SCALE-UP: THE EXPERIENCE GAME

THNK SCHOOL OF CREATIVE LEADERSHIP

Deloitte.

What does it take to beat the odds and create a true Scale-up? Scale-ups, also referred to as fast growing market-innovating new enterprises, disrupt and revolutionize entire industries. They embody ingenuity, innovation and foresight.

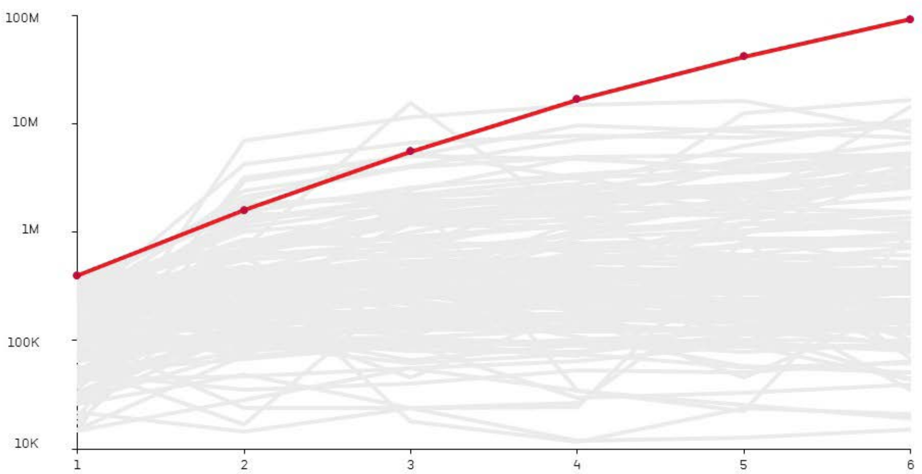
There is no formula to success. Every scale-up is a unique story in which luck always plays a major role. Still there are some common elements that seem to materially increase the scale of success: experienced leadership, design for scalability, and patience to get market timing right.

Fast growing startups, also called scale-ups, are important. Defined as companies that grow to more than $10 million by their 5th year of revenue, they constitute a large chunk of employment and revenue of all startups in their cohort once they reach maturity.

Once they reach that stage, which occurs on average in their tenth year, their valuation can amount to billions.

EXHIBIT 1

REVENUE EVOLUTION OF STARTUPS



Scale-ups are also exciting. They demonstrate a spectacular growth and expansion, while revolutionizing industries with new business models. Coming from nowhere and with a fresh new outlook, they topple incumbents that have been around forever, all the while garnering unprecedented wealth for their founders. Today, scale-ups are omnipresent and have embedded themselves into our daily lives – just think of Facebook, Google, and Uber.

Creating a scale-up is truly against the odds. Our research shows that the chances of a new enterprise to ascend as a scale-up are around 0.5%, which means that only 1 out of 200 surviving new enterprises will become a scale-up. "Unicorns" make up the even smaller subset of scale ups; only 103 start ups are valued over $1 bilion.

These figures stay the same whether the startup is founded in Geneva, Amsterdam, Shanghai, Tel Aviv, and even Silicon Valley. These odds also stay the same whether the startup is in software or hardware, healthcare, energy, financial services, or consumer goods.

Deloitte Fast Ventures and THNK set out on a journey to explore the dynamics and characteristics of scale-ups. We assembled a database with 400,000 new enterprises[1] from all over the world and collected financial figures, business dimensions, and leadership characteristics. We looked for commonalities and patterns within the hard data that would help answer our question, "*How can we recognize a potential scale-up and what improves its ability to scale?*"

1 Defined as new enterprises excluding independent professionals, craftsman, non-profits, farming, and small hospitality companies.

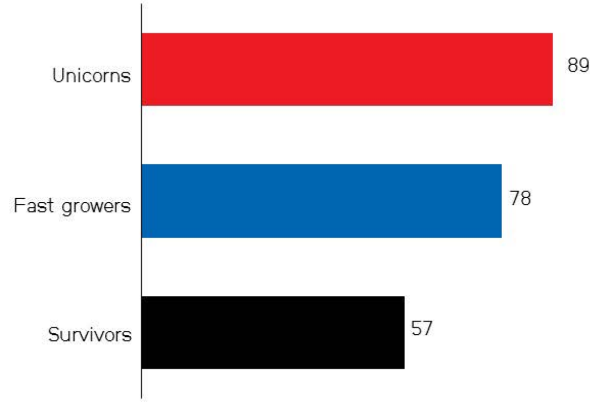
EXPERIENCED LEADERSHIP

While we all recognize the stereotypical image of the 20-year old college dropout that goes on to become a billionaire, our data clearly states otherwise. What we found was that the founders of scale-ups, as opposed to startups, all had prior corporate experiences under their belt.

EXHIBIT 2

EXPERIENCED FOUNDING TEAMS

PERCENT OF UNICORN FOUNDING TEAMS THAT HAVE AT LEAST 1 EXPERIENCED TEAM MEMBER



Many of them already had entrepreneurial experience (successful and not), and academic degrees. Interestingly, it was a founding team – versus a single individual founder – that started half of all scale-ups. The university dropout that went on to launch the start-up that made him a billionaire might be a popular image in the media, but it is a rare case within an already rare category.

This also means that university incubators and first-time startup support systems are not the breeding ground for scale-ups. They serve foremost as a playground sandpit for first-time entrepreneurs and for graduates that will thereafter move into the corporate world. Only later in life and packed with experience and know-how are they likely to launch their scale-up.

So then the question becomes, how does this experience manifest itself? How does it teach and inform founders differently than first-time entrepreneurs, and help them make decisions that increase their chances of realizing a scale-up?

FUNCTIONAL DEPTH

Starting a business requires a combination of motivation and mindset, including independence, street smarts, agility, persistence, and drive. Creating a scale-up requires an additional functional edge: a capability that is distinctive when compared to the incumbents in the field, which cannot be copied quickly and has broad market application.

Developing these capabilities requires significant time dedication. As Malcolm Gladwell famously stated in his bestseller *The Outliers*: success is made by putting 10,000 hours of work into something you love. Before Mark Zuckerberg or Bill Gates started their respective world-changing businesses, they had both put in many years of experience and hard work behind their computers. Martha Stewart began planning her classmates' birthday parties at the age of ten, and moved into a freelance catering business for offices in the upstate New York area that eventually turned into a billion-dollar, self-standing pioneering industry.

Scale-up founders typically have the research background and industry experience that qualifies them as true masters of their particular trade. A 2014 Deloitte report on scale-ups in the UK showed that 61% of leaders said they would grow quicker if it were easier to hire specialists from established businesses. Looking at it from this perspective, it is not a coincidence that Israel excels in scale-up companies that specialize in security.

Finally, what is vital in terms of experience is the deep understanding of your customer, and thus your market. 85% of all unicorns are active in a market where at least one of the founders had extensive market know-how and insights before embarking on their success story. In fact, the majority of cases saw the founders come to their breakthrough moment of insight while working at industry leaders like Google, Microsoft, or Apple. As is the case with the majority of unicorns, the experience within their specific market allowed the founders to recognize a business opportunity that would outperform and outsmart the incumbents in their own field.

LEADERSHIP MILEAGE

Considering that 50% of new enterprises fail before their fifth year of revenue, creating even a small business is a real accomplishment. It is meaningful and empowering as it creates independence, economic contribution, and (self-) employment. Many leadership dimensions come to play within those first five years, among them communication effectiveness, confidence, and creativity.

Leading a scale-up requires additional leadership dimensions: the ability to inspire, direct, support, empower, and enable many, many others.

The majority of these abilities and qualities are developed through years of experience. Leading others cannot be learned from reading books or listening to leadership lectures. It can only happen after years of trials, errors, feedback, encouragement, and an increase in responsibility. Experience in leading others starts at a very young age, which develops into adolescence, and goes on to reach full maturity in adulthood. As a result, we see that the founding team members of scale-ups typically have multi-year experience in leading others.

ADVANCED INTUITION

Creating something new is intuitive. After all, one can never prove that a new idea will work until it has been created and tested. As the saying goes, it is difficult to predict the future, especially as you have no data.

Intuition is a developed sense. You can only intuit whether or not a new product will fly off the shelves, or whether a new business model will take off, or whether a new service will expand across borders if you have a good sense of the market in which you are operating. “The best qualification for a prophet is to have a good memory,” said George Saville, and this results from studying past successes and failures, analogies from other situations and industries, and repeating patterns. All these will fine-tune one’s intuition about what might be possible next.

Hence, founders of scale-ups are older, typically in their forties. The founders of the majority of unicorns have twice as much work experience as startup founders. They also have experience-rich backgrounds, both in a professional and a personal sense. The latter can mean multi-cultural backgrounds, extensive travel opportunities, and a diverse education.


5 x 10€

DESIGNED TO SCALE

The majority of startups is designed to quickly develop a product and realize a profit margin as soon as possible. They work on the assumption that as long as customers will like the product, revenues will grow and the company will at some stage become profitable, since some costs are fixed. First-time entrepreneurs experience that even when initial customer feedback is positive, quick-growing revenues is not the obvious consequence. Also, they find that customers expect ongoing product improvement with greater functionalities, which was not anticipated in the initial product design.

As product volume grows, so does complexity, and that results in costs growing even faster than revenues. The company's growth is therefore stunted and ends up occupying a local niche. The median successful start-up realized $300K of revenues after five years, and realizes 5% annual top-line growth thereafter.

CATCH A WAVE

A typical startup has a very specific plan: to launch as quickly as possible, given that it tends to work on very limited resources. Many incubators and accelerators promote and facilitate this fastest-time-to-market model, and advise to make a minimum viable product that will launch as quickly as possible. The idea is that pivoting will take place after the product is on the market, as insights will allow for improvement along the way. This will ideally convince investors to finance the subsequent development stage. While this approach is a tested-and-proven way to determine whether a new product can establish a minimum market position, it says little about its scale-up potential.

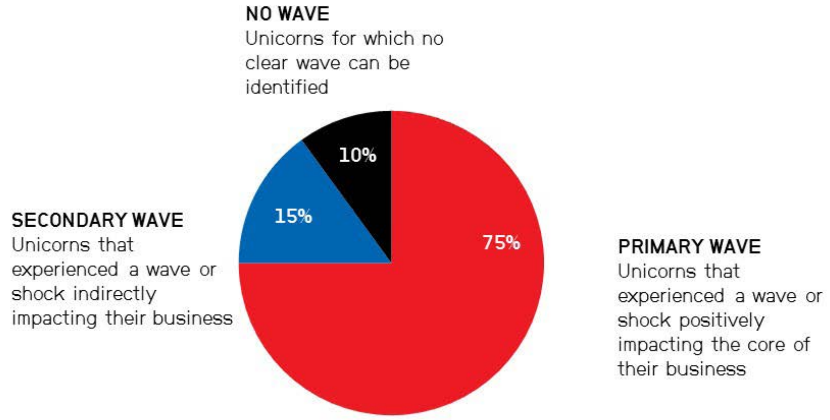
A scale-up distinguishes itself by getting the market timing right. The right timing means various things: the first is that the industry itself is experiencing growth. This allows for newcomers to have room to capture scale without directly costing sales volume to the incumbents, which would invoke a competitive reaction. Also in periods of industry growth, price competition is less severe. We found a significant correlation between growth rates of new enterprises and the growth rate of their respective industry subsector.

Some industries can experience a real "wave" - a large shock, movement, or trend that opens up the market. This can be a customer trend, for instance the growing appreciation of sharing products or goods, or the affinity with sustainability and healthy living. It can also be a technological breakthrough, for example the introduction of 3D-printing or the economic viability of solar panels. It can be a change in regulation or in the economy, as shown by the impact of the most recent economic downturn.

We used Google Trends to define and analyze over 30 waves in consumer trends, technology breakthroughs, regulatory changes, or economic shifts. These are the kind of major waves that are featured on the front pages of major newspapers and magazines. Successful scale-ups, and unicorns in particular, in almost all cases coincided perfectly with a wave.

EXHIBIT 3

PERCENT OF UNICORNS ON A WAVE



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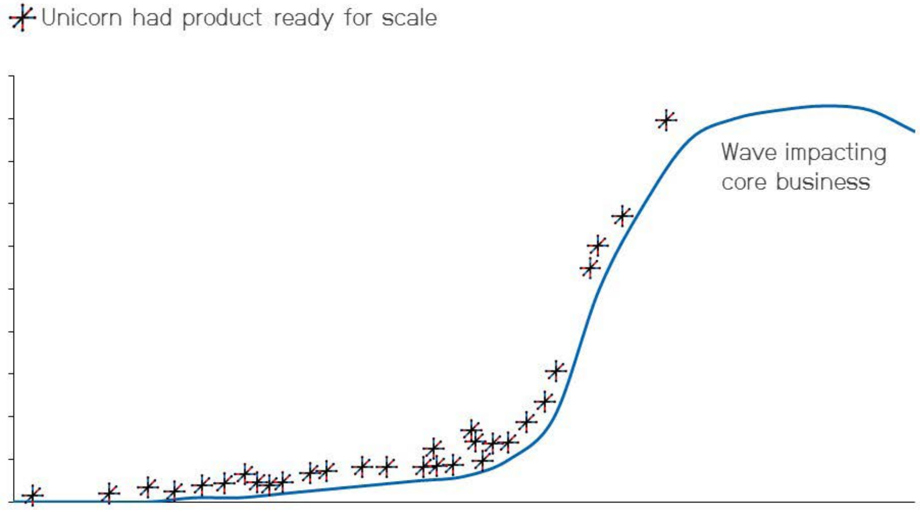
Think of Xiaomi riding the smartphone wave; Uber riding the sharing economy wave; Palantir riding the big data wave; SpaceX leveraging the discontinuation of the space-shuttle program.

Waves typically have an S-curve pattern: the wave starts to slowly gather momentum, then accelerates, until it grows to full impact and stabilizes or tapers off. The large majority of unicorns timed their market introduction just before or exactly as the wave took off. Of those, about a quarter was ready long before the wave began to form.

EXHIBIT 4

TIMING OF UNICORNS ON A WAVE



Scale-ups are more patient and take more time to get ready. For startups and scale-ups, we measured the time between establishing a legal entity and obtaining the first revenue, and what the data showed was that scale-ups took more than two times longer for market launch. They have the stamina to do all necessary preparation and wait until the conditions are right for market entry.

SCALE POTENTIAL

A business concept that is "designed to scale" can be witnessed from the outside. Some products are inherently more scalable than others: software products, online services, media and entertainment formats and content, electronics, infrastructure, and energy are some examples. Scalable products address larger markets and are well suited for international roll-outs. We found that 25% of startups were based on scalable products, while 85% of scale-ups had products that were designed to scale.

B2B businesses are more successful scale-ups than B2C, even among unicorns. B2B business models tend to take more time in the beginning, giving extensive focus to getting the product right for the first launch. But once they take off, they really take off.

"Designed to scale" can also be designed-in, that is, creating a business model that scales. This can mean an "open" business model which takes advantage of customer networks to scale. This allows the product or service to spread quickly. Uber is a prime example of an open business concept that is sustained by taxi drivers volunteering to join and an intensive feedback system to motivate drivers, and customers. Its customers spread their positive experience among family and friends, and thus encourage others to join.

Almost all unicorns (except for a true outlier like SpaceX) aim for large homogenous target markets, launch products with high "must-have" appeal that is easily accessible (e.g., mobile based) and require to be used frequently, preferably several times a day. Furthermore, they stimulate users to engage friends, peers, and colleagues to use the product: think of Whatsapp, Snapchat, Pinterest, and, of course, Facebook and Twitter.

WILLINGNESS TO SCALE

Scaling potential can also be judged by looking into the eyes of the founding team. Do the founders want to change the world, do they articulate their vision to become really big? Do they create a management team that is truly heavy-hitting, and able to build something at scale? As Bruce Kirchhoff stated in 1994, "*It is widely believed that all highly innovative firms are destined for high growth. This is not true. Some firms and entrepreneurs are simply not willing or unable to obtain the resources they need for achieving growth. In fact, it is my estimate that the unwilling exceed the unable, but no entrepreneur will admit to being unwilling. Still my experience is that the largest percentage of constrained growth firms are self-constrained.*" We were able to validate this in our mentoring experience with several hundreds of new enterprises.

THE SCALING ACT

Is there anything that can guarantee scaling? That is, assuming that the business concept is designed for scalability and that the leadership is experienced and wants to shoot for the moon.

Our research concluded that scaling is a "drop-off game" – a group of new enterprises with the potential for scale-up takes off with high growth rates, but sees their pace eventually slow down. The new enterprises with a slow growth after launch or a missed growth period almost never regain speed later on. The top 20% of new enterprises in terms of first-year revenue have a 70% chance to stay in this top-league over the next five years. The ones that started in the mid-quintile in the first full revenue year only have a 7% chance of becoming a top-revenue player later on. The bottom quintile will never reach that top 20%. In other words, aim to start in the top league, and then keep up the pace.

"Keeping up the pace" is not about dogged persistence. Instead scale-ups maintain a dynamic focus; they maintain a clear long-term vision, but are not afraid to be flexible and adaptable, which can be done by changing products and their business model along the way.

Scale-ups do not use their customers as guinea pigs. They turn their users into ambassadors by over-delivering from the very start, and keeping up that standard along the way. To quote Seth Godin, "*Lean entrepreneurs can talk about the minimum viable product, but far more important is the maximum do-able project. Given the resources you have (your assets, your time, your patience), what's the biggest thing you can possibly pull off?*"

A scalable organization is key. Once an organization starts to scale, it can become complex, bureaucratic, and administrative, or ends up duplicating efforts for lack of coordination and control. Centralized development and production with decentralized sales and services as organized by country is one effective structure for scaling, as seen at Google, Apple, Huawei, Facebook, Salesforce.com, and Uber. But all of this flies in the face of the entrepreneurial and decentralized spirits of many start-up founders.

Scale-ups anticipate and avoid the complexity of supporting ill-designed product delivery systems that have not been designed for delivery at scale. High-performing innovators rapidly drive down the cost curve, and realize ongoing improvement in functionality and customer service. This requires deep industry-specific operational expertise: Airbnb, for example, preemptively solved the problem of how to deal with hundreds of thousands of rooms that needed timely payments by using automation. In an offline world, these cash flows would require streamlining by thousands of account managers. The Airbnb business model was designed so that the entire process be computerized and directly handled between the landlord and tenant. As a result, less than 0.5% of payments require Airbnb's involvement. Now that's scalable.

Finally, as soon as unicorns pick up substantial growth, they apply for billions in investment money. At the time of writing this article, the 103 unicorns in our dataset had jointly acquired $404 billion of investment money – almost $4 billion per company. What do they use it for? Growth. Outcompeting the competition. On his last funding round of over $1 billion, Uber CEO Travis Kalanick pointed out that while Uber doesn't need money to flourish, the extra cash will allow them to conquer the Asian market earlier than they could without it.

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Does all of this compile a magical formula for scale-up success? The truth is no, it does not. What we do know is that there are some factors that can actually make a huge difference, and these can be controlled and designed for the specific purpose of scaling. When the average odds of success are less than 0.5%, that difference can be quite big.

SCALING RESEARCH PROJECT

For the Startup Scaling Research Project, Deloitte Fast Ventures assembled a database with 889.348 companies, of which 400.000 new enterprises across the Western world, spread over 24 countries and 790 industry subsectors were analyzed. All startups were established in or after 2005. Per startup, Deloitte Fast Ventures collected financial figures (e.g., revenue over time, # employees, etc.), business descriptions, as well as leadership characteristics (e.g., # founders, gender diversity of founders, founder education level, founder's corporate experience, etc.).

Subsequently, we combined the startup dataset with data from Eurostat and U.S. Bureau of Labor Statistics (e.g., industry growth and startup density within industries) to analyze the relation between startup's performance and their economic environment.

Finally, we measured the performance of a subset of the startups from different perspectives (survival rate, lead-time from establishment to generating revenue, revenue size, and revenue growth trends) and analyzed the outcomes with respect to specific startup characteristics (e.g., leadership, industry, business model, geography, etc.).

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ABOUT

Deloitte.

Deloitte Fast Ventures offers data-driven corporate venturing services. We use high quality data sources and advanced search and analytics technology to help companies map innovative ecosystems and identify relevant investment opportunities.

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THNK develops creative leaders from across corporate, private, public, and social sectors, and from all over the world. Dubbed by Stanford University as "the future of higher education", THNK leverages creativity, business model innovation, and entrepreneurship for social impact. We conduct innovation programs with leading international organizations with a passion for innovation. Our research focuses on Scaling, exploring the conditions and factors that help make innovative and socially relevant business concepts take root and grow. We have locations in Amsterdam, Vancouver, Lisbon, and Shanghai.

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