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Please sir, can I have quite a lot more?

The dance between innovators and their financial backers

By Paul Seabright

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Jesse Eisenberg as Mark Zuckerberg in The Social Network, 2010 | © AF archive/Alamy

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THE POWER LAW
Venture capital and the art of disruption
496pp. Allen Lane. £25 (US $30).
Sebastian Mallaby

Sebastian Mallaby has done what many people would have thought it impossible to do: write a gripping book about the modern history of venture capital. The subject is certainly important. If you want to understand the dynamism and dysfunctions of contemporary capitalism, you must be curious about this unconventional form of financing for areas as diverse as the semiconductor industry, computing and biotechnology, as well as the internet and the digital platforms that use it.

Most readers would quail at the prospect of wading through innumerable accounts of meetings in which Steve negotiates with Don and Tom over breakfast at the Four Seasons – or among discarded pizza cartons in the back of a trailer – after a stormy meeting in which Tony refuses to work with Phil (they are almost all men in this story). But Mallaby elegantly fits these potentially excruciating details about networking into his broader narrative about the financing of innovation. He explores why conventional finance could never have worked for his given examples, and takes an instructive look at the kinds of collateral damage that happened along the way.

The key to his narrative lies in the “power law” of the title, which is a fancy way of saying that most would-be innovations – at least 80 per cent and in some areas well over 90 per cent – fail completely, with the idea being that the gains of a few spectacularly outweigh the costs of the rest. The problem lies in knowing how to identify and support successes. Conventional bank finance ultimately doesn’t work, because a bank cannot charge an interest rate that compensates for 80 per cent or 90 per cent failure. If it tried to, it would force most borrowers into early default.

Equity finance (in which lenders take shares in the venture) is the only solution. But you can’t sell shares for such ventures on stock markets because there will, almost by definition, be too little available information about them, which means that prospective lenders are forced to undertake massive due diligence – and this is precisely what venture capitalists are prepared to do. Financers will also need to provide funding in tranches over time as the risks reveal themselves. And finally, since success depends on the character, talent and commitment of the founders, it usually makes sense to reward these founders handsomely – but in a delayed way, through stock options, to discourage them from retiring too early.

This is how venture capital works, but it doesn’t tell us what venture capitalists *do*. Do they just choose between submitted projects, like literary agents staggering beneath the inflow of mostly unreadable manuscripts? It is a little more complicated than that because it is rare for a start-up with an innovative idea to have all the elements of the project in place. Its founders may have an idea for a product without a prototype, or a manufacturing process, or a marketing strategy, or a vision of its financing needs.

As well as vetting innovative ideas, venture capitalists often help entrepreneurs to recruit people to transform them into businesses. They may train or mentor entrepreneurs who lack basic skills. This requires nourishing contacts, identifying talent and understanding the ways in which the talents of different people complement each other. It is a rare skill set, and the rewards reaped by the most successful reflect how rare it is to be able to spot the most promising innovations bobbing away in the sea of optimistic pitches, to understand who matters for achieving the desired outcome, and to oversee projects so that they have the best chance of being successful.

This might make you think entrepreneurs will always be knocking on the doors of the venture capitalists rather than the other way round, but one of Mallaby's themes is how often these relationships have alternated. Entrepreneurs may not understand the potential of their innovations until venture capitalists show them, as happened in the early days when Arthur Rock persuaded eight scientists working for William Shockley at Stanford to leave and found Fairchild Semiconductor in 1957. By the 1970s, there were many more entrepreneurs pitching to venture capitalists, and even some of the ideas that eventually proved to be the most successful had initially to scale a steep wall of scepticism from potential backers. One curious detail reported by Mallaby is that Apple almost failed to obtain seed financing because so many financers reported adverse reactions to the young Steve Jobs's personal hygiene. By the late 1990s and early 2000s, the tide had turned again (with brief interruptions around the turn of the millennium): it was now the financers clamouring to invest in Google and Facebook, rather than the entrepreneurs chasing the venture capitalists. This was the environment in which, in 2004, the twenty-year-old Mark Zuckerberg arrived at a meeting with Sequoia Capital in pyjamas, claiming to have overslept.

One important difference between Apple and Google/Facebook lay in the complexity of the projects. Apple's idea needed complex manufacturing, marketing, a computing ecosystem; few financers understood the challenge in all its details, let alone believed the project could work. Google's idea was much simpler, as was Facebook's; both may have needed sophisticated computing skills, but far more was known by the late 1990s and early 2000s about what such things entailed. Any venture capitalist could see after a short demonstration that Google would knock its rivals out of the park, so there was a throng wanting to invest (though the role of John Doerr at Kleiner Perkins in persuading the founders to recruit Eric Schmidt as CEO would still be crucial). As for Facebook: it already existed. Zuckerberg simply wanted to expand, massively.

Mallaby is excellent on the different cultures at various venture capital firms, but less attentive to the financing predicaments faced by innovators of different types of technology. He can portray shifting movements of capital as if they were tidal waves rather than distinct responses to different challenges. He also often leaves the impression that disruptive innovation can only ever be financed by venture capital, on the basis that established companies are unable to make fundamental innovations themselves – through a sclerotic culture or from fear of cannibalizing their own markets. As a general claim, this isn't true. The most world-changing innovation of the past quarter century, the smartphone, was developed when Apple was an established company (it raised venture capital finance in the 1970s for personal computers, not smartphones, and the iPhone certainly cannibalized the iPod). And while venture capital has played a part in the astonishing development of Covid vaccines over the past two years (Moderna was a start-up financed by the Boston venture capital firm Flagship Pioneering), many other established firms have played a leading role.

But these are quibbles, and Mallaby's overall story is well-argued and compelling. And, despite its US focus, it also has a global span. Apple, Google and Facebook may be American-owned but American money does not just get spent at home. It is sobering to be reminded that Alibaba, Ten Cent, Baidu and many of today's most dynamic Chinese internet companies owed their initial financing to American firms.

As for collateral damage: Mallaby is more interested in success than failure, though we get a taste of failure too, notably the kind that began as success, before it went to the heads of the respective innovators. His examples include Elizabeth Holmes of the health technology company Theranos, Adam Neumann of WeWork and Travis Kalanick of Uber. All have since parted ways with the companies they founded, under various clouds. Mallaby persuasively lays the blame for these failures at the door of later-stage investors, who took much less rigorous approaches to oversight than the initial venture capitalists who launched the projects.

Mallaby does acknowledge the terrible record of Silicon Valley in recruiting and promoting outstanding women and minorities. But he underplays the extent to which this grew from a culture privileging clubbability and geeky monomania over anything resembling work-life balance. He writes often, and too admiringly, of deal-makers who unhesitatingly scheduled meetings for Friday evenings or Sunday mornings, who disappeared from family reunions to huddle with colleagues, who took calls on a Saturday evening and were on a long-haul flight the next morning. Some transactions may well have to seize the moment - but many do not benefit from being approached in this frenzied way. And it is precisely this sort of culture that has so often acted to exclude women, as well as ethnic minorities and people who didn't go to the right business school. Not only has this damaged the wider culture, which so often sets up venture capitalists as role models, it has done economic damage by excluding many of the brightest and the best. It could also be argued that this culture has encouraged too much money to be poured into start-ups that improve the experience of ordering pizza rather than, say, looking after elderly relatives.

The Power Law nonetheless remains a superb introduction to an important subject. Anyone who cares about innovation in the modern economy will need to think in detail about how it can be financed, and about the broader social consequences of doing so. If you can avoid being distracted by the empty pizza cartons, Sebastian Mallaby's book is an excellent place to start.

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