CHAPTER 12

Taking a Job with an Entrepreneurial Firm

INTRODUCTION

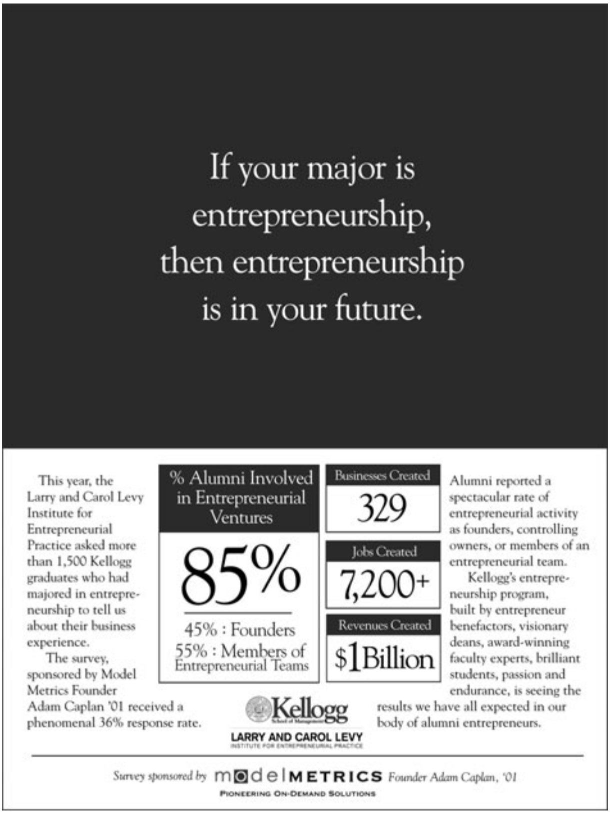
Five years ago, the Levy Entrepreneur Institute at Kellogg published the findings of our research regarding Kellogg alums and entrepreneurship. Specifically, we wanted to answer the question, how many of our 45,000 alums have become entrepreneurs? The first stage of this research focused on alums who majored in entrepreneurship from 1997 to 2005, while they were students. We contacted 1,500 alums and got a 36 percent response. We were enormously happy with the findings, which are given in Figure 12-1.

One of the unexpected takeaways from the research was that a large percentage of our alumni who were involved in entrepreneurship were employees in an entrepreneurial firm. They had resigned from their safe job with successful investment banking, consulting, or manufacturing companies and had taken a job with a start-up firm. How does a person make such a decision to leave the security of a well-established, in many instances Fortune 500 company to work for a high-risk venture in its embryonic stages of development?

The following case study, followed by an analysis of the situation, should be used as a template for answering these questions: Should I leave my job to take a job with a start-up? How should I do a financial analysis of the decision?

FIGURE 12-1

Results of Kellogg Alumni Entrepreneurship Study



CASE STUDY: CONSIDERING A JOB OFFER FROM AN EARLY-STAGE COMPANY

In her Chicago home on a warm Friday afternoon in June, Nailah Johnson, who was graduating from the weekend Executive MBA (EMBA) program at the Kellogg School of Management in 2 weeks, hung up the phone. She was happy. John Paul, founder of AKAR and Johnson's potential future employer, had said as their conversation ended: "Tell me what it would take to get you on board."

For many reasons, Johnson was excited about joining an entrepreneurial firm and possibly much later even buying her own business. She recalled including this goal in the essays that had helped her gain admission to the Kellogg School 2 years earlier. The role Paul wanted Johnson to have at AKAR was appealing: a director of sales and marketing position with significantly more responsibility than Johnson currently had, and with possible promotion to vice president in less than 12 months. Johnson had heard about the many downsides and upsides of positions with an early-stage company. If the company failed, it could result in a direct financial loss because employees at start-ups were paid low salaries. On the other hand, the financial rewards could be lucrative if the employees owned part of the company and its value increased.

Johnson had joined Motorola in 2004 as a director of operations. Recently, based largely on her Kellogg School training and her desire to broaden her on-the-job skills, Johnson had successfully moved to a product marketing manager role. She and her husband enjoyed comfortable professional and social lives in Chicago. Just 2 days earlier, Johnson had informed her husband that she was pregnant with their first child. They expected this new addition to their family to increase their annual budget by $19,000. Early in their marriage, they had envisioned her becoming a full-time mother when the time came.

Still giddy from Paul's call, Johnson sat at her kitchen table, thinking about what he had said: "The sooner we can start you, the better." Until that moment, Johnson would have predicted that she would accept the position with AKAR on the spot, on almost any terms that sounded reasonable; after all, she had invested many months and a great deal of energy in making it happen. But now, as the costs and benefits of the position swirled through her mind, she felt unsure about what terms to request. Johnson owed Paul an answer in 5 days, but she was not sure if she could determine what she wanted even if she had 3 months. She also considered rejecting this opportunity because the risk was too high and the timing was poor. Finally, she wondered, if she took this or any other job, would she ever become an actual entrepreneur, or would she always be simply someone's employee? Should she pursue acquiring her own company instead?

In many ways, Johnson's career was typical for an MBA student. Thus, despite her interest in entrepreneurship, seriously considering an offer from an early-stage company was new territory for her. As Johnson reflected on the offer's pros and cons, she thought back to the path that had led her here.

Walking the Straight and Narrow

Johnson had attended Williams College, graduating near the top of her class (see Figure 12-2 for Johnson's résumé). Immediately after college, she began her career at Sun Microsystems and later moved to Motorola. Although Johnson enjoyed working on mobile devices, she found the business issues related to them even more interesting: Who were their target segments? What were the best ways of distributing and marketing the products? What kinds of new products were most likely to survive?

FIGURE 12-2

Nailah Johnson's Résumé

Nailah Johnson
EDUCATION:

2005–present **KELLOGG SCHOOL OF MANAGEMENT** Evanston, IL

Executive Master of Business Administration, GMAT 770

- Majors in Management & Strategy, Finance, and Marketing
- Member of NBI team that created a strategic marketing plan for Handi-Ramp Foundation; member of Kellogg team that reached the school finals for AT Kearney Global Prize competition
- Entrepreneurship Club Member; GIM-China participant; logistics director for India Business Conference

1995–1999 **WILLIAMS COLLEGE** Williamstown, MA

BACHELOR OF SCIENCE IN COMMUNICATIONS, GPA: 3.92/4.0

- Financed 100% of education through assistantships
- Selected as key instructor for freshman-level mathematics courses. Taught classes of forty students, consistently receiving high ratings (4.5/5). Selected to teach remedial courses
- Member of school's five-person badminton team. Won the zonal championship in 1996

Continued on next page

FIGURE 12-2

Nailah Johnson's Résumé (continued)

EXPERIENCE:

2004–present **MOTOROLA** Chicago, IL

Senior Director of Sales (2006–present)

- Manage marketing for next-generation mobile video service with expected commercial value of $48 million over 5 years
- Coordinated cross-functional team, including eight experts from different divisions of Motorola, to develop marketing plan for mobile video system
- Independently led research initiative to explore new distribution channel for music and talk shows on cell phones. Market estimated at $2 billion

Director of Global Product Marketing and Director of Operations (2004–2006)

- Selected technical consultant on an 8-month-long project valued at $2 million. The project cemented Motorola's relationship with a major external customer
- Collaborated with six other research experts to develop differentiating technology for the $13 billion home networking market. Technology is showcased in Motorola's Horsham (PA) innovation center
- Selected into Motorola's Applications Research patent committee of ten senior researchers among eight hundred to evaluate the technical and business viability of innovation ideas; authored eight Motorola patent applications and five external publications

1999–2004 **SUN MICROSYSTEMS** Oak Brook, IL

Senior Product Manager (2002–2004)

- Led eight-person, $2 million platform integration project for new SPARCstation products
- Presented major Sun engineering initiatives to more than one hundred client managers at annual customer meeting
- Selected from more than sixty other project leaders to demonstrate research prototype at WIRED NextFest 2004. More than twenty thousand members of the public attended the exposition

Product Manager (1999–2002)

- Presented research to senior Sun executives. Presentation was subsequently broadcast to more than thirty thousand Motorola engineers
- Awarded "Significant Achievement Award" for integrating third-party location detection system one month ahead of schedule

ADDITIONAL INFORMATION:

- Robot inspector for Midwest regional championship. USFIRST, an organization that aims to increase interest in science and engineering among children, hosted the event
- College lacrosse enthusiast (fanatical supporter of Williams College). Enjoy playing golf and traveling

These interests led to Johnson's application to the Kellogg School. Because she had always had an interest in start-ups, she took several courses in entrepreneurship and joined the entrepreneurship club. As part of these student activities, Johnson enjoyed discussing entrepreneurship, especially the potential for new high-tech products, but her career goals remained focused on larger-company opportunities. In line with this, she pursued a marketing manager position at Motorola and was pleasantly surprised to receive an offer. The new position came with a salary of $115,000 (a 30 percent raise that put her in the 28 percent tax bracket), bonus potential of approximately 25 percent of her salary, and responsibilities for marketing a next-generation mobile video device. Johnson loved the work, and was already in line for a promotion to business development manager.

Taking on the new position a year ago had not been the only change in her life: she married Naeem, her classmate at Kellogg, soon afterward. They purchased a $400,000 two-bedroom condo in Chicago. The Johnsons made a 20 percent down payment (their entire savings) and secured a 30-year fixed-rate mortgage at 6 percent interest. The mortgage and the school loans were their only debts. Monthly assessment, taxes, and insurance were approximately 40 percent of the mortgage. All other household expenses, including telephone, electricity, cable, gas, and groceries, were approximately 35 percent of the monthly mortgage. They owned two cars, which were paid in full.

By the time Johnson was considering a position with AKAR, Naeem had also been promoted at Kraft; his salary was $105,000, with a bonus of approximately 20 percent. His company's health, medical, dental, and vision care insurance were all free. Together, the couple led a busy but enjoyable life, building their career experience, earning their MBAs, and taking vacations. They spent approximately 25 percent of Naeem's monthly salary on recreational activities. Despite some tuition reimbursement from their companies, they amassed significant student debt (see Figure 12-3).

Below is a summary of all loans processed by the financial aid office as of 6/14/2007. The principal amounts listed are the original principal balances. These amounts do not reflect any payments made to these loans. Loans from other institutions are not included on this form.

FIGURE 12-3

Student Loan Separation Statement

Kellogg School of Management
Office of Financial Aid
June 14, 2007
Nailah Johnson
652 W. Evans Dr.
Chicago, CO 80201
Separation Date: 14-JUNE-2007
School: Kellogg School of Management

Lender	Guarantor	Int.	Loan Type	Amount Borrowed
Kellogg 555 Clark St. Third Floor Evanston, IL 60208	Illinois Student Assistance Co. 500 W. Monroe 3rd Floor Springfield, IL 62704–1876	6.8%	Subsidized Stafford	$17,000.00
Kellogg 555 Clark St. Third Floor Evanston, IL 60208	Illinois Student Assistance Co. 500 W. Monroe 3rd Floor Springfield, IL 62704–1876	6.8%	Unsubsidized Stafford	$22,000.00
Kellogg 555 Clark St. Third Floor Evanston, IL 60208	Kellogg 555 Clark St. Third Floor Evanston, IL 60208	5.0%	Perkins	$12,000.00
Total				**$51,000.00**

The Search for More

While she had walked a successful career path to date, for the last several months, Johnson had found several questions frequently on her mind: Is this all there is, career-wise? How can you keep more of the value that you are creating for yourself? How can you become a millionaire without risking everything? These questions also arose when she recalled how much she had enjoyed her entrepreneurship classes or heard news of others' entrepreneurial accomplishments.

According to the *Kellogg World* alumni magazine, Deniece Grant, a recent alumna from the part-time evening program, had raised $4 million in angel and early-stage venture capital for the company she founded, which provided software that allowed computers to search automatically for information related to documents on which the user was working. Grant gave "put rights" to some of her managers who owned stock in the company. She had originally given these employees restricted stock units (RSUs) when they were hired.

Raymond Robinson, a friend of Johnson in Chicago who had graduated from the full-time day program 2 years earlier, was already a vice president with a 2 percent ownership stake after exercising the stock options given to him when he was hired at a wireless technology company that had just completed a successful initial public offering (IPO). Robinson was now a multimillionaire. His stock options were originally scheduled to vest 20 percent annually after his second year of employment. But the IPO triggered the "change in control" clause, resulting in the immediate full vesting of 100 percent of his options. "That could be me," Johnson thought when she heard such stories.

Four months ago, after the completion of a very challenging project at work, Johnson had decided to stop sitting on the sidelines of entrepreneurship. She began reading entrepreneurship magazines and books, reaching out to friends who she thought would know of opportunities with early-stage companies, scouring the Kellogg School alumni database for people in small firms, and setting up as many informational interviews as she could. Johnson also connected with a recruiter who specialized in placements at early-stage firms and a business broker who could show her businesses for sale. The time she spent on the search, on top of her responsibilities at work and at school, left Johnson with almost no space in her weekly schedule for fitness, social activities, or spending time with Naeem. But it felt like the right thing to do.

Despite Johnson's enthusiasm for the search, months passed without major progress. If anything, like a corporate Goldilocks, she discovered many of the things she was *not* seeking in a new opportunity: what had appeared initially to be several promising positions were rejected as being too risky (a five-person software company in the initial fund-raising stage), not exciting enough (a firm that provided marketing solutions to the paper industry), or too strange (a venture that developed software so proprietary that the founders asked all employees to sign nondisclosure agreements—daily).

But 2 months earlier, Johnson's luck had changed when she met John Paul. Johnson had signed up to meet him through the entrepreneurship center's Entrepreneur-in-Residence program (EIR), through which entrepreneurs and principal investors spent a full day at Kellogg meeting in 30-minute sessions with individual students to answer questions and provide experience-based insights.

AKAR: The Opportunity

John Paul was only 46 years old, but he had already sold two companies. According to an article Johnson had read, AKAR, Paul's most recent venture, was very promising and had received significant industry attention. The article also characterized Paul as a "gambler with great judgment—or maybe great luck."

After dropping out of Grambling University in 1981, Paul had worked as a computer programmer for a series of video game manufacturers before moving into roles in operations and database design. He prided himself on being self-taught in most aspects of business, from finance to marketing: "Best teachers I ever had? Trial and error," he often said. Paul sold his first company, GamerParadize (launched out of his apartment 6 years earlier), one of the first online gaming portals, to Midway Games for $40 million (20 times its revenues) in its third year of operations. Paul owned 60 percent of the company, and the top two levels of management (vice presidents and managers), consisting of nine people, owned 20 percent. At closing, the four vice presidents shared $4 million. The remaining 20 percent went to the investors, who had invested $2 million 5 years earlier.

Paul was much more ambitious for his second company: to fund X-Cell, an Internet design and security firm, he obtained venture backing of $15 million. He had "call rights" agreements with all managers who owned stock in the company, giving him the option to buy the stock back at any time at a multiple of 3 times the original price. Unfortunately, because of a patent-related lawsuit, X-Cell had to stop marketing its main security product, and Paul and the investors decided to sell off all assets in 2003, losing a portion of their investment.

AKAR was Paul's current company. Based in Chicago, the tech company had been built around a simple idea that Paul had developed with his chief technology officer (CTO), who had worked with Paul at X-Cell: distributing digital information across several geographically dispersed storage sites to store it more securely, reliably, and cost-effectively. AKAR was commercializing this idea as an online data storage service while offering commercial software for firms seeking to build their own storage capabilities. With this value proposition, AKAR was trying to capture share of the $43 billion global data storage management services market, with initial focus on the $3.3 billion U.S. market for automated data backup services.

At the time that Johnson met Paul, AKAR had just launched the commercial version of its backup services. With only a few loyal customers in place, the firm's revenues were minimal, but Paul—and many observers—was confident that that would change soon (see Figure 12-4 for AKAR's pro forma financials). Paul had self-funded much of AKAR, but he had also received round A financing of $3.2 million from one venture capital group in return for 23 percent of AKAR.

FIGURE 12-4

AKAR Financials (Pro Forma)

	Best-Case Scenario				
	Year 1	**Year 2**	**Year 3**	**Year 4**	**Year 5**
Revenue	$950,000	$5,000,000	$10,000,000	$20,000,000	$40,000,000
	Most-Likely Scenario				
	Year 1	**Year 2**	**Year 3**	**Year 4**	**Year 5**
Revenue	$950,000	$2,500,000	$5,000,000	$7,500,000	$15,000,000
	Worst-Case Scenario				
	Year 1	**Year 2**	**Year 3**	**Year 4**	**Year 5**
Revenue	$950,000	$1,500,000	$2,500,000	$3,000,000	$3,500,000

Aside from CEO Paul, AKAR had 14 employees; most of these were engineers with hardware and/or software experience, several of whom had come to AKAR directly from college. None of them, including Paul, was paid a six-figure salary. Paul believed that everyone should sacrifice salary for annual performance bonuses and company stock. The only other senior manager at AKAR was Mark Chin, the CTO. Chin had helped Paul build X-Cell. "My right- and left-hand man," Paul often called him.

From the moment Johnson met Paul, she described the recruiting process as "casual, but intense." For example, the day after the event where they first met, Paul called Johnson and told her how impressed he had been by Johnson's qualifications. "You'd make a heck of a marketing director," Paul said numerous times. In the weeks that followed, the two kept in close contact: three phone calls that lasted late into the night, several strings of e-mail correspondence, and two dinners. During these interactions, they discussed technology trends, the fit between Johnson and AKAR, sports, and Paul's personal life. Johnson learned that Paul had divorced and remarried ("Second time's the charm, so far") and had two elementary school–age stepchildren, a 132-foot yacht ("Want to sail her around the world—hopefully after selling this company"), and Type II diabetes ("For me, they're not doughnuts, they're dough-nots").

One month ago, Paul had invited Johnson to meet the CTO and tour AKAR's office, a hip loft space in the Bronzeville neighborhood of Chicago. The meeting with CTO Chin was similar to Johnson's encounters with Paul: casual but intense. For almost two and a half hours, Chin discussed AKAR's products, mission, and culture, rarely pausing to ask Johnson questions. When he did, it was typically to probe Johnson's level of commitment to AKAR's vision and mission. During the marathon interview, Chin used the phrase "John's way" often, endowing it with an almost mythical quality. After the interview, Paul and Chin introduced Johnson to several of the other employees and took her out to dinner with a customer. On her way home, an exhausted Johnson called Naeem. "It's like I already work there," she told him.

Four days after the meeting, Paul called Johnson with good news: the team wanted to make her an offer. "But first," Paul said, "it would mean a lot to us if you and Naeem came to 'Shut Up and Sing' in 2 weeks." Johnson thought she had misheard Paul, until he explained: Shut Up and Sing was a party that Paul threw twice a year at his house for all AKAR employees and their spouses or partners. The two main ingredients: homemade sangria and karaoke.

Two weeks later, Johnson and her husband attended the party. Paul stayed by Johnson's side most of the night, guiding her around his large lakefront home and introducing her as "guest of honor and future marketing director." For Johnson, the night was a blur of smiling faces, handshakes, and her singing "Girls Just Wanna Have Fun" in front of about 50 people she barely knew. She also could not help but feel that the party had been a final test for her, to see how well she would fit at AKAR.

Four days later, Paul called, as enthusiastic about Johnson as ever. Johnson had expected an offer from Paul, even if only verbal. Instead, Paul had said, "Tell me what it will take to get you on board."

Decisions, Decisions

As Johnson sat at her kitchen table, thinking about Paul's words and the position with AKAR, Naeem returned from work. She smiled at him. "They want to hire me," she said.

"Great news!" Naeem hugged her. "What's their offer?"

CASE STUDY ANALYSIS

The following questions illustrate key items for Nailah to consider as she evaluates the opportunity with AKAR.

Question 1: Should Nailah keep her job?

Yes	No
■ She has a new baby.	■ The new job is an opportunity for entrepreneurial experiences.
■ She has job security with her current position.	■ There is limited financial upside in her current position.
■ Her current company is stable and established.	

Question 2: Should Nailah pursue the AKAR employment opportunity?

Yes	**No**
■ They want her	■ Decrease in salary
■ More responsibility	■ Paul's quirky personality
■ Promotion opportunities	■ Company could fail
■ Wealth opportunity	
■ Nailah's passion for entrepreneurship	
■ Paul's past success	
■ Chance to experiment with entrepreneurship	

Question 3: What are Nailah's personal strengths and weaknesses?

Strengths	**Weaknesses**
■ Smart	■ Never been an entrepreneur
■ Successful business career	■ No finance experience
■ Sincerely interested in entrepreneurship:	
■ Hired specialized recruiter	
■ Worked with business broker	
■ Participated in Entrepreneur-in-Residence program	

Question 4: What are John Paul's strengths and weaknesses?

Strengths	**Weaknesses**
■ Founded two companies	■ X-Cell failure
■ Wealthy	■ Quirky personality
■ Willing to share wealth with employees	
■ Made other people rich (Midway Games), including:	
■ Investors	
■ Managers	

Question 5: What was the value of GamerParadize to each stakeholder?

Stakeholder	Total Financial Return
■ Paul	■ $24 million (60% of $40 million)
■ Investors	■ $8 million (20% of $40 million) – Original investment: $2 million – Time: 5 years – Cash-on-cash return: 4× – ROI: 300% – IRR: 32%
■ Employees	■ $8 million (20% of 40% million) – 4 V.P.s: $4 million, or $1 million each. – Managers: $4 million, or $800,000 each

Question 6: What is the Johnson family's current maximum income?

	Salary	Bonus	Total
Nailah (salary)	$115,000	$28,750 (25% of salary)	$143,750
Naeem (salary)	$105,000	$21,000 (20% of salary)	$126,000
Total	**$220,000**	**$49,750**	**$269,750**

Question 7: What is the Johnson family's after-tax cash flow?

	Worst-Case (without bonus)	Best-Case (with bonus)
Nailah and Naeem	$220,000	$269,750
28% tax	−$61,600	−$75,530
Total	**$158,400**	**$194,220**

Question 8: What is the Johnson family's current budget?

Expense	Annual	Monthly
1. New baby	$19,000	$1,583.33
2. Household expenses (35% of monthly mortgage)	$8,058	$671.50
3. Assessments, taxes, and insurance (40% of monthly mortgage)	$9,209	$767.42
4. Recreational activities (25% of Naeem's monthly salary)	$26,250	$2,187.50
5. Five school loans (10-year amortization)	$6,913	$576.10
6. Mortgage (principal and interest)	$23,022	$1,918.56
Total	**$92,452**	**$7,704.56**

Question 9: What is the minimum amount of cash that Nailah needs to bring home for the Johnson family to pay their expenses?

Naeem's salary (worst case, without bonus)	$105,000
axes	−$29,400
Naeem's after-tax cash	**$75,600**
Family budget	$92,452
Naeem's after-tax cash	−$75,600
Cash needed from Nailah	**$16,582**

Question 10: What should Nailah propose?

Key Terms to Propose
At least 4% raise annually
Put rights
2–3% ownership
Starting salary $95,000
Change of control clause with immediate vesting
6-week maternity leave with full pay
No termination without cause
3-year contract
Stock options *or* restricted stock units

Question 11: What is the difference between stock options and restricted stock units?

	Stock Options	Restricted Stock Units
Stock-based compensation?	Yes	Yes
Employers required to expense immediately?	Yes	Yes
Taxed when?	At exercise of option	At time of vesting
Employer required to withhold taxes?	No	Yes. Some options: 1. "Same-day sale" 2. "Sell to cover" (sell just enough to cover taxes) 3. "Cash transfer" (you give the employer cash to cover taxes and keep all the shares
Retains value?	Not always. Example: ■ Strike price: $10 ■ Stock price: $8 ■ Has no value ■ "Underwater" ■ Lost 100%	Yes. Example: ■ Given at $10 ■ Stock price at vesting: $8 ■ Lost 20%

Question 12: What is the potential future value of AKAR?

GamerParadize multiple of revenue	20
Best	20 × $40,000,000 = $800 million
Likely	20 × $15,000,000 = $300 million
Worst	20 × $3,500,00 = $70 million

Question 13: How much could Nailah make?

Nailah's potential ownership stake	2%
Best	2% × $800 million = $16 million
Likely	2% × $300 million = $6 million
Worst	2% × $70 million = $1.4 million

Question 14: Is she entitled to 2 percent of the company or 2 percent of the new value of the company?

She's entitled to 2 percent of the company.

Question 15: What is the starting point for Nailah's value?

Equity series	**A**
Investment	$3.2 million
Premoney valuation	$10,713,043
VC ownership stake	23%
Equation for postmoney valuation	23% × Y = $3,200,000
Postmoney valuation	$13,913,043

Question 15a: What is the worst case for Nailah?

Worst-case future value of AKAR	$70,000,000
VC ownership	$13,913,043
Remaining equity	$56,086,057
Nailah's ownership stake	2%
Nailah's potential return	$1,121,739

Question 15b: What is the financial difference of staying versus going?

Scenario 1: Remain at job for 5 years with 4% increase annually

Year	**Worst Case (Guaranteed Compensation)**	**Upside (Bonus)**
0	$115,000	$0
1	$119,600	$29,900
2	$124,384	$31,096
3	$129,359	$32,339
4	$134,533	$33,663
5	$139,914	$39,978
Total	**$647,790**	**$161,946**

Total value of staying = $809,736

Scenario 2: Take AKAR job with 4% annual increase

Year	Worst Case	Equity
0		
1	$95,000	
2	$98,800	
3	$103,740	
4	$107,889	
5	$112,204	$1,121,739
Total	**$517,633**	**$1,121,739**
Total value of taking job = $1,639,372		

Comparison of staying versus going:

Value of staying	$809,736
Value of going	$1,639,372
Difference	$829,636
Percent difference	102.26% better to take job