VENTURE CAPITAL

THE NEW WAY TO
IN SILICON VALLEY

PHOTOGRAPHS BY JOHN HARDING
A new breed of “entrepreneurs in residence” is scoring big returns for venture capitalists playing in an arena where too much money is chasing too few high-tech deals. BY MELANIE WARNER

YOU MIGHT BE INCLINED TO THINK THAT THE most important thing about a technology startup is, say, oh, the technology. Venture capitalists don’t see it that way—and the way they see it is remarkably important since they’re the middlemen who turn today’s bright ideas into tomorrow’s Intels and Yahoons. To a venture capitalist, the crown jewels of a hot new tech company are not closely guarded software codes but the talented people who can quickly transform that technology into a revenue-generating product that leads the company to a blockbuster IPO or a lucrative acquisition. These stars, dubbed simply “the talent,” aren’t necessarily young and restless Gen Xers slaving away in garages. They’re people who, in one way or another, have been around long enough to earn a few stripes. They’re people like Keith Krach.

An affable 40-year-old engineer (yes, 40) with a Harvard MBA, Krach is exactly the kind of entrepreneur today’s Silicon Valley VCs are drooling to give money to. He’s worked at both a big company and a startup, and he’s been in both management and engineering. Most important, he’s helped lots of people make lots of money. All that helps explain why, for six months in 1996, Krach occupied an office at the venture firm Benchmark Capital and why he held a position you’ll find only in Silicon Valley. His title: “entrepreneur in residence.”

The so-called EIR concept has been around in various forms for about a decade; as competition for the talent has grown feverish, some VC firms are relying on it more and more. Technically, what VC firms do is fund startups in return for stock that might someday be worth a lot of money. But the average venture capitalist actually spends most of his time schmoozing with po-

Keith Krach heads a startup that will make it easier for your business to buy file cabinets. The idea may earn him millions.

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tential managerial talent for startups he’s funded and building a treasured database of contacts. Last May, Benchmark hired David Beine, the 34-year-old hot-shot executive recruiter who, among other coups of persuasion, brought Jim Barksdale to Netscape and lured AT&T President Alex Mandl to a little-known startup now called Teligen. Beine wasn’t hired just to spot great new technologies or deals. “Ideas and money are commodities,” he says. “If you have an A team of talented people, you’ll win.”

Keith Krach was in the Rolodex of Benchmark partner Bob Kagle for years. The two got acquainted when Krach was a rising-star engineer at General Motors. (He became GM’s youngest vice president at age 26.) From 1982 to 1987, while Krach directed a GM robotics joint venture that went from scratch to market leadership and annual revenues of $200 million, Kagle would meet Krach for breakfast several times a year. In 1987, Krach became COO of Rasna, a startup that sold software for mechanical engineers. In nine years he helped position the company for a $200 million sale to Parametric Technology in 1995, a bonanza that produced 31 Rasna millionaires and returned many millions to happy venture investors. Soon after the sale, Krach left Rasna, and Kagle saw the opportunity to get him into Benchmark’s entrepreneur-in-residence program.

Krach had many other options. A few well-placed phone calls to other VC firms or individual investors would have secured financing for his own startup. Heck, since Krach walked away from the Rasna deal with more than $10 million, he could have bankrolled a startup himself. That would have enabled him to retain ownership of much of the company’s stock. Krach could also have taken one of a number of CEO jobs available at existing startups, where the going rate is typically $200,000 a year in salary and options on 5% to 10% of the company’s stock. Or he could have simply retired; moved his wife, Jennifer, and three kids to the south of France; and spent the rest of his days picking mushrooms. But Krach liked Kagle. He decided he might learn a few things by hanging out with venture capitalists for a while.

Besides, at the time Krach wasn’t sure what kind of company he wanted to get involved with next. To hear him tell it, he still hadn’t figured out what exactly he was going to do when he grew up. To the five partners at Benchmark, a 2½-year-old firm formed by Young Turks from old-line venture capital firms Merrill Pickard and Technology Venture Investors, Krach’s lack of direction didn’t matter; he would eventually figure it out. As a Benchmark EIR, Krach would be paid $10,000 a month (Silicon Valley’s concept of a minimum wage) to “incubate” an idea.

From an office at Benchmark’s digs on Sand Hill Road, a strip of land in Menlo Park, Calif., so crowded with moneymen that it is to Silicon Valley what Wall Street once was to the robber barons, Krach would spend his days playing venture capitalist—meeting with industry leaders and other VCs, attending Benchmark’s Monday-morning partners’ meetings, listening to pitches from eager entrepreneurs looking for funding, and generally ruminating on the future of technology. Eventually, if he felt like it, he could form his own company and Benchmark would fund it.

Nice life, huh? Being an entrepreneur in residence is indeed one of the dream jobs of the late 20th century, but it’s hardly some kind of equally nimble, keeping our customers freely and constantly in the first to use a new generation of technology.

Our innovative leadership is the first to us. Our customers freely and constantly in the first to use a new generation of technology. Our innovative leadership is the first to use a new generation of technology.

At first glance, our innovative leadership is the first to use a new generation of technology. Our innovative leadership is the first to use a new generation of technology. Our innovative leadership is the first to use a new generation of technology.

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of so-called angel investors, wealthy individuals and tech-
industry veterans (often one and the same) who relish the
vicarious joy and respectable returns of doing-early-stage
funding of new tech compa-
nies. Jeffrey Sohl at the Uni-
versity of New Hampshire's
Center for Venture Research
estimates that angel investors
committed at least $10 billion
to technology startups last
year. There are also more
and more large technology
companies eager to make siz-
able investments in startups.
Microsoft and Intel alone in-
vested almost $1 billion in
them in the past two years.

The abundance of capital
is thanks largely to the
frothy IPO market of the
past three years, which has
enabled VC funds to post
spectacular returns. The aver-
age annual return of VC
funds was 48% in 1995, 40%
in 1996, and about 36% in
1997, according to Venture
Economics. Some annual
returns are simply astounding
such as Benchmark's 100%
on its first fund. Results like those,
of course, attract even more money from the pension funds and
college endowments that invest in venture capital funds as limited
partners.

The downside of all this cash rushing into Silicon Valley is that
VC firms find themselves in the humbling position of having to
tell entrepreneurs on why their money is better than somebody
else's. To do so, they pour their chests about successful com-
panies they've funded, tout their partners' specific areas of ex-
pertise, and use the term "added value" a lot. For entrepreneurs,
it's never been easier to raise large sums of money in Silicon Val-
ley. To be sure, some would-be Bill Gates may still go unfunded.
But anyone with a track record like Krach's will find investors lin-
ing up at the door.

Krach chose to be an EIR at Benchmark because he liked Ka-
agle's promise of time to ponder his next move. The soul-search-
ing took about four months. After a string of breakfasts and
lunches at Il Fornaio, Silicon Valley's undisputed power eatery of
the moment (sample mogul meal: antipasto and pollo toscana, at
$20), and meetings in office buildings up and down Highway 101,
Krach hooked up with, of all people, another Benchmark entre-
preneur in residence. Paul Hegarty, ex-vice president of engi-
neering at Next Software and a close associate of Steve Jobs', had
come to Benchmark three months after Krach.

Together they hit upon the golden startup idea—automating
the purchase of office supplies and services at large companies.
Hegarty developed a blueprint for software that would enable
every employee in a business to order mundane but indispensable
supplies—paper clips, file cabinets, pencils—by using desk-

**THE MONEY MANAGER**

On the say-so of analyst Emeric McDonald, pension-fund manager
Amerindo invested $4.5 million in Ariba, raising its value sixfold.

**What VCs expect to get from their EIRs is the chance
to invest in a company's early stages, when the
stock's the cheapest and the potential for big returns
are the greatest.** (Startup tech companies do a series of
funding rounds, and the price per share typically in-
creases with each round.) "We want the opportunity
to invest $2 million to $3 million on your first round at a market
price," says Rachleff. "If we do our job right, we're going to have
an investment opportunity that's vastly superior to anything that's
going to come in off the street."

Benchmark got what it wanted with Ariba. When the company
officially formed in September 1996 and set out to do a first
round of financing, Krach didn't even talk to other venture firms.
He and Hegarty had been living in Benchmark's offices, rubbing
shoulders with the Benchmark partners at Monday meetings and
getting loopy with them at Friday-evening office beer busts.
They felt they owed it to them. “Obviously Benchmark was the first group we approached, and their reaction was, ‘We want to be the guys that fund you.’ We said, ‘Here’s what we think is a fair price,’ and they agreed to it,” recalls Krach. Benchmark and Crosspoint didn’t try to haggle a lower price for Ariba’s stock, and went into the first round as the only investors, putting in $3 million and $2.5 million, respectively, for 19% and 16% stakes in the company.

In theory Krach had been free to skip down Sand Hill Road and take money from, say, Kleiner Perkins or Mayfield, leaving Benchmark out of the deal. Of course, no one actually does that. “The people in our EIR program are under no obligation to do anything with us at all,” insists Benchmark’s Kagle. But since venture capitalists make it their business to know everyone in Silicon Valley, burning bridges with a major firm probably isn’t an enlightened idea. Nor a practical one, since free rent in one of the most congested and expensive real estate markets in the country’s nothing to scoff at. It took three months after incorporation for Ariba to find real offices just south of Menlo Park, first in Mountain View and then in Sunnyvale. In the meantime 12 employees crammed college-dorm style into four Benchmark offices. Ariba’s first two customer meetings were held in Benchmark’s boardroom; the first conception of the product architecture was sketched with crayons on a paper tablecloth over lunch at Menlo Park’s Quadrus Cafe, last year’s II Fornai. “A lot of energy comes from that whole process,” says Kagle. “There’s kind of a special place in their heart for you because you have the offices they first got going in. They can talk to other venture guys, but they’ve been living with you.”

Since venture capitalists own a significant chunk of equity in a company, the game changes. The objective is not to keep other investors away but to find ones who will pay a higher price than you did for the stock, thereby raising the theoretical value of your investment. So after the first round, talking to other VCs isn’t just okay, it’s encouraged. Ariba decided to do a second round of funding in June 1997, and Kagle recommended that Krach meet with various VC firms whose calls he’d been receiving regularly since late 1996. He also thought Krach should seek out corporations and other later-stage investors that tend to offer higher prices, since he felt Ariba was now worth a lot more. For eight months sales manager DeSantis had been talking to large companies across the country about the impact Ariba’s product could have on a company’s bottom line. The seductive pitch, supported by research from Kilgen Associates in Palo Alto, was that a 5% drop in purchasing costs may result in a 20%-plus increase in profits. Having seen little more than that, three high-profile customers—Cisco Systems, Advanced Micro Devices, and Octel Communications—put in orders for more than $1 million worth of software, several months before the product would be generally available. Ariba looked like a hot deal.

After conversations with everyone, Krach shunned VC suitor and went with later-stage investors (even though this was only Ariba’s second round). It was a lucrative move. On a good day VCs hope to double or triple their startup’s valuation from one round of financing to the next. In this second round, however, Amerindo Investment Advisors, Van Wagner Capital Management, PeopleSoft, and Visa bought Ariba stock at $12.50 per share, or six times the price paid in the first round. Ariba’s valuation, the private company equivalent of market cap, had jumped from $16 million to $113 million in nine months.

In fact there had been so much investor interest in Ariba that the company actually turned down an even higher price, fearing the effect of an unrealistic valuation. Amerindo, a San Francisco pension-fund manager, initially offered a price eight times the first round. Emerico McDonald, the Amerindo analyst who spearheaded the investment, liked what he saw when he ran financial models projecting Ariba’s revenues and comparing them to publicly traded enterprise-software companies in which Amerindo owns big stakes, like PeopleSoft and Siebel Systems. “Ariba had significant and important customers and had proved the concept. It is the first enterprise application that is entirely Java-based, and I think this market has the potential to be really enormous,” explains McDonald.

Ariba took Amerindo’s money, though not as big a chunk as McDonald had hoped. Other investors were so eager that Ariba ended up doing what many companies do when they find themselves the belle of the technology investors’ ball—it took in more money. Having planned to raise $6 million in the second round, it accepted $13.2 million instead. Amerindo paid $4.5 million for 4% of the company. Compare that to the 19% stake Benchmark bought for $3 million, and you see the advantage of getting in on the ground floor. The value of Benchmark and Crosspoint’s investments in Ariba have already increased by a multiple of four (not six, because additional shares were issued in the round and each firm put in additional capital to maintain its percentage.) Crosspoint partner John Mumford thinks that’s just the beginning. He hopes ultimately to get a 100-fold return. “You’ve got to get that out of your winners to make up for the craters you create,” says Mumford.

With a 100-fold return, Ariba wouldn’t be a mere winner; it would be the Silicon Valley equivalent of Jurassic Park. You have to wonder—can a 1½-year-old company that’s had just two rounds of funding already be considered a potential blockbuster? So far, the signs look good. By investing in Ariba, Amerindo and Van Wagner are betting that an IPO will take place sometime this year—both buy equity only in companies they believe will go public in the next 12 to 18 months.

Even if Ariba doesn’t prove to be the next PeopleSoft, Benchmark and Crosspoint may still make out like bandits. When a company in its portfolio goes public, a VC firm generally distributes 80% of its stock to its limited partners, while the general partners get 20%. Those shares may be sold in the public market after a statutory post-IPO waiting period (at least three months). Even if Ariba’s share price reaches, say, only $30 after the IPO, Benchmark and Crosspoint would each still make at least $45 million. Ariba employees could cash in some of their options to dash out and buy new Porsches. And Krach would reap another $10 million-plus and go on to the next chapter in the storybook life of a Silicon Valley entrepreneur.