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High-Risk/Reward Startup Investing: Tech-Driven vs. Tech-Enabled Startups

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A lot of folks think of high-risk/reward startups in terms of technology, probably because most people think of Silicon Valley, the epicenter of high-risk/reward startup investing, primarily in terms of technology innovation. And, indeed, most Silicon Valley startups are “technology” businesses in the popular sense of the word. That said, there are technology startups, and then there are *technology startups*. Let’s call the first group “tech-enabled” startups, and the second group “tech-driven” startups.

Tech-driven startups succeed – or fail – according to their ability to timely and economically develop and commercialize products and services that incorporate new and often proprietary technology innovation. They are the “real thing” technology-wise. Companies like Intel and Genentech are tech-driven in the sense that their success is rooted in creating compelling value propositions for their customers by pushing technology envelopes. While most tech-driven companies are not primarily research-driven (though they often have research arms, and work closely with public and private research organizations), their success hinges on when, how, and at what cost they can push the technology envelope to drive their customer value propositions past the offerings of their competitors.

Tech-enabled startups, on the other hand, generally do not push technology envelopes, but rather work creatively within those envelopes. They are more “users” of innovative technology than “creators” of the same. Lyft, for example, creatively uses available software technologies to conceive and realize new products and services that offer compelling value propositions in the personal transportation space.

If you are having trouble seeing the tech-driven/tech-enabled distinction consider two startups, Nvidia (graphic and AI chips) and Lyft. When investors thought about Nvidia’s technology risk profile, they doubtless had serious concerns about whether Nvidia could actually deliver the technology that was at the heart of their customer value proposition.

There was a material risk that Nvidia could not make their technology vision work.

Now, think about Lyft's early investors. Do you think they spent a whole lot of time wondering whether the founders' vision was doable in a technology sense? When they tallied up the list of investment risks for Lyft do you think the technical feasibility of developing the necessary software was very high on the list? (If it was, it shouldn't have been.)

And now, the key tech-enabled/tech-driven distinction in terms of investment analysis: solving tech problems "within the envelope" (tech-enabled) almost always costs less, takes less time, and involves less "can it even be done" risk than solving problems that require expanding the technology envelope (tech-driven). And so, it turns out that tech-driven startups usually involve longer technology-associated time horizons, larger capital needs, and more technical "can it be done" risk than otherwise similarly situated tech-enabled startups. And that, in turn, means that other things being equal there is more *financing risk* – the risk that a deal will crater for lack of access to capital – in most tech-driven startups than tech-enabled startups.

The added financing risk of the typical tech-driven startup is something smart investors factor into their investment analysis. It is particularly important when they look at tech-driven startups located in places with limited access to larger risk capital pools. And, it is critically important when those same deals involve technical founders who don't already have serious street cred with larger risk capital investors in larger markets. At the end of the day, it explains why smaller investors, in places with limited access to larger risk capital pools, should generally steer clear of tech-driven startup deals.

All of that said, the startup world, not unlike life in general, is seldom reducible to simple "either/or" dichotomies. General rules, including the one discussed above, are often accompanied by various exceptions and qualifications. Here are a few of those applicable to the tech-enabled/tech-driven dichotomy.

Envelope vs. Execution Risk. The argument that tech-driven startups have greater technology risk than tech-enabled companies does not mean that tech-enabled companies don't have technology risk. Execution risk can be as significant in the tech-enabled context as the tech-driven context. Suppose, for example, your author, who last wrote a software program (a half-dozen lines of Basic code) thirty years ago, was pitched by Lyft as its Chief Software Engineer. The intrinsic technical risk would still have been modest even as the technical execution risk would have been prohibitive. Just because something is doable, doesn't mean Jane Doe can do it.

Technology Risk vs. Market Risk. When we say that tech-enabled companies are generally less capital- and time-intensive than tech-driven companies, the focus is on capital and time needed for technology development. So, for example, while Lyft's technology risk is generally lower than Nvidia's, Lyft's market risk and related investments – think customer acquisition and branding – are much greater than Nvidia's. Tech-enabled companies (as tech-driven) can absorb enormous amounts of capital on key tasks like customer acquisition and branding.

Bookends vs. Bookshelves. Tech-driven and tech-enabled are categorical bookends, and there is plenty of room on the shelf between them for tech-mixed businesses. Uber and Lyft both started out pretty far to the tech-enabled end of the bookshelf. However, while Lyft has pretty much stayed there, Uber later invested billions of dollars in envelope-pushing new technologies, mostly around autonomous vehicles.

It's worth noting, though, that Uber and Lyft started out as pretty much tech-enabled pure plays, with Uber adding tech-driven investments, well after its startup stage and initial market penetration.

At the end of the day, technology companies come in many flavors, not just in terms of their particular innovation focus, but also in terms of whether they are fundamentally creative developers of mostly-existing technology (tech-enabled companies), or alternatively, they are premised on actually pushing technology envelopes and commercializing new technology (tech-driven companies). Investors, particularly smaller investors outside of regions with ready access to larger pools of risk capital, are particularly advised to consider those distinctions when they consider startup investment opportunities, as well as to avoid tech-driven deals unless they are comfortable with the generally greater financing risk of those deals.

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