ALEX RUBALCAVA *of* STAGE VENTURE PARTNERS

DISTINGUISHED THOUGHT LEADERSHIP INTERVIEW SERIES

"Warren Buffett says that he's a better businessman because he's an investor, and he's a better investor because he's a businessman. I feel the same way about VC and value investing."

It's a wonderful delight to be speaking with Alex Rubalcava, a founding member of Stage Venture Partners. Prior to launching Stage Venture Partners, Alex managed a long-biased, value-oriented investment partnership focused on public market securities. Before launching his eponymous fund, Alex was an analyst at Anthem Venture Partners, a venture capital fund in Santa Monica, CA. While at Anthem, Alex worked on early stage investments including Myspace, TrueCar, and Android.

Alex has also been an active angel investor and is active in Los Angeles nonprofits; he has served on the board of Los Angeles Animal Services, KIPP LA Schools, and South Central Scholars. Alex is a 2002 graduate of Harvard University and we've known each other for a decade.

Alex, thank you for the opportunity to learn from your experience and share your cumulative wisdom with our community.

MOI: We've enjoyed many great conversations together over the past decade at Berkshire Hathaway shareholder weekends and Wesco annual meetings. Please help our community understand your professional journey.

AR: I have always had one foot in the public markets with a value approach, and one foot in the early stage markets with a venture capital approach. I started my career as an analyst at Anthem Venture Partners, an early stage VC fund in Santa Monica. That was my first job out of college, and I was the only analyst supporting a team of four partners. Anthem I was a vintage year 2000 fund, which was a terrible year to raise a venture fund. Even though most vintage 2000 venture funds struggled, Anthem did very well, because the partners backed some really transformative and important companies. I was part of the team that did the Series A in companies like MySpace, TrueCar, and Android. It is amazing to see an idea go from a guy with a PowerPoint deck in your office like Andy Rubin in 2004, to Android with nearly 2 billion active devices globally today. That's a kind of experience you just don't get in the public equity business, and it is something I wanted to get back to in the venture business.

Warren Buffett says that he's a better businessman because he's an investor, and he's a better investor because he's a businessman. I feel the same way about VC and value investing. Being good at value investing can make you good at venture capital, and vice versa. At heart, VCs and value investors are fundamental investors. Both strategies emphasize long-term perseverance over short-term gratification. Both strategies reward independent thinking and contrarian perspectives. And both value investors and VCs benefit from mental models like circle of competence, opportunity cost, and the power of incentive.

MOI: Is there a particular road map you are emulating? Perhaps, elements of what you experienced early in your career, or nuances you've observed from the Daily Journal or Berkshire Hathaway vehicles?

AR: In Stage VP, my partner and I are trying to bring the best practices of both VC and Buffett/Munger style investing to bear. There are certain things we cannot do, such as structuring Stage as a permanent capital vehicle like Berkshire. A fund with a limited life, and minority stakes in portfolio companies, is the right way to do venture capital. However, the way that Buffett works with his portfolio company CEOs – striking the delicate balance between letting the CEOs run their business units the way they see fit, while being a supportive resource back in Omaha when needed – is highly applicable to venture capital. We tell our founders that we have no desire to run their business for them, because running our own business is hard enough. But we also pride ourselves on being there when they need us. We know we're doing our job well when we get a late night

BOTH STRATEGIES EMPHASIZE LONG-TERM PERSEVERANCE OVER SHORT-TERM GRATIFICATION. BOTH STRATEGIES REWARD INDEPENDENT THINKING AND CONTRARIAN PERSPECTIVES. AND BOTH VALUE INVESTORS AND VCS BENEFIT FROM MENTAL MODELS LIKE CIRCLE OF COMPETENCE, OPPORTUNITY COST, AND THE POWER OF INCENTIVE.

phone call from one of our founders. We want to be the first call when our founders are struggling with a problem in their business, and we work hard to earn that trust.

We are also building on the best models of the venture capital industry itself. Just like in value investing, there has been a proliferation of content and information in the last 20 years. When I started in venture capital in 2002, it was even more of a dark art, kept locked in the minds of its practitioners, than special situation investing before Joel Greenblatt's book. There were few books about venture capital, no podcasts, no blog posts, no social media. Even term sheet templates, which are mostly open source today, were closely guarded secrets. Today, all of that has changed, and there's amazing data available for new entrants like there was for us at Stage.

With all that information available, we built Stage on a core set of ideas:

Number one, we believe that a small and tight partnership is the right way to run a venture firm. There are many venture firms that have layers of analysts and associates That personnel structure works for many firms, but we are always going to be a partner-focused firm.

Number two, we believe in concentration, just like most good value investors. At a seed stage venture firm, concentration means something a little different than in the public equity business. We expect to invest in 25 companies over the three to four year deployment period of our fund. That number translates into about 8 investments a year, and we think that is the right number for a firm of our size. In contrast, there are many seed venture firms that will make over 50 investments a year. They have a different approach. They try to distribute their capital widely, gain the benefit of diversification, and generate more predictable returns. Diversification also gives them the opportunity to invest in pre-revenue startups, which we don't do. In addition, firms like this acknowledge that they can't devote time, attention and resources to each startup in their portfolio.

At Stage, one of our key questions is *Why Us*? Why are we the right investors for this company, in a way that's unique from our competitors? That question forces us to recognize not just our circle of competence, but our ability to help a startup to grow. It's a question that winnows down the forest of deal flow, allowing us to focus not just on the best startups, but the best startups for us. A concentrated portfolio flows as a natural consequence from this kind of self-reflection.

MOI: Please do expand on personal takeaways you have picked up from your prior experience as a value-oriented, public equities fund manager.

AR: The Buffett and Munger approach to investing is quite applicable to venture capital investing, it is just applicable in a way that requires Munger-style inversion. As I mentioned earlier, good investors in both the value and venture worlds analyze business fundamentals. VCs analyze optionality and upside as opposed to margin of safety, a difference best expressed by Tren Griffin, the prolific blog author. There is no margin of safety in the early stages of venture investing – it's not how you manage risk in this business, nor is it how you construct a portfolio.

The way investors relate to change is the other way in which value and VC are inverted reflections of one another. As pointed out by Marc Andreessen of Andreessen Horowitz, when a value investor is wrong, it is often because he was assuming that something was going to stay the same, that in fact changed. When a venture investor is wrong, it's often because she was assuming that something would change, that does not after all change. So, venture investing is about seeking out change, whereas value investing is about trying to avoid change. If you are good at identifying one thing that is unlikely to change, you may also be good at identifying something else that is likely to change. At least, that's the way I see it. Andreessen, by the way, reads value investing material voraciously, and follows hundreds of prominent value investors on Twitter. He seems to perceive advantage in his business from studying value investors; I would encourage value investors seeking advantage to study venture capital with equal intensity.

TIMING OFTEN COMES DOWN TO TWO QUESTIONS. IS THIS TECHNOLOGY READY FOR MARKET NOW, AS OPPOSED TO A FEW YEARS FROM NOW, OR A FEW YEARS AGO? AND, ARE CUSTOMERS IN CLAMOROUS NEED OF THIS PRODUCT NOW?

MOI: How did you gain this perspective?

AR: I realized that the universe was trying to tell me these ideas about four years ago. From 2005 to 2015, my day job was managing capital in the public equity market. Nevertheless, I spent a fair amount of my time watching the venture world and making an occasional angel investment on the side with my own personal capital. I found myself in the odd situation of having better performance in my hobby than in my job, especially after an exit in 2013.

Around the same time, Rob Vickery joined the board of South Central Scholars, where I had served since 2006. Rob had just made his first few angel investments at that time, and we started looking at deals together. We had so much fun working together, and we found that we had such complementary skill sets, that it became inevitable that we would start a fund together. That's how Stage was born.

MOI: Starting early and having passion are often key ingredients for long term success. How did you get your start and what drives you?

AR: Unlike many people who come to venture capital from other careers, I have been an investor for my entire career. My two and a half years at Anthem were formative, because it was in the aftermath of the dot-com bust. I started in July 2002 when technology startups were in a sort of nuclear winter – a value investor's dream, I would say in hindsight. There was a feeling that the Internet was over hyped, and it was unclear when and even if the promise of the nineties would ever be realized. The firm I was at was one of the last early stage venture funds that was raised in the year 2000.

We found ourselves picking through the rubble of the dot-com era, where lots of startups had run out of money, lots of enthusiasm was gone, and yet there were still great technology startups being built. Nevertheless, there was little capital around to support this kind of company.

Anthem seized those opportunities. While the fund had a track record in consumer innovation – with investments like TrueCar, MySpace and Android – Anthem's bread and butter was semiconductors and networking. We invested in all sorts of groundbreaking semiconductor companies. One of our companies was the first to develop CMOS (Compound Metal Oxide Semiconductor) power amplifiers for cellphones, taking that component out of expensive gallium arsenide and into cheaper silicon CMOS. Another pioneered 10 gigabit Ethernet over Cat 5 cable, a formidable engineering challenge. Yet another dramatically increased communication bandwidth over high frequency millimeter wave spectrum, a technology that's now widely deployed in the satellite industry.

Even though I am not an electrical engineer, at Anthem I learned how to conduct due diligence on highly technical startups. The partners there taught me how to assess the capital needs and time to market, the sales process for complex components, the standardization process – all very complex yet critical to winning in venture capital. They taught me how to reference check CTOs, how to identify projects that sounded complex but were actually trivial, and how always to seek out the competitive advantage that comes from truly differentiated technology.

I'll tell you about one mental model I learned in those days. When assessing highly technical startups, a good investor focuses a lot on timing. Market timing is something that has a bad name among value investors, but technological timing is critical in venture. Bill Gross of Idealab has studied failed venture capital investments in depth, and he's found that failure often comes down to timing. Timing often comes down to two questions. Is this technology ready for market now, as opposed to a few years from now, or a few years ago? And, are customers in clamorous need of this product now? Gross gave a fascinating TED Talk on the topic of timing in venture capital a few years ago – I'd encourage MOI Global members to watch it.

A recent example would be pet food in e-commerce. Twenty years ago, the market wasn't ready for this business model, and Pets.com became a legendary embodiment of the excesses of the dot-com era. Yet in 2017, PetSmart paid $3 billion for Chewy.com, in the largest acquisition in the history of e-commerce. Apparently, selling dog food online is an idea whose time has come.

At Stage, we assess technological timing by asking a simple question – *Why Now*? If a company could have been founded five years ago, it probably was tried at the time, successfully or not. Likewise, there are a smaller number of companies that are too early for the market – they are more like applied research at universities than fundable startups. The art of venture capital is to live on the razor's edge of what is soon to be commercial, and to invest with conviction when you find an idea that's moving from latent to urgent.

MOI: Regarding *Why Now*? — what has influenced your worldview in this area?

AR: I recommend *Technological Revolutions and Financial Capital* by Carlota Perez. Perez argues that all technological revolutions start with an installation phase, funded by financial capital. The emerging technology then experiences a crash, followed by a rebound she calls the deployment phase, funded by production capital.

Perez's framework explains all sorts of interesting technological cycles that have happened over the years, and it really in-

THE ART OF VENTURE CAPITAL IS TO LIVE ON THE RAZOR'S EDGE OF WHAT IS SOON TO BE COMMERCIAL, AND TO INVEST WITH CONVICTION WHEN YOU FIND AN IDEA THAT'S MOVING FROM LATENT TO URGENT.

forms our view of timing. You can think about the consumer Internet market using Perez's framework. The moment of initiation, which she calls the irruption, was the emergence of the first web companies like Yahoo and Netscape in 1994, both funded by VCs, or what Perez calls financial capital. That culminated in the crash of 2000, only to be resurrected in the 2000s in the deployment phase. The signature innovation of the deployment era was the iPhone, funded by the R&D budget of Apple, what Perez calls production capital.

MOI: Are there *patterns* that you are trying to avoid, and if so, how do you compartmentalize areas to avoid?

IN VENTURE CAPITAL, A TIGHT SECTOR SPECIALIZATION IS MORE DANGEROUS THAN IT IS IN PUBLIC EQUITY INVESTING. A SECTOR SPECIALIST IN PUBLIC EQUITIES CAN ALWAYS BE A LONG-SHORT HEDGE FUND, SO THE FUND MANAGER DOES NOT NEED A ONE WAY BULLISH BET ON THE MARKET. BY CONTRAST, IN VENTURE CAPITAL THERE IS NO SHORTING, SO A SECTOR FOCUSED VC FUND IS ALWAYS A LEVERED LONG BET IN A SINGLE INDUSTRY.

AR: We think about areas to avoid by using two mental models – the Perez framework, and base rates for success in the startup world. To use an example that everyone's familiar with, let's analyze consumer apps through both lenses.

The moment of initiation for the app market, Perez's irruption, was the release of the iPhone in 2007, followed by the app store a year later in 2008. Most of the great consumer apps that we use fall into two categories. First, there were existing web companies that pivoted to consumer apps early, like Facebook, Twitter, and Yelp. Secondly, there were mobile-only companies that could not have been launched before the iPhone, like Uber or Instagram. As you think about this second category of companies that launched after the iPhone, it's striking to note how virtually all of them launched within the first 36 months of the iPhone era. There's been almost nothing of note since late 2011.

Fast forward to today, and we can now talk about base rates in consumer apps. There are over 1.5 million apps in the Apple app store, and more than that in Google Play. Generating downloads, new user registrations and then repeat daily usage is vanishingly difficult. You can see how difficult this is by looking at your own phone. On an iPhone, click on settings, then click on battery. The bottom of the screen will show you how much each app on your phone uses your battery. If you're like 90% of smartphone owners, you'll see that you spend most of your time using apps that are at least five years old, and owned by the big seven or eight public tech companies we all know. My phone, for example, shows 50% of my usage is Twitter, followed by email, phone calls, and podcasts. There isn't a new app anywhere in my top 20, and there probably isn't on your phone either. As a result, something has to be overwhelmingly compelling in order to break through consumer inertia. Until we see something overwhelming and compelling, we will wait to invest in consumer apps.

By contrast, the base rate in enterprise software is completely different. If you can show a business that your technology will reduce costs, eliminate risk, or accelerate growth, you will sell software. That's not to say that building an enterprise software company is easy – it's not. But the base rate of startup success in this area may be an order of magnitude more favorable than it is among consumer apps. In addition, the drivers of value growth are more tangible, and thus more subject to analysis from an investor. It's easier to see why a new corporate travel software vendor is better than the incumbents than it is to figure out what app teenagers will be obsessing about in 2018.

MOI: As we explore areas you tried to avoid, have you have observed any mistakes of others — and if so what you have learned from these observed mistakes?

AR: There are all sorts of mistakes you can make in venture capital, so let's talk about a few categories. We've noticed plenty of VC funds that are thematic and that invest very narrowly in a sector. In venture capital, a tight sector specialization is more dangerous than it is in public equity investing. A sector specialist in public equities can always be a long-short hedge fund, so the fund manager does not need a one way bullish bet on the market. By contrast, in venture capital there is no shorting, so a sector focused VC fund is always a levered long bet in a single industry. You have to get the sector and the timing perfect in order for that model to work. Often, sector funds only work once, in the sense that there is some wave that they catch. Then the wave is over and their investable universe has passed them by. We think generalist funds are a better idea in venture capital and are more robust than sector funds. While we focus on enterprise software, we invest across industries, across underlying technologies, and across types of software buyers. We're not, for example, going to fill our fund with startups that build different types of marketing software selling to the same CMOs, and call ourselves diversified.

Another mistake in venture capital is to be too valuation sensitive. Your community members are probably cringing as they read this, and as a committed value investor in public equities, I can sympathize. At Stage, we typically invest in a startup that is a year to three years old, has a handful of early employees beyond the founders, and has early customers. Startups like this are usually raising their first seed round from true VCs, as opposed to a pre-seed round when angel investors predominate. Typically, deals in the institutional seed stage have a pre-money valuation between \$5 and \$10 million. Most of our investments are made in that pre-money range. As long as the deal is somewhere in that range and somewhere appropriate, we don't negotiate on valuation.

Now, if a valuation is wildly out of line – if someone tries to raise money at a \$25 million pre-money, when they don't have a shipping product yet and it is just two founders with a dream – then we pass. There's no point in trying to negotiate the founders down to a reasonable range, or doing any further work, because a founder raising money so far removed from reality like that is probably making other mistakes. As long as valuation is within the appropriate range, other factors – like the quality of the team, the readiness of the market, the fit between our firm and the startup, the size of the market, etc. – are much more likely to be the difference between success and failure.

MOI: Let's please pivot to real-world example, even a case study — if you feel comfortable sharing.

AR: Let's talk about one of our Fund I portfolio companies, a startup called Iris.TV. We met Iris in 2015, when Field Garthwaite, the founder, pitched us just as we were setting up our firm. Iris makes a plugin, called the Adaptive Stream, for online video publishers. The Iris Adaptive Stream creates a personalized video programing experience – think of it as Pandora for three-minute video clips, all behind the scenes when you're on some of your favorite video sites. Iris analyzes three things – a user's identity, how the user interacts with a video they're watching, and how that video fits into the taxonomy of other video assets owned by the publisher who has installed Iris on their site. With natural language processing and machine learning, Iris infers what you are likely to watch next, automatically generating a playlist from the library of thousands of video clips that Iris's customers have on their servers. Iris works with customers such as Conde Nast, Hearst, and Time Warner on dozens of their properties. The Iris software keeps users watching videos on average 70% longer. Thus, viewers see 70% more ads and the publishers earn 70% more revenue. As you can imagine, enabling customers to make 70% more revenue makes Iris very popular with its customers.

Iris is a great case study for us because my partner and I have extensive contacts in the media industry in Los Angeles and beyond, whether that's studios, newsrooms, or cable networks. All of them tell us how difficult is to make money on the Internet. You know the phrase that you are exchanging print dollars for digital nickels, as businesses switch from old advertising models to new ones on the Internet. Nowhere is that more the case than in video, where social media dominates. When a publisher posts their videos to Facebook or YouTube, they give up control over pricing, allowing Facebook and YouTube to dictate revenue share, resulting in razor thin margins. More importantly, whenever you distribute through a channel, you don't own your customer.

If you publish large amounts of video, you would much rather host that content on your own site, a site that you own and operate, than on Facebook or YouTube. Compared to publishing on YouTube, a publisher that hosts video its own site typically earns ten times the revenue per view. However, when you are on your own platform, you need the kinds of tools, analytics, and data that are hard to come by and hard to develop on your own. That's what Iris does.

So, we saw an exceptional founder in Field Garthwaite who had come out of both the media world and the technology world. Prior to starting Iris, he worked at several talent agencies, and later at HBO and at the Rubicon Project, an adtech company that has since gone public. Field identified a key problem and realized that advances in natural language processing and machine learning could solve this problem for customers, for the first time. Now his customers love Iris, the company has virtually no churn, and it is completely dominating the video recommendation world for short form video.

MOI: And that's the *Why Now?* question — it sounds like.

AR: Yes, when you look at Iris it has almost the perfect answer for all three of our key questions – *Why You*, *Why Now*, and *Why Us*. You have the right founders here in Field and his cofounders. You have a software solution that could only be built with today's state of the art technology – it would have been impossible to build Iris.TV even five years ago. You have customers who need the solution right this minute, because their business depends on it. And you have us, uniquely positioned to recognize the opportunity and to help the company pursue it.

MOI: There is a lot to unpack. Regarding *Why Us?* — what is the value-add that Stage Value Partners provides to portfolio companies, in addition to financial capital?

AR: Yes, often the hardest question we ask in our due diligence is *Why Us?* Why are we the right investors for this particular company? *Why Us* is not just a question about circle of competence, it is a question of influence and of how we can contribute to the likelihood and/or the magnitude of success of any company in our portfolio. Our goal is never to write a check and then walk away. This particular point of emphasis is the contribution of my partner Rob Vickery. Rob was an angel investor before starting Stage with me, and he was the most active and engaged angel I had ever seen. He just was relentless in supporting his portfolio company founders. His relentless drive for founder support is a core value and principle of our firm.

How we can add value is always case dependent. Often times it involves access to customers and introductions, especially in enterprise software startups. In southern California, there are numerous corporate headquarters, but there are not a lot of seed venture funds focused on enterprise software. We think that about five of the 75 venture funds in LA are really good at supporting these types of startups. The number is much larger in the Bay Area, but in this town, there aren't that many, because investors are more focused on other types of startups.

Rob and I have relationships with media companies, with local government, with logistics companies at the Port of Los Angeles, with light manufacturing companies in the Inland Empire [a metropolitan area and region in Southern California], with real estate companies, and lots of other types. Those relationships are different from, and complementary to, the networks of the firms from the Bay area with whom we often co-invest. Our reach is also international. In just the last two weeks, we've developed customer leads for Iris in India, the UK, and Finland. Recently, we also introduced Field to the former CEO of a movie studio, who may come on as an advisor to Iris. Often, the best answer to the *Why Us* question is that a particular software company is selling into industries that we know well.

Hiring and recruiting is another key need for any startup. We have a company that makes social augmented reality experiences using holograms, and they needed to bring in a new technology lead. We were able to find them a developer who actually had hologram experience. There are probably a hundred people like that in the world.

Solving other types of problems is critical for early stage startups. On several occasions, we've helped a founder fire an employee who wasn't working out. They wanted our advice, and they wanted us in the room, when the hard conversations were happening. It's not a fun thing, not an easy thing to do but it is a kind of thing that we want to do for our founders.

As I mentioned earlier, one of our KPIs [Key Performance Indicators] that we think about at our firm is when a founder of ours calls us up at 9:45 PM on a Saturday with a problem. And anytime we get an after-hours call from one of our founders, my partner and I text each other and let each other know. It's a sign that we are doing our job well.

MOI: If I may put you on the spot — how many KPIs do you have and are there patterns among the KPI's?

AR: That is a good question.

MOI: While respecting the secret sauce, anything you are comfortable sharing?

AR: One of the KPI's that is really telling for a seed venture fund is the graduation rate from seed stage to series A, and the quality of Series A investors who lead rounds in your portfolio. Because our firm is only a year and a half old, it's too early to tell how well we're performing with regard to that KPI, but that is something that we watch very carefully. We introduce our founders to later stage VCs, help them prepare their investor materials, and work with them to measure and manage their internal KPI's. The goal is a crisp message to enable an efficient search for the best-match firm to lead the Series A. Since our fund is young, we have only assisted one company, Iris, with this process. We're happy to say that they found an excellent lead for their most recent round. Using the tools we developed to assist Iris with that process, we expect that we'll be more effective as our other seed startups approach their A rounds in late 2017 and early 2018.

The base rate data here is quite clear. The private company data platform Mattermark has reported that the graduation rate from Seed to Series A rounds hovered around 32% earlier this decade, with a downward trend in the preliminary data from recent years. If we're doing our job well, our portfolio will outperform this benchmark. Ask us in a few years and we'll give you an update.

THE MOST IMPORTANT QUESTION IS ALWAYS ABOUT WHY THIS FOUNDER IS UNIQUELY CREDIBLE TO BE ATTACKING THE PROBLEM SHE'S PICKED, AND BUILDING THE COMPANY SHE'S CREATING. WE DELIBERATELY CHOSE THE WORD *CREDIBLE* WHEN THINKING ABOUT FOUNDER/STARTUP FIT BECAUSE WE RECOGNIZE THAT CREDIBILITY CAN BE OPEN-ENDED.

MOI: How do you assess talent and assess incentives?

AR: We already touched on the *Why Us* question, so let's talk about how we think about founder/startup fit. While determining if we're going to be the right investor for a startup is a difficult question, the most important question is always about why this founder is uniquely credible to be attacking the problem she's picked, and building the company she's creating. We deliberately chose the word *credible* when thinking about founder/startup fit because we recognize that credibility can be open-ended. Credibility can mean someone with a unique technological skillset, for example a world-class software developer. It could be someone with highly relevant domain experience from their prior employment. Credibility can mean someone who discovered a problem in a very organic way and set out to solve it. That last criterion is important. When we see people who are starting companies just for the sake of starting companies, or who are attacking an area because they think it's hot and they don't have any sort of prior experience in it, we question their credibility. We find that founders like that are less likely to succeed than people who are mission driven. The best founders approach a problem from the perspective of need and inevitability. They feel that they have to solve a problem they seen in the world because they can't believe no one else has done it yet.

MOI: I'd love to really hone into the intersection of *Why You* and *Why Us?* What sourcing mechanisms, or discovery channels, have you found most valuable?

AR: Sourcing deals is not all that difficult. If you hang up your shingle as somebody who has money to invest in startups, people will find you. That is not the hard part. Finding great founders and great startups is the hard part.

When you are a new firm, like Stage, you have to be cognizant of the fact every entrepreneur who has struggled to raise money in your market for the last few years will find you instantly. You will get a giant pulse of deal flow from startups with indistinguishable technology, mismatched founders, and poor fits to us as a firm. Anticipating that surge, we invested at a deliberately slow pace in our first year. As a firm like ours gets more reputation and traction in the market, we start to get deal flow from other sources that can be better. We've gotten to know the local incubators and accelerators, other venture firms in town, lawyers, accountants and payroll service professionals who work with startups. As all of these sources of referral learn about our preferences as a firm, they start referring us better deals. Eventually, the signal to noise ratio in deal flow starts to improve, as it has for us in 2017.

Then, you face the next problem – how do you win the deal? We think there are two types of deals. We call them Type A deals and Type B deals. Type A deals are consensus startups – great founders, innovative technology, and visible traction with customers. A founder with a startup like this might field $15 to $30 million of in-

THE BEST FOUNDERS APPROACH A PROBLEM FROM THE PERSPECTIVE OF NEED AND INEVITABILITY. THEY FEEL THAT THEY HAVE TO SOLVE A PROBLEM THEY SEEN IN THE WORLD BECAUSE THEY CAN'T BELIEVE NO ONE ELSE HAS DONE IT YET.

terest for a $1.5 million seed round. A VC working on this deal might spend 20% of his time working on due diligence, and 80% on fighting for space on the cap table. It's important to be a firm that consistently wins these opportunities.

Type B deals are different. Maybe the founder is a bit too eccentric. Maybe the market is one – like renting out spare bedrooms in your home to strangers in 2007 – that doesn't exist, or doesn't appeal to wealthy VCs. Maybe there are key gaps in the team that need to be filled. For whatever reason, it's a round the founder struggles to raise. But as an investor, you think you see something special. You see the need for a lot of work, for a lot of guidance to get the company to where it can go, but you also see the potential if it can work. Precisely because they are contrarian, Type B deals can be the most lucrative. Fred Wilson of Union Square Ventures said it well in a recent talk at MIT. According to Fred, "the best time to invest in something is when nobody believes in it besides you. You have to totally believe in it and you have to know why." On deals like this, you spend all your time on due diligence, to validate that what you're seeing is real, and not in your imagination. Your due diligence also emphasizes the work necessary to support the company post investment.

I was lucky to work for partners at Anthem who excelled at each type of deal. Today at Stage, we have portfolio companies where we had to fight to be let into the round, and we have portfolio companies where we are the only venture capital investor in the seed round. We hope to do well on both types of startups.

MOI: How do you optimize the limited time you have versus an infinite number of data channels?

AR: Every quarter we look through our deal flow and we look for a pattern as to where good startups are coming from and so far, we have found zero pattern. Good deal flow moves in mysterious ways, and all we can say at the moment is that we just have to be ubiquitous. We have to be out there constantly hunting for and searching for deals, and searching for sources of referral because there is no signal in the noise quite yet. Maybe a year or two from now, we will see patterns that are not yet apparent.

MOI: It's my understanding is that you have found opportunity beyond the United States. Can you share more?

AR: One of our most exciting portfolio companies, Kuona Analytics, is based in Monterrey, Mexico. We are the only US venture fund in the company right now, and it is showing the fastest sales growth of any enterprise SaaS company we have encountered so far. Kuona develops price optimization software for consumer packaged goods companies. For example, if you think about the largest street by your office, there are probably about a hundred places to buy a bottle of soda. Yet, the large beverage companies don't have good data to determine where and when they should price a twenty-ounce bottle of soda at $1.69, or $1.89 or $1.99. Nor do they know when to change those prices. Today, pricing is guesswork, and until recently no software tools could ever hope to price at the resolution of a single SKU in a single store, in real time. The advent of deep learning and cloud processing makes that kind of high-resolution optimization possible. Kuona uses deep learning on data from ERP and POS systems to make pricing recommendations that improve gross margin, sell-through, or market share in real time.

Kuona went through an online course whose graduates are presented to angel investors and VCs in a fairly public way. They should have garnered more interest, but they didn't. As best I can tell, the only reason for the investor indifference was the fact that they're based in Mexico, the team is from Mexico, and they were all educated in Mexico. If one of the founders had studied Symbolic Systems at Stanford, worked at Google, and lived in Mountain View rather than Monterrey, I think this would have been a Type A deal rather than a Type B deal.

We recognized the opportunity in Kuona because of some very fortunate pattern matching. I noticed that the founders of Kuona had graduated from Instituto Tecnológico de Monterey, also known as El Tec, somewhat akin to the Stanford or MIT of Mexico. Twenty years ago, my high school initiated a sister school relationship with the lab high school at one of the El Tec campuses, and I was sent to study abroad there. El Tec's students impressed me greatly in 1997, so in 2016 when I saw Kuona's team of founders and data scientists from El Tec, I knew enough to take them seriously and to dig into the opportunity. It turns out that Kuona's team is exceptionally smart, it turns out that they have an amazing product and an amazing list of customers, but no one from the US was paying attention to them. Everybody on Sand Hill Road knows what a degree from Stanford means, but few people there know what degrees from El Tec mean.

MOI: You and your partner have a system to manage consensus, or the lack of consensus, when making joint investment decisions. I think many others might benefit from the solution you've designed.

AR: Yes. Out of our current fund, we are going to invest in about 25 companies over the next three years. All but two, or maybe four, will require unanimous agreement from us. Rob and I need to agree enthusiastically that each startup making it into our core portfolio is a worthy one. However there will be cases where one of us is more enthusiastic about a particular deal than the other. Our view is that in non-consensus deals the risk is higher, but usually the potential return is also higher. In venture, you always want to optimize for upside capture, and as a result we needed a mechanism whereby we could invest in startups that had captured one of our imaginations, but not the other's. So, we have determined that each of us is going to get what we call a silver bullet idea, maybe two over the life of the fund.

There are two critical components to making the silver bullet mechanism work. First, the number of silver bullets must be limited, forcing each us to think long and hard before exercising this option. Second, once a startup enters the Stage portfolio via the silver bullet program, we treat it no differently than our other portfolio companies. Our philosophy is very much like Amazon's culture of disagree and commit, where a team can commit to exploring an idea even if they didn't agree on initiating the project.

Neither of us has fired our silver bullet yet, and we may not for a while. Our expectation is that the portfolio of the silver bullet startups might end up outperforming the consensus deals, because venture is a market where variant perceptions are rewarded to a higher degree than in public equities. We wanted an internal mechanism to be able to capture that kind of optionality, and we hope the silver bullet mechanism works to that effect.

MOI: How do you *define* alignment and how do you *structure* alignment.

AR: Alignment often comes down to making sure that deal terms are appropriate in the case of individual term sheets with startups, and in the case of a partnership at large. For our partnership, we deliberately chose a European waterfall, which means that we don't collect any carried interest until we've returned all the principal to our limited partners. We think charging carry only when we are paying our LPs a return on their capital, and not just a return of their capital, aligns our interests well.

VENTURE IS A MARKET WHERE VARIANT PERCEPTIONS ARE REWARDED TO A HIGHER DEGREE THAN IN PUBLIC EQUITIES.

With regard to our individual startups, clean term sheets are critical for proper alignment. Most of our deals have a standard 1X liquidation preference, and they have relatively few other terms other that would misalign our incentives with the founders. Similarly, we want our founders to have substantial interest in their companies so that they are properly motivated to succeed.

We often see misalignment where one founder has a dominant share of the company and another founder has a much smaller share. Sometimes that is appropriate, if the main founder worked on the company for two years before recruiting their cofounder, but other times the unbalanced ownership reflects a power dynamic that is inappropriate. Recently, we noticed that problem at a startup we were considering. We erred by accepting a canned answer to our ownership questions. Only later, at the eleventh hour, did we learn the true reason for the misalignment, and we walked away from the deal.

MOI: What other insights have you picked up through osmosis?

AR: One critical thing I learned from Anthem was a process for assessing technological competitive advantage, even when you're not a technologist yourself. This skill was critical at Anthem, where the firm invested in analog and mixed signal semiconductor startups, even though none of us were electrical engineers by training. Anthem knew the product roadmaps of the major semiconductor companies, it knew the standardization process, and it knew the process of taking a chip from an EDA (electronic design automation) file into taped-out mask and then into production in the fab. Unlike venture funds that would dabble at semiconductors without developing real expertise, Anthem knew what it was doing.

Today at Stage, Rob and I bring a similar model to bear around enterprise software. All of our startups face similar challenges – recruiting software engineers and data scientists, building sales pipelines, converting customers at each step of the way in those pipelines, setting and maintaining price, and managing churn. Stage has real, growing expertise to offer our startups around each challenge they face – a benefit of our focus.

MOI: What are common traits you see among successful venture investors and how do you try to nurture these traits in yourself?

AR: Venture capitalists must have an ability and an eagerness to learn new things at all times, even more so than public market investors. By definition we are investing in change, by definition we are investing in things that are new. The best part about being a venture investor is that I am living two years in the future at all times. What I learned yesterday is less relevant to what's going to happen tomorrow than it is in almost any other field. I always have to be learning new things and I have to turn that into a process, turn that into a continual effort in order to be effective.

MOI: I'm hearing you describe curiosity and creativity. How do you structure curiosity and how do you structure creativity? How do you nurture these traits?

AR: One of the things that we learned relatively early on is that you are better off if you are founder-driven rather than thesis-driven. To be thesis-driven means that you set out with assumptions around the technologies, industries, and themes that will shape your investment portfolio. Media exposure and LP marketing play a role here. Everyone likes to ask VCs, as if we were fortune tellers, where the next great disruption will be coming. It takes discipline to resist the ego trip that can come from making grand pronouncements, and it takes even more strength to resist the commitment and consistency bias that comes from repeated public statements.

Investors should not be making these determinations about the direction of technology. Founders should be. Our job as investors is to be adept at recognizing and supporting the best founders. We should ask questions more than we answer questions, and we should listen more than we talk. That's founder-driven investing, and

THE BEST PART ABOUT BEING A VENTURE INVESTOR IS THAT I AM LIVING TWO YEARS IN THE FUTURE AT ALL TIMES. WHAT I LEARNED YESTERDAY IS LESS RELEVANT TO WHAT'S GOING TO HAPPEN TOMORROW THAN IT IS IN ALMOST ANY OTHER FIELD.

we think that's the model that leads to long-term success.

AR: I love learning how one differentiates being early and from being wrong, as it might be a thin line. Refining the question for our context — how do you differentiate catching a wave as opposed to identifying a fad?

MOI: In enterprise software, fads are less of an issue then they are in consumer facing areas, just because enterprises don't invest in software unless they think they are getting an ROI. Sometimes they can be right about the ROI they think they're achieving, and sometimes they can be wrong. However business spending has a higher bar associated with adoption than consumer tech spending does, so bubbles are less of an issue.

EVERYONE LIKES TO ASK VCS, AS IF WE WERE FORTUNE TELLERS, WHERE THE NEXT GREAT DISRUPTION WILL BE COMING. IT TAKES DISCIPLINE TO RESIST THE EGO TRIP THAT CAN COME FROM MAKING GRAND PRONOUNCEMENTS, AND IT TAKES EVEN MORE STRENGTH TO RESIST THE COMMITMENT AND CONSISTENCY BIAS THAT COMES FROM REPEATED PUBLIC STATEMENTS.

We think the best startups use new tools to solve old problems. The problems that face businesses are ongoing. Companies must control costs at all times, they must seek out new customers, they must set pricing, and they must respond to competition. Those problems are never going to change. The tools that are available at any given time to address these challenges will always change, but the key problems of running a business and the key drivers of purchasing software to run a business are never going to change.

When it comes to picking startups to back, and others to avoid, we have a number of mental models that we employ. I'll walk you through a few. First we, think about the number of customers. If there's too few customers, like a company selling software to the top ten automotive OEMs, then the customers have too much power. If there's too many customers, if you're trying to sell to every pizza parlor and dry cleaning shop in America, then customer acquisition costs and churn are going to kill you. The right number of customers is probably between 500 and 25,000.

Second, we think about the incumbents. We never want to fund a startup that's mounting a frontal assault on a giant tech company that's run by its founder. Taking on Marc Benioff on his own turf is not a recipe for success. Ideally, we fund companies defining a new category, where there is legitimately no direct competition. Or, we look for startups entering markets where the incumbents are run by CEOs who were hired by a board. If the incumbents are subsidiaries of larger companies, paying some sort of strategy tax related to their ownership, even better. It's safer to prey on manatees, not mountain lions.

Third, we look for markets with few new entrants because the credibility needed to be a founder is high. Where the bar is low, we see hordes of undifferentiated startups. Social media marketing is a good example. We've met nearly a hundred companies in the business of connecting brands and social media influencers. Even if these were legitimate technology companies and not marketing agencies masquerading as tech startups, they would still have the problem of ruinous competition. All one hundred that we've met say they're going to get twenty percent market share. We wish them luck.

Fourth, we look for startups selling a pill, not a vitamin. A core belief of ours is that software is sold, not bought. Every sale competes with the inertia of doing nothing. Your software had better solve a large, urgent problem for your customer, even if your customer wasn't aware of the problem before learning about your product. Vitamins, by contrast, have the dual problems of urgency and attribution. There is never an urgent reason to take a vitamin. Similarly, if you do take a vitamin, how do you attribute any changes in your health to the vitamins you took last month? Large categories of software have no urgency surrounding their adoption, and limited attribution of results for those customers who do adopt. We avoid investing in software like this.

MOI: Allow me to respectfully raise the subject venture capital industry structure. As I understand, the "top" or "best" or "largest" venture firms comprise nearly all the profit pool for the entire industry, as value capture skews to entrenched organizations for whom legacy success — rightfully so — leads to further success. How do you navigate this structural challenge?

AR: There's a wonderful neologism – mesofact – that's applicable to this question. A mesofact is something that used to be true, or that has changed continuously over time. It used to be true that the top ten or twenty firms earned most of the returns in the venture capital market, but it hasn't been true for the last ten to fifteen years. The primary reason for that change is the reduced cost of starting a company relative to the past, thanks to resources like Amazon Web Services. When I was a young analyst in 2002, founders would come to venture capitalists to raise $5 million just to build the alpha version of their product. Once raised, the money would go right back out the door to license an Oracle database, a BEA web server, and a data center rack full of Sun servers. Having anted up your $5 million table stakes, you could then sell something to customers.

Thanks to Amazon and others, those table stakes have gone down in price between 90% and 99%. A product that cost $5 million to launch in 2001 might cost $500,000 in 2017, or more likely, you can ship a minimally viable product for close to free. As a result of the startup proliferation

WE LOOK FOR STARTUPS SELLING A PILL, NOT A VITAMIN. A CORE BELIEF OF OURS IS THAT SOFTWARE IS SOLD, NOT BOUGHT. EVERY SALE COMPETES WITH THE INERTIA OF DOING NOTHING.

unleashed by this deflation, the Sand Hill venture firms have mostly relinquished the seed market to angels and to funds like ours. Some have done exceptionally well. As far as I know, the best performing investment partnership of any kind ever is Lowercase Capital, Chris Sacca's seed fund. Lowercase had $7 million of capital committed to it in the 2007 time frame. Today, the net asset value of Lowercase is about 250 times committed capital. Seven million times 250 is about $1.7 billion.

Chris Sacca did not work for Kleiner Perkins or Benchmark or Sequoia. He was out on his own doing it from Truckee, California near Lake Tahoe. And he put up the best performing venture fund and investment partnership of all time. There are dozens of other firms that didn't have the name brands like Greylock and Bessemer behind them. No one has matched what Chris Sacca achieved, but these funds have still put up very attractive returns for investors. And I believe that this characteristic of the market, that there will always be room for excellent investors at the seed stage, is a structural fact of venture capital today.

THE SAND HILL VENTURE FIRMS HAVE MOSTLY RELINQUISHED THE SEED MARKET TO ANGELS AND TO FUNDS LIKE OURS.

In fact, the seed stage of venture capital is just like small cap value equities in the public market. A manager starts small, earns good returns, and eventually gathers more AUM, pricing him out of the names on which he built his track record. The same is happening in venture capital. The first entrants in micro VC, guys who raised $5 million funds in 2007, are investing $150 million funds in 2017.

MOI: Switching gears, in ways has your experience as a mentor for youth improved your ability to identify adult talent?

AR: Whether I am mentoring kids at a group like South Central Scholars or investing in a 26-year-old founder building a disruptive company, the skillset is largely the same. It's recognizing young people who have not yet accomplished anything easily identifiable, but who have the potential to do so. Identifying unproven young talent may be our core competency as a firm. Not only did my partner and I meet on the board of South Central Scholars, we both had a longstanding interest in mentoring young people who came from disadvantaged backgrounds. Working with hundreds of young people striving to achieve their dreams is great training for being a venture capitalist. Typically, startup founders have never managed people before, have never sold software before, and have never had to tackle all these challenges under the resource constraints of a startup. It's similar to an underprivileged kid who's trying to navigate his way to and through college.

MOI: MOI Global is a network of intelligent investors which includes allocators, endowments, capital providers, Berkshire Hathaway and Wesco enthusiasts, high net worth individuals, people who breathe disruptive business models, and more. What type of feedback from our audience would be most valuable to you and how can we help you in the future?

AR: Stage is always looking to meet founders of really exciting software startups. If any of your readers are starting companies, or know of people who are, we would love to meet them.

MOI: Are there any additional nuances you care to share with our community that we may have overlooked?

AR: One issue that is not well known among investors is the unique tax advantage to investing in startups today. That's as a result of a change to the tax laws from late 2015. In December of 2015 Congress passed a law called the Protecting Americans from Tax Hikes Act of 2015, the PATH act. And the PATH Act updated Section 1202 of the Internal Revenue Code dealing with qualified small business stock, or QSBS. QSBS is stock issued by a C corporation that has gross access under $50 million. The corporation cannot operate in certain excluded industries, like financial services, consulting, restaurants, hotels, and real estate. But it can operate in any other industry, including almost every area in which technology startups operate.

If an investor purchases qualifying small business stock, holds it for five years and then sells it to anybody but the issuer, the gain is excluded from taxation, up to ten times your investment or $10 million per issuer per year, whichever is greater. Some states offer a similar exclusion, but others like California do not. If you have a big exit that meets the QSBS criteria, you'll pay nothing to the IRS, but you'll make the same payment to the California Franchise Tax Board as you would on any other capital gain. Of course, no tax exclusion, even one as generous as QSBS, changes the risk profile of early stage venture investing. Investing in any startup is still highly risky, but from the IRS's perspective, it might as well be municipal bond. Finally, I should note that the tax code explicitly extends the favorable tax treatment of QSBS to limited partners in venture fund.

MOI: Alex, thank you so much for sharing so much time and so much wisdom. How can community members learn even more about your endeavors and what would be the best channel to reach out to you?

AR: The best way to reach me is via email – alex@stagevp.com. I can also be reached on Twitter @AlexRubalcava or on AngelList via https://angel.co/alex-rubalcava

MOI: Thank you. I'm always grateful to learn from your example and to count you as a friend. I hope we can keep the dialogue going forward.

Editor's Note: Latticework 2017 brings together select individuals for community learning and relationship building on September 7, 2017 at The Yale Club of New York. Attendance is strictly by invitation-only to ensure an intimate forum for the exchange of ideas among key industry professionals, domain experts, and thought leaders. To learn more visit www.latticework.com/lw17