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## SPEAKERS

Joe Zell, Nick Jamell, Clay Gordon



Joe Zell 00:00

The value that the venture capital partner brings the general partner brings is their experience and knowledge and scar tissue. And we often say that is our greatest value is pattern recognition.



Nick Jamell 00:28

Hey there powderkeg fans, Nick here from the powderkeg team. And this is Episode 122 of powderkeg igniting startups, the show for entrepreneurs, leaders and innovators building remarkable tech companies in areas outside of Silicon Valley. And today we're going to be looking at an interview that I had the opportunity of hosting recently at the unmet conference for 2019 in Denver, Colorado, and today's episode I speak with Joe Zell and Joe is a venture partner at growtech ventures, an early stage VC firm based out of Vienna, Virginia that focuses on series A Be round high growth tech and software investments. And Joe join grow tech back in 2002 as a general partner, and focused on investment opportunities in the IT infrastructure, cloud services, mobile networking, internet and digital media sectors. And Joe is actually active on several of the portfolio company boards for grow tech. But prior to joining grow tech, Joe had built an extensive 20 year operating background and communications and data networking, including nine years with us West communications, which is now CenturyLink. And there, he was instrumental in building a data networking division that started as a startup all the way up to \$2.5 billion in revenue, and was the president, President of the division as it grew from \$300

million to \$2.5 billion in revenue. So he is an incredibly smart guy. There's a lot of great info in this conversation. So definitely check it out and listen all the way through because he's just full of information. So let's jump right in. So today we're talking to Joe sorry. Today we're talking to Joe Zell, who is an experienced venture investor with a prior operational background and communications technology and services. He's currently the general partner and venture partner at grow tech ventures, which is an early stage seed, early stage venture capital firm focused on series A and B round high growth tech and software investments. Their focus is to invest in areas like the Mid Atlantic, Southeast and Rocky Mountain regions. And they're at actually Joe is an advisor for St. fund. Sorry, I'm gonna restart that part there. And actually, Joe is an advisor for clay here who was South Street. And so I'm gonna let him help out on this interview a lot, because you're really familiar with his Yeah, he's Well,



Clay Gordon 02:52

yeah, I'm really excited about this, this one in particular. So Joe, thank you so much for joining us today. You know, As salary was growing, we were looking to add a human capital to round out our advisory board. As you know, there's no one more experienced in Colorado venture than Joe Zell. And so we're extremely grateful that he partakes his wisdom upon us. And then to get some background on more of the VC culture as well. So the first question I would ask is, you know, very frequently do I get a lot of companies that come to me asking for venture dollars, but they're not a traditional fit for venture backing? Could you elaborate a little bit more on maybe the venture economics at play and what companies may or may not be a fit for venture capital?



Joe Zell 03:40

Absolutely, thank you. So I think I think it's really important for entrepreneurs to understand how the venture capital model works and what the motivations are of venture capitalists. Because if they're going to be seeking money, they need to understand really what they're looking for. So So first of all, you have to recognize that if a venture firm is investing in series A and Series B deals as my firm has been doing for 30 years, the actual experience of venture capitalists is that out of every 10 investments, they hope to have one or two in their portfolio that will do five to 10 times their investment, and then have another couple that do maybe one to five times their investment. And the remainder, they are hopeful to maybe just get their money back. And if that plays out, then over a 10 year period, assuming reasonable cash flow timing on those liquidations, they can make, you know basically a cash on cash return of about 2.5 times to three times the fund value. So what investors are looking for to put money into the Limited Partnerships of venture firms you A 16 to an 18% IRR over the long term. And for those venture firms to accomplish that,

recognizing that they're really only going to have a couple of big winners out of every fund, they have to basically go into every investment with the expectation that they can make 10 X or more on that investment. And so, then if you look at, you know, how does this play out for, for a venture backed company, for a company to get a 10 x kind of exit. You'll often hear venture capitalists say that they want to make investments in businesses that are going after markets that are half a billion to a billion dollars in size. And so the way that that math connects is that if it's a half a billion to a billion dollar market, and you assume that a successful company maybe gets 10% market share, so you can't go into this thinking that you're We're going to create this winner that dominates the market, a successful company maybe gets 10% share, that might mean that they get



06:08

they get



Joe Zell 06:12

revenues of 50 to 100 million dollars. So, so at a baseline, you can say, for a venture capitalist want to invest in your company, it needs to be a business model that within the three to five year time frame, can get into that 50 to 100 million dollar revenue range. And the reason for that is that if you get into that 50 to 100 million dollar revenue range or something close to that, and then that business is able to sell out a software multiple, which is mostly what we all invest in these days, then they can expect to make maybe five to eight x, that revenue, and then that all translates into them being able to make a venture return. So what's critical here is that For a business to really be venture bankable, it has to be something that has a very large market opportunity. And it has to be a business that you think can get to that 52,000,050 \$200 million revenue range.



Nick Jamell 07:16

I have a question. So then you say that it's that half a billion to a billion dollar market, you want to stay in that that's like a sweet spot. You don't want to go above that, either. You don't want to be playing in too big of a market. Is that what you're saying as well?



Joe Zell 07:29

No, no, no, I'm not saying that. I just said, Okay.



07:32

I was gonna say,



Joe Zell 07:33

Yeah, no, I think I think that generally what we find is, here's a simple way of looking at it. If you take all of the ideas that entrepreneurs come up with, there is a subset that represent really big ideas. And those are ideas that are really big because they're attacking what's either already a very large market or what is expected to be a very large market meaning half a billion to a billion or more in that time frame. And its team and it's a technology that's capable of taking a leadership position, which implies that kind of 10% for, you know, picking around number kind of position in the marketplace. And so if you look at all the companies that are venture that get presented to venture capital firms, there's a, there's a subset that really fit that criteria. It's really a big idea. It's really going after a big market, and it's really a team and technology that's likely to be dominant. Everything else is by definition, a smaller idea. And, and many of those can't attract venture capital because they can't defend that they're going after a market that's big enough. So So I guess to put a point on this, if somebody came in with something where they said, I'm going after 100 million dollar market I think I'm going to get 50% of it, the venture capitalist is going to go, well, it's a really small market. And the odds of you taking 50%, for me to be able to make a venture return are really low, because very few companies get that kind of a dominant share. So what ends up happening is if they're going after too small of a market, then venture capitalists look at it and say, we can't invest here. Because by the time you've done a series, seed a series A, Series B, series C, and maybe a series D, to get into that 50 plus million revenue range, you've raised so much capital, that there's no chance that I can make a five to 10 x return. Mm hmm. So, so fundamentally, there are many, many, many great ideas from entrepreneurs that aren't going after big enough markets, or can't get there fast enough to really raise venture capital. And the best thing that venture capitalists can do is help them discover other ways to try to find Their business through customer contracts through bootstrapping, through other forms of private finance. But But the point here is there are lots and lots of great ideas, but there's only a small group that are really big enough to get on to this venture capital cycle.



10:18

Well, that that leads me to my first question is if there's few companies that kind of are those winter companies that are those funds returners? If those if the profile that companies look very similar, then the company can really pick and choose what investors

that they can have invest in their company. So I guess looking from maybe the company perspective, what differentiates VCs from one another? And if you need to be in, let's say, these winners and say you can pick these winners, what gives VCs an edge to get into the deal where sums get left out?



Joe Zell 10:51

That's a great question. So I think the first thing I would say is these VC relationships unfold lasts longer than many marriages. It is not uncommon at all for a VC to be an investor for six to 10 years in your company, and for you to maintain that relationship with them in a board role. So for one, it needs to be somebody that you like, and that you feel like you're going to be comfortable working with, that you trust enough to be collaborative and transparent with. So the first piece of it is the venture capital decision is a very personal one, because you're not getting a corporation sitting on your board, you're getting a person and and that man or woman that you get to be your board member is going to be a really critical adviser to you. And so it has to be somebody that you think that you can work with. The second point that I would make is for most venture firms, the value that the venture capital partner brings The general partner brings is their experience and knowledge and scar tissue. And we often say that is our greatest value is pattern recognition. So if I'm meeting with an entrepreneur who's facing a problem, and I have had the benefit of being on 10, other boards where this problems happened, and I can say I understand the best way to solve this potentially, that will keep you from going down a bunch of different rabbit trails. That's very, very valuable. So the greatest value that an entrepreneur can get from a good investor is their experience insight, and their pattern recognition in helping them make better choices, make better strategic decisions, get to answers more quickly, pick the right, the right solution more quickly. I think that's the greatest value. There are other What I would call secondary or tertiary benefits that you can get from a firm, which have to do with credibility when you go to do additional fundraising, you know, obviously, the better the credibility of the firm, the easier it's going to be for you to open doors and say, Well, I'm backed by XYZ company and because they're so credible, that helps you get to the next year of firms, their relationships with other investors is critical. their track record is is an important factor because there are companies like correlation ventures today that that essentially make their investment decisions not only on the invest stability of the company, but the invest stability and track record of the general partners that have invested in the company. And then there is a very small set of firms who actually also invest in operational resources to help startups and and some of those firms will bring in human resources. Experts, marketing experts, sales, model, development experts, financial experts. So there are some firms that also bring some expertise. But the majority of the time, what you get as a GP. And what you have to do is try to pick somebody that you think has relevant company, industry sector

experience, that's really going to be able to help you build your business. It's very fitting to have pie have powder, keg hosts This podcast is that's basically what they do. And another reason why we wanted to invest in powder keg is for those HR resources and that capability aspect. One question for the company, how can a company be more attractive to VCs? Because I feel like you know, you're always pushing VCs, to hear about your company to take a meeting. But what can you do to kind of get that pull effect where VCs do cold outreach to say I really like your idea. I want to learn more about it. Well The most attractive feature of any startup is traction. And so traction trumps everything else. So the the most important thing that an entrepreneur nor can do is really focus on getting traction with their, with their customer base. Below beyond that, it's important that they understand those venture capital economics so that they are presenting a defensible strategy that says I can be a 50 to 100 million dollar revenue business. They have to be able to show that with credibility, it's entirely reasonable to say I'm going to take five years to do it and it's going to take 50 million in capital. You just have to have a plan and demonstrate that you believe that you can make those milestones and get to that next that next point. And then the last point I would make is that how clearly you articulate your story really matters because venture capitalists are in a position where they may look at 50 to 100 companies for every investment they make. And I know that you all even look at more than that. And so for you to rise above the fray, you have to have a really, really clear story about why this is a big market. Why you why you have a solution that's really needed, why you're solving a really big problem, and why you've got so much demonstration of progress and traction, that somebody should support you going into it. And so I think investing a small amount of money and time and the resources to help you have a really, really clear message is really important. I can't tell you how many ducks I've seen in my 18 years of doing this, where great stories are told so poorly that they fell on deaf ears. Yes, we see that quite a bit. So to that point, you know, we did see you know, It's all about the team at such an earlier stage, do you weigh the team or the product more? So when you make an early stage investment, or does it need to be a balance between a good product and a good team? How would you evaluate the team versus the product? This is a this is an area of huge debate, as you know, within the venture community, and, and I think that, you know, interestingly, the investment decisions that these firms make is usually very, very personal and very emotional. It's not a very quantitative business typically. So all of us have a little bit different bent, I would tell you that over time. You know, the more money you lose in this business, the more scar tissue you gain, the more you try to, you know, kind of improve your sights. And I think that over time, what I've learned is that you have to start by really focusing on the market opportunity, and focusing on whether this company really has a significant advantage in something that is a real must have for their clients. So I guess I would say that I start with is this really a viable venture, bankable business opportunity. And then the secondary piece of it is, if it is if it meets that criteria, that it's a big enough market and a strong enough value

proposition to be sustainable, then you can say, does this feel like a team that I can work with that is that that can execute? And then we often say, you know, do the entrepreneurs have ears because you know, you want to get people that listen, and are willing to take input because, you know, like I said, the majority of these things don't work. And that's why you need to have good advisors around us to try to make yours one of the few that does by avoiding some of the pitfalls balls. And another question as I guess it relates to that as well, you know, companies when they speak to VCs, you know, VCs are operate very differently. And so you realize how diverse VCs can be in their approach. Could you talk a little bit about maybe the different strategy by VCs, investing in a fewer companies but play a more active role versus VCs that invest in a larger quantity of companies that are maybe less involved, and if there's one that maybe grow tech or other models that you've seen have worked successfully? Well, I think that because this is a numbers business. There are only a couple of a couple of strategies that have really worked. One strategy is to be if you can't make such a high volume of investments that the law of large numbers is going to save you. Then you have to make a small Number of, really, of, of investments where you've got better odds. And so the way that, you know, the way that most venture firms work is that they're making a relatively small number of investments, maybe 15 to 30 in a fund. And, and they have to believe that they're going to succeed because they have better sector knowledge, have better deal flow, have got better decision making on how they choose the companies they invest in, they have to do something to basically juice their odds of winning. And so most firms go down the path of trying to invest in things they know, invest in entrepreneurs they know and then be as deeply involved as the entrepreneur let them because the more involvement that you can bring through your partnership, the more you can help that firm and try to improve its odds of success. If you can't invest Where you've got deep knowledge of the sector, and real expertise in it, and where you don't have the operational resources to really get engaged, then you're far better off using a fun strategy where you're making 50 to 100 investments, and having a law of large numbers save you. So, you know, to me, to me, you, you can't make a small number of investments in things that you don't really know a ton about it where you're not going to be deeply involved, because you're just probably gonna lose all your money. So, and sorry, if I was a listener, and I was accompany either based in San Francisco or Denver, Colorado, what do you think are some advantages or disadvantages by being placed in or living in Denver versus San Francisco? Or if I have a company should I move to San Francisco, just because there's more resources available? Well, I think that there are two Trying to trade offs. Right? The what we've found is that if you think about software startups, their their expenses are dominated by human capital and real estate, right? There isn't really much else they spend money on just people in their space. And if you look at the cost of people in the cost of space, it's about a 40% difference between here in California, so, so a company, a company could raise a \$3 million dollar series a round to support 18 months of development and hiring 15 people in Denver, and to do that same

amount of development, hiring, that same number of people for that same period of time in California would be 5 million. So it costs a lot more money to do the same thing. So, you know, my bias is that if you can raise less and make the same person progress as an entrepreneur, you're probably going to make more money in the end, because you own more of the business. So I think that there's an advantage to the entrepreneur to being in an environment where the costs are lower. The trade off is that we don't have the same capital environment here that they have in the valley. And so you have to be an entrepreneur that is willing to really work hard on the fundraising side. And and not solely rely on Denver resources. Because there are plenty of firms outside of Denver willing to invest in Denver for great opportunities. But it still takes the entrepreneur going out to find that because the VCs aren't here with a hunting license per se. And this is probably one of my last questions is do you feel optimistic about the VC industry and non coastal markets like Colorado or Indianapolis or in the Rocky Mountain or Midwest Do you feel like there's kind of like a cap of potential in the middle of the country? So how do you view venture in the middle of the country? Well, I think that the middle of the country even has a greater advantage from a cost standpoint than even living in Denver. So, you know, if it costs 3 million to build a business here in and around and 5 million in San Francisco, it may only be 2 million in Indianapolis or Kansas City or something. So I think, you know, those those markets clearly have lots of qualified employees, they certainly have plenty of talented people, what they, what they have traditionally, not had, has been the seed stage and series a stage investment capital needed to get those companies going. I would argue that once a company gets to 5 million in revenue when they're raising a Series B, they could be living on Mars, it doesn't matter if it's a great company money will find it. So to me, the money problem exists at the seed stage in series And I think stout street is helping with its network address this issue. And I think that there are other companies in the ecosystem that are helping address this issue. And to the extent that you can bridge that gap, what you're doing is essentially enabling the viability of those businesses, because we've had growth Tech has had many great investments outside of our core regions, where we have lucked into finding a great entrepreneur, and have been able to support it. But but that's been the key is building the network effect, to allow those companies to succeed, because the markets aren't big enough to justify venture firms building, you know, big firms there. Well, that that's all the questions that I had, I just want to say thank you so much. And, Nick, I'm not sure if you any questions, or

N

Nick Jamell 25:46

I think you covered it all was it was an awesome, I mean, great insights, and we really appreciate you coming on the podcast today.





Joe Zell 25:53

Thanks very much. It was really fun.



Nick Jamell 25:54

Thanks again for listening to today's episode. If you have any thoughts or feedback on the conversation with Joe Zell. Feel free to let Just know in the comments, we'd love to hear from you. And as always, to be among the first to hear the stories about entrepreneurs, leaders and investors outside of Silicon Valley. Subscribe to us on iTunes Powder Keg comm forward slash iTunes. We'll catch you next time on Powder Keg igniting startups.



26:17

Oh, I got that mixed up. This is the real outro that one got messed up. Hold on.



Nick Jamell 26:24

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