Building a New Venture Firm: Brian Jacobs of Emergence Capital (Part 1)
February 25, 2008

Most Venture Capitalists that entrepreneurs work with these days have never been entrepreneurs themselves. They have not had to take substantial personal risks. They are used to cushy lifestyles, fat paychecks, and existing brands that their firms have built long before they came on board.

Most VCs also do not have an investment thesis. They raise funds based on historical reputation, and tell their limited partners, "Trust us, we know what we are doing." Again, they are selling the credibility of an existing brand. In contrast, entrepreneurs almost never get funded without an investment thesis. And, by definition, the brand is new.

In this series, however, we will be talking with Brian Jacobs, one of the founders of Emergence Capital - a relatively new fund that came into existence WITH an investment thesis, and quite a contrarian one at that.

I chose to do this story because I found it compelling as a case study of a venture firm that can truly empathize with entrepreneurs. I hope you enjoy reading it as much as I have enjoyed writing it.

SM: Give me some personal history, first, Brian.

BJ: I have been in the venture business for 20 years. I was initially an engineer working in the Valley and got into the venture business in 1988 with Security Pacific Venture Capital. When they merged with Bank of America, I was recruited to be the third partner at St Paul Venture Capital in Minnesota. I was there for 10 years and opened their Silicon Valley office in 1998. I was investing actively through the bubble period and then into the bust. It was in 2002 that I felt it would make sense to launch out on my own and form a new venture capital firm.

SM: What was going on in the industry at the time that made you want to leave a secure place and go off on your own? That was obviously not a great time for the industry.

BJ: The venture capital industry experienced a whipsaw effect where the huge opportunities in the bubble caused the venture industry to expand. New firms were created, and the established firms expanded to the point where they were much larger than before. St Paul Capital grew significantly and had a lot of access to capital through the insurance companies which were our primary source of funding. We were encouraged to grow and take advantage of the opportunity. I participated in that growth; I entered as the third partner and by 2001 we had 12 partners.

When the industry started to collapse and the opportunities started to shrink dramatically, St Paul and many other venture capital firms found themselves overextended. I think we are still seeing some of those effects today because a lot of established venture firms have had to re-trench, downsize and in some cases have broken apart. A lot of venture firms were going through this soul searching in 2002 in terms of "what do we really want to do now that we have seen the unprecedented gains and flurry of activity and an unprecedented collapse in close succession?"

As a partner at St Paul, I was very much involved in those discussions, but I was getting frustrated that it was taking a long time to figure things out. I saw a huge opportunity in Silicon Valley and I recognized that my partnership could not take advantage of it because they were consumed with the restructuring needed from the bust period.

SM: When you are talking about the restructuring are you referring to large funds finding themselves in a situation of having too much money while simultaneously not being able to fund early stage investments and not being able to find enough late stage opportunities?

BJ: Certainly it is some of that. If you recall back to 2002, about 20 funds had raised over $1B. We were one of them. Our largest fund was $1.3B, raised in the year 2000. At the time we thought with the explosive growth we were seeing in the bubble it might be possible to invest $1B and return $10B.

By the time we hit 2002 it was very clear it would be extraordinarily difficult to invest $1B, let alone return $10B. The right size for a venture firm had to be dramatically smaller. If you were a firm with 12 partners, and at our peek we had over 90 portfolio companies, it was very difficult to change directions and go where we needed to be. I recognized that a quicker way to get well positioned for the new environment was to start something brand new rather than transform something that had grown for a different purpose during a different era.

Building a New Venture Firm: Brian Jacobs of Emergence Capital (Part 2)
February 26, 2008

SM: Even so, 2002 was not a great time to start a new fund.

BJ: No, it was a horrible time to do that!

SM: Tell me more about that experience.

BJ: I knew a few VCs who had tried to raise a new fund in 2002, and most of them gave up. They concluded the market was so bad there was no way they could succeed in raising a fund. The investors and venture funds were not interested after losing lots of money over the last few years. My partners and I thought very carefully before we decided to go fund raising.

SM: Can you give me some background on your partners? How did you find them and why did they share this crazy idea that in 2002, in the middle of nuclear winter, you ought to go out and look for funding?

BJ: When I decided to explore raising a new fund, I obviously started talking to some of my contacts in the Valley. One of the first people I talked to was Jason Green who was a partner at US Venture Partners. I had a lot of respect for Jason; we had worked in the marketplace in cooperation and in competition with each other during the previous five years. I knew we had similar ideas regarding identification of new venture opportunities.

We had both done a lot of investment in the services area. Specifically, we both looked at technology companies that were building service businesses versus product businesses. When Jason and I spoke, I was surprised to learn he was having similar ideas and had also come to the conclusion that a large venture fund was not well positioned for the future. We both agreed that services based investing was so different from product investing, that traditional venture firms had a hard time grasping the value. We had shared common frustrations of bringing a service deal to an established partnership.

Jason and I both had relationships throughout the Valley with individual partners who appreciated the model but had partnerships who were not fully supportive. Jason and I thought perhaps we would be good partners to work on this new venture firm together. Jason had also started conversations with an entrepreneur named Gordon Ritter who had led some important service companies as an entrepreneur and was also thinking about investing in this category.

We coalesced together as a partnership and we talked about whether or not we would work well together as a team. We spent about 6 months working together to test and see if we would be a good team, and concluded we would be a good team.

SM: Let’s delve into your investment thesis.

BJ: Most of the technology industry has been based on companies inventing some technology and selling it to their customers. The customers buy technology and get value out of it by implementing it and automating a business process. In the late 90’s there was a flurry of acquisition of technology by major companies as they were trying to use technology for competitive advantage.

What a lot of companies experienced was difficulty extracting the value they believed they would get. It is very hard to actually use technology after it was purchased. Billions of dollars were spent integrating the technology to the specific uses of the customers, which also took a long time to do. By the time the technology was implemented, often the requirements had changed or the technology was obsolete. There was a lot of frustration among customers at this approach to buying technology.

Building a New Venture Firm: Brian Jacobs of Emergence Capital (Part 3)
February 27, 2008

SM: There was a piece of the services industry that is well known, which is consulting services. That is not what you have in mind when you say services.

BJ: Correct. We are talking about technology companies that use their technology to provide a service and usually they are using a network to deliver that service. It is really the advent of networks that allows an automated service to exist. Without the Internet or mobile networks you do need people to travel to a customer site in order to provide value. With the advent of worldwide networks you can have a small startup in Silicon Valley serving customers all around the globe from a simple server setup . It is very cost effective because the distribution of that service is now literally free.

SM: What did you call this model?

BJ: We agonized over how to describe this, but we finally concluded the right term was **Technology Enabled Services**. They are service companies, but they are not labor based service companies, they are technology service enabled companies.

SM: What type of investor did you go after and what was the reception of your thesis?

BJ: Before we started fundraising, I mentioned that we spent months making sure we had the right fit amongst our team. We knew that if we did not believe 100% in ourselves that we would be successful, then no other investors would either. Before we started raising money we concluded one of the only ways to test our partnership and how well we would make decisions together is to make actual investments, and they had to be real investments. We pooled some of our personal money together and we decided to make some investments. The first investment we made was in SalesForce.com. We negotiated the deal in December of 2002 and the deal closed in the first week of January 2003.

SM: What stage was SalesForce.com at?

BJ: They were a private company; they had grown nicely and were in the $40-$50M revenue range. We knew some of the executives there through Gordon Ritter's relationship with Mark (Benioff), and we negotiated to buy some shares at $1.67 per share. Today it is about $55.

SM: Was there any other company that was on your radar that you thought would be successful which you could show to potential investors?

BJ: There were a handful of companies that were typically formed in the bubble and had survived when many others had failed. What we found was a lot of the companies that failed were these technology product companies that could not get anyone to buy their product after the bust.

The service companies had advantages in down economic times. It is not a big capital expenditure, it does not take a long time to implement, and companies can try it first. We had seen a number of these companies and we invested in some but we had a few others we pointed investors to. WebEx was already doing well at that time and they were one of the few other companies we could point to as successes.

We also included some of the consumer services in our category of technology-enabled services. Many of the companies that failed in the bust were either content companies or e-commerce companies. We were more supportive of companies that had subscription business models or transaction-based business models.

Building a New Venture Firm: Brian Jacobs of Emergence Capital (Part 4)
February 28, 2008

SM: Can you give some examples of companies using these subscription or transaction models?

BJ: EBay and Travelocity are two. These are companies providing a service over the net to consumers but they are getting paid for the service. That was critical to us.

SM: You had a bias towards subscription service versus advertising, which at that point hadn't yet ramped up.

BJ: Exactly.

SM: What happened next? How did the market respond?

BJ: We concluded we were so passionate about this opportunity we were going to raise money even when others were unable to. It took us a little while to make these initial investments and also to prepare our story and our private placement memorandum for the new fund.

We started fund raising in late Q1 of 2003. While we were doing all of this preparation, there were a lot of things going on in the world that we were not really planning on. I believe we were invading Iraq in March 2003. This was not in our playbook, but we had already committed to make the fund a success. We had already left our jobs, had made these investments, and there was no turning back. Initially, the reception was modest at best.

SM: Can you talk about specific people and funds you went after and what the target fund amount was?

BJ: Our first target was $100M. We used our contacts to meet people who invest in venture funds. Typically they are University endowments, fund of funds, pension funds, and insurance companies.

SM: You didn't go after anything out of whack in terms of whom you targeted?

BJ: No, we felt that what we wanted to do was to go after the best investors in venture capital. There are some investors who are new to venture capital investing business. There were a bunch of European pension funds which had not traditionally invested in venture capital and had just started finding US venture firms to invest in but they did not have a track record of supporting firms through decades, and if you talk to people who have founded other venture firms like Kleiner Perkins, Sequoia or Benchmark, most often they were initially funded by Yale, Princeton, and Stanford. These endowments have very long-term horizons. They are prepared to invest for decades. By establishing a base like that, we felt we would have the wherewithal to grow Emergence to an industry leader.

SM: How did they receive your investment thesis?

BJ: At that time there were hardly any new venture funds being formed. There was a flurry of new venture fund formations in the bubble, but most of them did not do well and by 2002 and 2003 there was little appetite for a new fund. We would not take no for an answer, and we kept coming back and explaining more and more why this thesis was different and why it would be successful. While we were fund raising, SalesForce.com continued to grow, and continued to get higher and higher visibility. It went public in the summer of 2004, around the time we closed our fund. It took us a year to raise the fund, and we stuck to it until we were able to raise $125M, which was more than our target.

Building a New Venture Firm: Brian Jacobs of Emergence Capital (Part 5)
February 29, 2008

SM: What happened after you closed the fund? Did the thesis check out? What was happening in the marketplace, and how did you get your positioning and your thesis out there to solicit deals?

BJ: SalesForce.com went public as we were closing our first fund, and that proved to be a home run for Emergence. We had made a good bet and delivered a very significant return and we were able to tout that to investors and entrepreneurs. What we discovered was the theme we had chosen was very much taking hold in Silicon Valley and other places in the country. The term **Software as a Service** began to emerge as a new software company model following the SalesForce.com approach.

We initially were not well known, but we did get some press through our SalesForce.com investment, and a lot of entrepreneurs who were starting SaaS companies really wanted to partner with SalesForce.com and learn from their experiences of building that type of company. That helped us because many startup companies wanted to work with the venture firm that had helped SalesForce.com.

SM: The fact you were involved in SalesForce.com was well known in the entrepreneur community?

BJ: Even in 2004 and 2005 there was a significant contingency in the software industry that did not believe in the software as a service model. The conventional thought was that it was a fad, and not a big thing. There were only one or two conferences that had a focus around SaaS. Emergence was naturally drawn to those, and naturally asked to speak at those conferences.

The first one was sponsored by the SD Forum down in Santa Clara. They were not even sure if there would be enough people showing up to have a conference, yet when we showed up, there were lines outside the center. There was so much interest in this category there was standing room only. There was pent up demand for SaaS. Naturally, we were featured on a lot of the panels and we were able to spread our message.

SM: What was going on in the rest of the venture industry? Did other VCs start to position themselves around this?

BJ: For a few years we saw limited activity from other venture firms, yet there was still a lot of investment. There is typically one partner in each firm who had invested in services, and understood some of the opportunities we were seeing. We continued to partner with these individual partners.

SM: Would you name some?

BJ: Sure. People like Bob Spinner at Sigma, Tom Blaisdell at DCM, and Kevin Efrusy at Accel.

SM: What strikes me is that most of the tier 1 VC portfolios do not have a significant amount of SaaS.

BJ: Part of the dynamic of what caused us to want to form Emergence is that a large venture fund needs to be diversified. It would be very difficult for a large venture fund with $1B to invest in one sector only. When you are managing a pool of that scale, you typically diversify and invest across sectors. You have partners with expertise in communications, healthcare, and so forth. Typically, there are one or two software people in each firm. Those particular partners that are following the trends in software and trying to be on the cutting edge are great, but they are outnumbered in their firm when compared to Emergence, which is 100% focused on one theme.

Building a New Venture Firm: Brian Jacobs of Emergence Capital (Part 6)
March 1, 2008

SM: The surprising part of the story, one of the reasons I decided to cover it, is that I have not seen too many major trends in our industry in the Valley that all of the VCs did not run after. The venture industry is like lemmings. Everybody is running after the same trends. Someone figures it out, and everyone else chases. My own analysis is as follows: based on the time period, 2004 to 2007, it was also when Web 2.0 happened. People were chasing Web 2.0 and they got blindsided and missed the SaaS wave.

BJ: I think that is part of it. I also think that software is a product. Software as a Services is a service. If you look at every other category of investment in the venture business they are products. Communications systems, semiconductors, biopharmaceuticals, and software are all products. The knowledge that exists in venture firms is how to build a product company very quickly. It does not apply to service businesses. It is very different.

SM: What is different between the two in your opinion?

BJ: First of all, it is whom you hire. The people you hire in a service business are different than a product business.

SM: In what way?

BJ: A product business is transactional. You sell something, you get the money, and the relationship is over. A service business is about serving 24×7.

SM: You have to secure the renewal.

BJ: Exactly. It only makes sense if the person comes back for more. We know from experience that people who have been successful in product businesses are generally not successful in the service business.

SM: To be fair, large software deals are also reliant on customer satisfaction. They have not always been so. Siebel is notorious for selling products that were never implemented. By the time we got to the mature software industry, people realized they had to help customers derive value from their products.

BJ: I am not saying there is not value in products. It is simply a different mentality. We see this all around the Valley at the end of the quarter. What are you going to do to get the deal? You are going to discount, you will make promises, and you are going to try to force a sale. That is not the way service businesses sell. They have to create win-win. You have to have trust in your provider. In a product business, as long as you get the product, you don’t really care what happens to the business after.

The revenue trajectory of a service business is very different. It is laying out recurring revenue streams. If you chart the revenue trajectory, it looks different. You have to value these companies differently. You develop the technology differently. You compensate the sales people differently. You have different bankers to talk to about going public. These are very different animals.

The challenge that Jason and I felt in our former firms is that we would bring a good strong service business to the partners, but the other partners were inherently product people. That is true of most other firms. We have great respect for other SaaS investors, but we know their partners do not have the same appreciation for the realities of building a service business. It is harder to create a strong SaaS practice when you do not have the support of all of your partners.

Building a New Venture Firm: Brian Jacobs of Emergence Capital (Part 7)
March 2, 2008

SM: Tell me about some of the deals that you have done since coming into existence, and what is unique about them?

BJ: Since we started Emergence we have had three IPOs. That is pretty good for a young firm. Obviously SalesForce.com was one. We also invested in a software provider in the Human Resources space called SuccessFactors, and they have gone public in November of 2007.

We also invested in a company called HireRight, which provides pre-employment background screening as a service. This is not a pure software company. It is a technology enabled process outsourcer. They do not really provide their customers with an application, but they outsource and entire business process, and that process is heavily automated within HireRight so they are competing with traditional labor-based services. They went public in August of 2007.

We have invested in numerous SaaS companies that are still private today, such as Intaact in the accounting space, Genius in the marketing automation space, Pivot Link in the online business intelligence space, Ketera in the procurement space, and several more.

SM: Your investment thesis continues to be Saas, or technology enabled service. How long do you think this will last?

BJ: We think this is a very long term trend. Service businesses have been around since the beginning of economic activity on the planet and we do not think they are going to go away anytime soon. The core decision any customer must make is if they want to buy technology, and if they do they must own it and maintain it to ensure it continues to deliver value to them.

Their alternative is technology enabled service, to partner with a company that will provide them the technology they need. In that case the provider's role is to continue to upgrade it, maintain it, and ensure it is delivering value.

In many companies there is not a core competency around making their technology systems work. A retailer typically has a core competency around merchandising and marketing, not around running IT systems. We believe that there are some companies that have core competencies in IT systems, such as many financial service companies. They can buy technology and make it work.

SM: Even the large retail ones can, such as Walmart.

BJ: In every industry there will always be one company that will choose running technology systems as a competitive advantage. We believe that in most markets the majority will choose to outsource some functions.

SM: In many ways the comparable is BPO.

BJ: We think SaaS is a form of outsourcing. It is outsourcing the management of an application. As I mentioned, Hire Right is an example where they have written a software application which does this function. The users are not folks sitting in the client corporation, but the users are internal to Hire Right who known how to use the software to deliver the end result to the customer. In many ways the BPO is a larger value proposition than SaaS, though there are tradeoffs. Typically, the margins are lower in a BPO and of course we are looking at those BPOs that have technology leveraged. Their margins are supported by their use of technology.

Building a New Venture Firm: Brian Jacobs of Emergence Capital (Part 8)
March 3, 2008

SM: An example is when InsideView did the acquisition of True Advantage and laid off 150 people who were doing the same thing manually. I wrote a piece recently called the "Death of Indian Outsourcing" that featured InsideView and I talked about that example. My thesis is the Indian BPO industry is very much at risk because of the SaaS trend, and if they do not start to get their act together and respond to that trend, they are going to get punished.

BJ: I think that is true, but we see the opportunity that an Indian outsourcing firm could subscribe to a SaaS application and technology enable their BPO.

SM: Absolutely.

BJ: They can use their labor component to provide a complete outsourced business process.

SM: I think the issue is also in the numbers game. There is a lot of fat in the Indian BPO industry because they do not use technology effectively.

BJ: There are going to be natural forces that force them to embrace technology.

SM: Is there anything I should have asked you but didn't … anything else to discuss?

BJ: One thing that I think might be interesting to your readers is that we use this umbrella term technology enabled services, but there are three or four different categories of these services that are worth explaining. I have talked about SaaS, and technology enabled business process outsourcing.

The other two categories are consumer services and information services. Our investment model applies completely to the consumer side as well as to the commercial side. We regularly look at consumer investments as well. As I already mentioned, we do have a preference for subscription or transaction based revenue models versus advertising models because the advertising model is more of a media service.

The last category is information services, and InsideView is a good example of this. The customers are not buying an application, they are buying information that they want, and of course there is new data collected every day. The amount of data is growing exponentially and that is creating new opportunities for startups that figure out a way to harness that data, including, often, from user generated content which can be very effective in collecting massive amounts of data.

SM: PayScale is a good example of that.

BJ: Another is a company called Bill.com (previously CashView) which provides a Bill payment service. PayScale is an example of data that has been pulled together that in a way 5 years ago would have been impossible.

One of the interesting things is the blurry lines between these categories. Many SaaS companies are collecting massive amounts of data. They store the customer data of their subscribers and as those data stores grow and there is value in those databases that can be realized in additional revenue streams.

SM: Assuming the customers agree.

BJ: There are privacy issues and licensing issues. SalesForce.omc has more sales data on their servers than anywhere else on the planet. They have not got permission from their customers to use it in any other form, but we know of other SaaS companies that are already thinking about how they want to use this data eventually. They can provide it back to their customers in the form of benchmarking, best practices. There can be value to the customer to allow those uses. We are also seeing information service companies who are recognizing there are applications they can provide to take advantage of the data they are already selling to their customers. There are lines blurring between these categories.

Building a New Venture Firm: Brian Jacobs of Emergence Capital (Part 9)
March 4, 2008

SM: What is in your portfolio in those later two categories?

BJ: We mentioned InsideView as an information service. We have a company called Krugle, which provides a search engine for software developers. Most software developers start with a base of code, often an OpenSource project they download as the basis for a new project. It turns out that software developers often try to use Google to search code for pieces of libraries or snippets of code they want to use.

SM: It is a vertical search engine for software developers. What is the revenue model because those typically use advertising?

BJ: They have a public search engine that is advertising supported, but they also power the development communities of several large technology companies, so IBM and Yahoo! use Krugle to be there search engine to support their developer community. They are also selling an appliance that allows large corporations to search their internal spaces. That is on subscription basis.

SM: I think your investment thesis is also going contrary to the fact that the Valley has profoundly disliked selling to small and medium businesses.

BJ: That is correct, and that is one of the reasons we felt that a new venture firm could address some of these issues in the way that an established venture firm could not. There is no question that most VCs would state publicly that they hated selling to small and medium businesses.

Yet, what we observed was the more natural path for services was to start with small and medium businesses. If you think about ADP, they are a technology enabled business process outsourcer and it started years ago. Initially, their value proposition was that large companies had bought mainframe computers and were automating their payroll but small companies could not afford to do that. Having a company that could buy a mainframe and sell it on a service basis to small and medium businesses, they could automate the business process to an underserved market.

When we looked at Salesforce.com we saw a very similar phenomena. They were not selling to the largest companies at the time; they were selling to small and medium business. The service model allows serving companies that could not afford the old approach.

If you think about the problem of selling to a Fortune 500 as a startup, it is more natural if you have a product you can go do a transaction with a large company where they buy the technology and are no longer dependent on the provider. With a service provider that is not the case. I don't think Cisco or HP would outsource a critical business process to a startup if they were the first customer. You never crack that problem, although that is the regular approach for product companies. Service companies need to start with smaller companies who are not going to hold the bar as high as a fortune 500 company. As a service company builds a larger and larger base of customers, they become suitable to sell to larger companies. That is exactly what ADP did and that is exactly what Salesforce.com has done and we see that all the time in the SaaS market.

Building a New Venture Firm: Brian Jacobs of Emergence Capital (Part 10)
March 5, 2008

SM: You announced this million dollar challenge for SaaS startups developing on Salesforce.com's Force.com platform. What are you seeing in response to that?

BJ: We have a great relationship with Salesforce.com, and as you know their big initiative now is their Force.com platform – the ability for a developer to use the SalesForce infrastructure to write and deploy an application without reinventing that data center and development tool infrastructure that SalesForce has already developed and scaled. This is a new way to build a company. It is riding on someone else's platform and relying on them to deliver it over the web to customers. We think it is very exciting and it is a bit uncharted territory but it very much fits into our focus area of technology enabled services because most of these applications are service applications because they are hosted at SalesForce.com.

We are now taking registrations for the million dollar challenge where we will evaluate the contestants and award a $1M investment to the best Force.com application which will be announced at DreamForce next November. This was announced in mid-January, and we have approximately 50 applicants to far who have registered. We are busy sorting through those, and we are getting more each day.

SM: Does that force companies that build on the Force.com platform to an exit into SalesForce.com?

BJ: I don't think we know the answer to that yet.

SM: I can't see Oracle buying something built on the SalesForce.com platform.

BJ: As the platform evolves, we will see if it is a truly open platform that a competitor to SalesForce would feel comfortable buying. There are clearly some different camps on what the right platforms ought to be, but we regularly see companies being bought that are built on the .NET platform and there is a fundamental reliance on Microsoft in that case. Microsoft has to provide support to application developers who are developing on the .Net platform. If they withheld support, no one would use the platform.

SalesForce will face that same exact issue – either they will have an open platform and reinforce the confidence of developers to work on it, or if they withhold support from competitive companies then their platform won't succeed to the same extent.

SM: This has been a very good discussion. Thanks for taking the time.

BJ: It has been a pleasure.