes.

This means that the contracting partner will very carefully examine whether he is making the far-reaching decision to contractually bind himself to the entrepreneur. The stakeholder tries to minimise information asymmetries before concluding the contract through screening: he examines the business case, evaluates the founder and looks at the market. The founder tries his part through signalling — for example by pointing to his industry and management experience in senior positions (with references, testimonials, etc.).

For all the screening and signalling: in any case, not only the entrepreneur but also the partners must bring a considerable dose of courage. They are participating in an endeavour that has no history, no reputation and an uncertain future.

With the actors mentioned above, the entrepreneur enters into contractual relationships. Even if, with the exception of pilot customers, no goods are yet being exchanged for money, the entrepreneur is at least exchanging legal positions with the other actors. Without these contracts the company could not come into being. Due to the division of labour, the entrepreneur depends on the resources of other actors. And these are only obtained if he concludes contracts with these actors. But that is less formal than it sounds. No formal requirements apply. The bassoon example shows it: a blow that triggers a jingle is sufficient.

Over time there will be one contract that triggers the first heartbeat. With whom this is concluded depends on the business purpose, the entrepreneur, the market environment and chance.

If this contract precedes the market exchange relationship (customer buys goods and pays for them) — and we deal with this case in the variation of the second main theme — then it must fulfil special requirements to justify the founding of the company. The first contract must be of great relevance to the development of the company.

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The contract must bind the contracting partner, who enters into the contractual relationship for his own benefit, with great commitment — that is, the contracting partner gives up a significant legal position in order to take on a new one. Examples: the cooperation partner in pharmaceutical research waives the fruits of an independent development and brings his know-how into a joint venture. The employee resigns from his employment contract to support the entrepreneur in founding the company on a full-time basis. The investor gives up a significant cash position at the bank and exchanges it for equity stakes.

The contracting partner does not have to understand the gap, but must make his decision in view of the risk. And thereby place a special trust in the entrepreneur. At the same time, he must make his contribution with a view to building a company. The contract is the first significant contract in a structure of bilateral contracts that converge at the company. Even if the company is not yet tangible, the investor participates in the company and not in the entrepreneur. Even if the bilateral structure of a multitude of contracts is not yet discernible — in the extreme case there is only one contract — this contract must be capable of being fitted into such a structure. The fiction 'company' may only be recognised ex post; the high requirements on the contract as a constitutive element of a company are independent of this.

This means: even if the entrepreneur concludes the contract that exhibits the above-described characteristics 'privately' and the other contracting partner initially sees Fritz Schumpeter and not the company as the reference point, the conclusion of the contract can retrospectively be seen as the moment of the first heartbeat. Namely, when from this there emerges the company as the centre of a bilateral network of contracts with employees, suppliers and customers.

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If the postal service delivers the company's business letters, that is certainly not a constitutive contractual relationship. The temp worker who licks stamps for investor letters by the hour and gets paid cash in hand does not make a company.

When a central part of the team resigns from its old jobs and dives full-time into product development, this triggers the first heartbeat of the company. The reference point is the emerging company. They help build the company (and not the entrepreneur). But conversely: if the central team members are all still in old jobs, waiting until an investor strikes, then no company has yet been formed. Nor does the business plan sent to investors turn the idea into a company.

### **"Fortune Seekers with Comprehensive Cover"**

In times of the hype, investors all too rashly believed in the gaps identified by founders. Many hearts began to beat that did not beat for long. But they did begin to beat — at the latest with the investment agreement that fulfilled our above-defined requirements — and in this way companies were indeed created.

Independently of the market environment, problems can arise with a venture capital fund if the manager does not invest his own money but exclusively manages the money of others. At

the investment decision stage, his risk position is not the same as that of the investors who have invested in his fund. It leads to incentive problems when the manager participates only in the opportunities through the so-called carried interest and not in the risks, by receiving his management fee even when the fund performs poorly. It is therefore unsurprising that Lindner, who in his study of success factors of VC funds surveyed investors in VC funds, found that the investors regard the fund managers' own investment as an essential success factor.

In times of the hype, the investor's signature on the investment agreement triggered the first heartbeat; now investors want to see the company already alive when they invest. And they look at the contracts and call that due diligence — including, most certainly, the contract that triggered the first heartbeat. While investors before beginning discussions require a confidentiality agreement...