

Venture Capital Searching for Next Wave of East Coast Innovation

By Nicholas A. R. Hofer

“The biggest single trend we’ve observed is the growing acknowledgment of innovation as a centerpiece of corporate strategies and initiatives.”

So says Tom Kelley in his book, “The Art of Innovation.” Kelley, one of the key members of Silicon Valley’s most creative companies, IDEO, endlessly promotes innovation. Locally, it’s not hard to see why. Boston Private Bank & Trust Co. enjoys a unique perspective on the innovation behind some of the leading companies in Massachusetts. We see all types of strategies, visions and missions; we see companies separating themselves from the competition and others that fail to do so. The bottom line: if your business is looking for long-term success, you’d better start innovating.

Great leaders understand that promoting innovation doesn’t produce innovation; successful innovation requires diligent execution. Steve Jobs once ran a computer company; now he is best known for music and telephones. Bill Gates has given Microsoft prominence in the video game arena. And at a home here in Massachusetts, the management of Dunkin’ Donuts, sensing a declining business model, transformed their company from one that concentrated on donut sales to a company focused on coffee. The result of their strategic initiative: lines of extremely loyal, coffee-hungry customers.

Home to arguably the world’s best teaching hospitals and universities, Massachusetts provides an ideal landscape for innovation. A recent survey conducted by The Wall Street Journal asked a group of national recruiters to recognize those MBA programs that produce “the most creative and innovative students.” Among all 86 of the ranked U.S. and international MBA programs, Massachusetts enjoys three of the top 10 spots (No. 2 MIT, No. 9 Babson College and No. 10 Harvard University). These schools were chosen primarily because they have “a strong reputation for technology and entrepreneurship.”

Yet despite Massachusetts’ exceptional institutions of higher learning, when it comes to innovative companies, it’s hard to dispute the West Coast’s reputation as a leader. Google, Netscape, Apple, LinkedIn, PayPal – the list of innovators based there goes on. Even Facebook, born in Massachusetts, is now headquartered in Palo Alto, Calif. This begs the question: with such fertile ground for innovation, why isn’t Massachusetts recognized as the leader?

Since most emerging, innovative companies need funding and guidance during various stages of their business lifecycle, a venture capitalist plays a crucial role in a company’s success. But among some in the venture community, the perception is that West Coast firms are less conservative with their funds than their East Coast venture counterparts. “I would dispute this claim,” counters Josh Lerner, a professor at Harvard Business School. “That East Coast firms are more conservative is something that has been claimed for 20 years or more. But venture firms are bi-coastal now so the argument – even if once true – is not anymore.”

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It's true that pre-revenue companies may receive more funding on the West Coast than on the East Coast. However, this is because of the sheer volume of opportunities and a higher percentage of total dollars. Lerner states that, in fact, compilations suggest that the share of venture funding going to New England has, if anything, increased since the mid-1990s: certainly, Massachusetts is not seeing the vertical collapse that some alarmists would like you to believe.

While several Massachusetts venture firms “incubate” companies they feel show great promise, not all venture capitalists are willing to foster every pre-revenue company. Some, says Rashid Ashraf, a managing director at the Venture Capital Fund of New England, tend to shy away from investing in a pre-revenue company unless there is an experienced management team or a seasoned entrepreneur to move the company forward. “Seasoned entrepreneurs don’t need as much hand-holding when launching a company,” Ashraf explained. “They don’t need to be taught what to do.” Venture capitalists, while focused on the company’s competitive advantage and market potential, tend to lean towards experience and familiarity. Knowing the track record of the management team is the venture capitalist’s way of reducing risk in an already risky investment.

Bessemer Ventures, a successful venture capital firm operating on both coasts, highlights on their Web site some of the riskier investment opportunities that failed to receive its dollars. Titled “Anti-Portfolio,” the list includes such companies as Google and Apple. But Bessemer wasn’t the only firm, east or west, to reject these now iconic companies. “A company may get rejected by every major venture firm on Sand Hill Road,” says Ashraf. “But all you hear about is the one West Coast firm that invested ... and then you hear about the East Coast firms that passed. No one hears the complete story.” (By the way, a firm like Bessemer is able to post their missed opportunities because of a stellar reputation of picking exceptional companies. Ever heard of Staples?)

Overdue Home Run

The abundance of merger and acquisition transactions of the late 1990s and early 2000s could partially explain the exodus of some innovative entrepreneurs from the Massachusetts region. With many of the acquiring companies being from the West Coast during this period, after the transaction was complete, often times these West Coast companies would move the senior management team to their “hometown” headquarters. Instead of a thriving office headquartered in Massachusetts, what was left was either a satellite office, a diminishing presence in the region or no office at all. Subsequently, many management teams, full of seasoned entrepreneurs and innovators, tended to stay on the West Coast when pursuing future opportunities.

Portfolio companies and their innovative leaders help fuel the local economy and, as a result, the demand for Massachusetts real estate; the landscape, however, has changed. “The late 1990s and early 2000s witnessed such low vacancy rates that space was often auctioned off to the highest bidder with the best credit,” says Jim Nicoletti, executive vice president and partner at CB Richard Ellis. “Since 2005, after a cooling-off period, things have been hopping again – not as

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strong as the previous high-water mark, but pretty darn good nonetheless.” Massachusetts, once a hotbed of technology manufacturers with firms like Data General and Prime Computer, has evolved into a service-oriented economy. While many technology firms still exist and thrive in Massachusetts, other industries such as life sciences and biotechnology have emerged as the “next big thing” for the Bay State. The emergence of these fields will have an impact, not only for real estate but also in banking, as banks see the benefits of seeking out clients from these flourishing industries – both on the corporate and personal sides.

The perception of Silicon Valley as the most innovative spot in the country may have more to do with critical mass than anything else. As opposed to biotechnology, which generally comes out of the teaching hospitals and educational facilities, new information technology firms are more apt to emerge from existing IT firms. One look at the alumni of such firms as Google, Netscape and PayPal and it’s easy to understand how Silicon Valley continues to lead the charge in technology.

The real issue is not the lack of innovation or talent in Massachusetts, or the westward migration of innovative companies; rather, it is the skewed distribution of returns that is causing this false perception. A small amount of investments by venture capital firms have encompassed the bulk of the returns; these investments happen to be located primarily on the West Coast, reinforcing the false perception that the West Coast exceeds other areas of the country in terms of opportunity and innovation. Boston Private Bank & Trust Co. works with some of the premier venture capital and private equity firms in Massachusetts. Our clients, who represent over \$20 billion in assets under management, are continually searching for the next big innovation on the East Coast. And so is every other Massachusetts venture capitalist.

“It’s been a long time since there has been a really big home run here,” says Catherine Crockett, founder and general partner of Grove Street Advisors. “And East Coast managers are certainly aware of this.”

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