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How to build a unicorn: Lessons from venture capitalists and start-ups

New data highlights five things incumbent businesses could learn from venture capitalists and unicorns.

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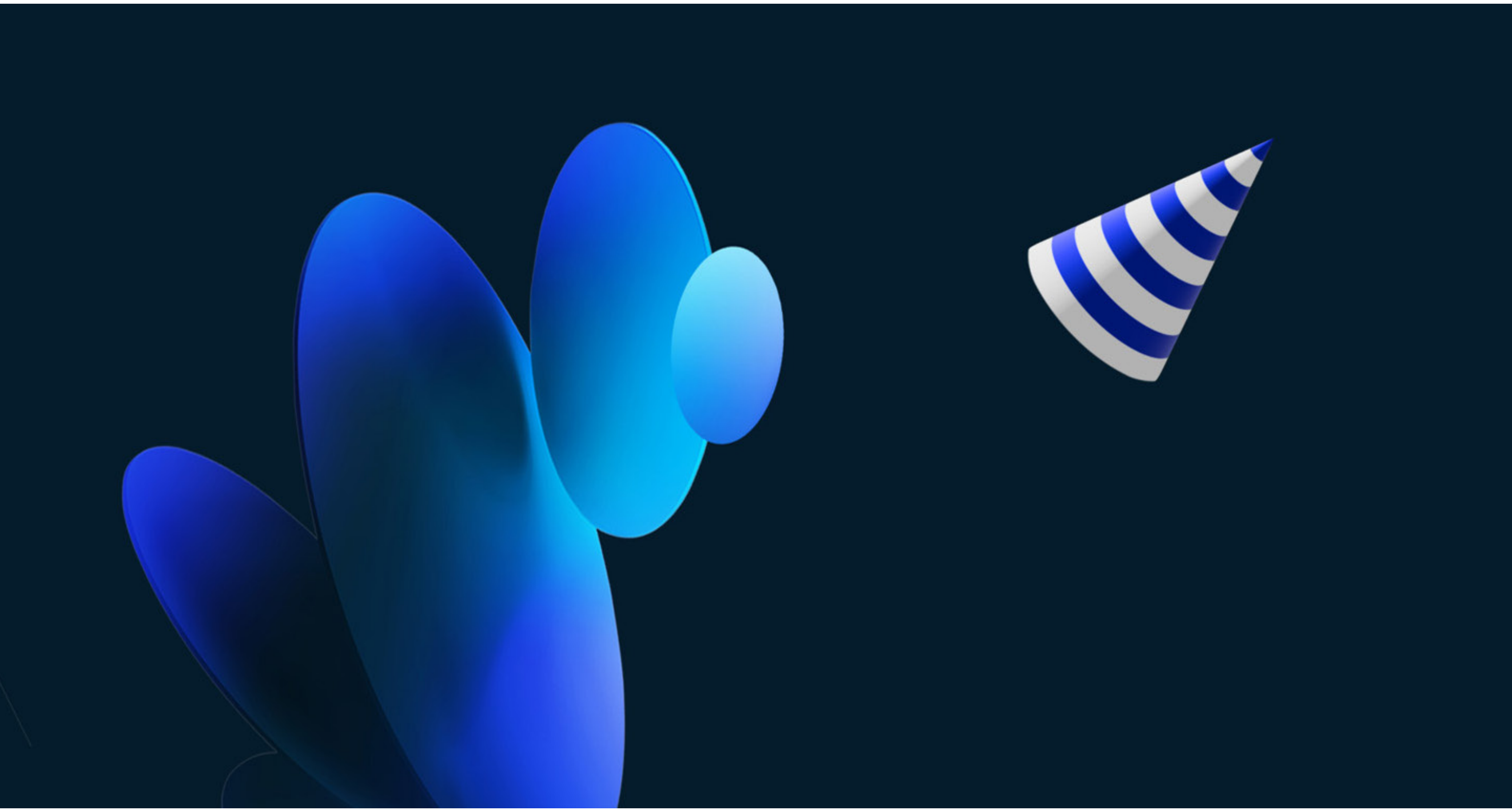

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A mythology often grows up around unicorns—start-ups with valuations of $1 billion or more—that burst onto the scene, with stories of bold action, "crazy" bets, quirky personalities, and luck. While these myths may make for great storytelling, underneath them lies a set of facts that helps to explain unicorns' success. Understanding these facts and how they can be applied to other enterprises is particularly important for CEOs of large businesses looking to build new revenue, bolster resiliency, and court venture capitalists (VCs).

To help incumbents launch new businesses, we at Leap by McKinsey interviewed ten successful VCs and angel investors and analyzed 100 unicorns to distill what really matters in developing start-ups. This analysis revealed five things that help start-ups morph into unicorns.

Five Ts for finding unicorns

VCs looking for companies that have unicorn potential ask five key questions as they evaluate prospective investments. Executives at companies seeking VC support for their new businesses should ask them, too.

1. Teams: Do they have sufficient experience and networks?

A common mantra among VCs, particularly about early-stage funding, is "Invest in people, not in businesses." But what kinds of people and in what kind of teams? Our analysis yielded four facts (Exhibit 1):

— *Mavericks are the exception*. The vast majority of successful scale-ups (around 75 percent) were started by two or more people.

— *Diverse founding teams are best*. Top founding teams bring complementary skill sets to the table. Their backgrounds include a mix of expertise in technology (around 40 percent of founders), natural science (around 25 percent), and business (around 25 percent).

— *University education still matters—a lot.* A large majority of founders of the top 100 unicorns have completed an academic degree (more than 95 percent), and more than 70 percent have advanced degrees such as a master's, an MBA, or a PhD. Interestingly, where the degrees came from mattered less. While about 25 percent of founders got their degrees from top US schools such as Stanford, Harvard, Yale, Wharton, or MIT, the rest came from other institutions. With education come important networks. More than 70 percent of cofounders went to the same university prior to building their unicorn.

— *Track records and experience are essential.* It is unlikely that founders will build a top 100 scale-up on their first attempt. More than 80 percent of founders gained work experience prior to building their successful venture, and more than half had founded start-ups before.

While these patterns broadly hold true globally, there are some regional differences. Founders of Asian scale-ups, for instance, commonly have less work experience prior to starting their venture. Top European scale-ups also have a significantly higher share of female founders (16 percent versus 12 percent globally).

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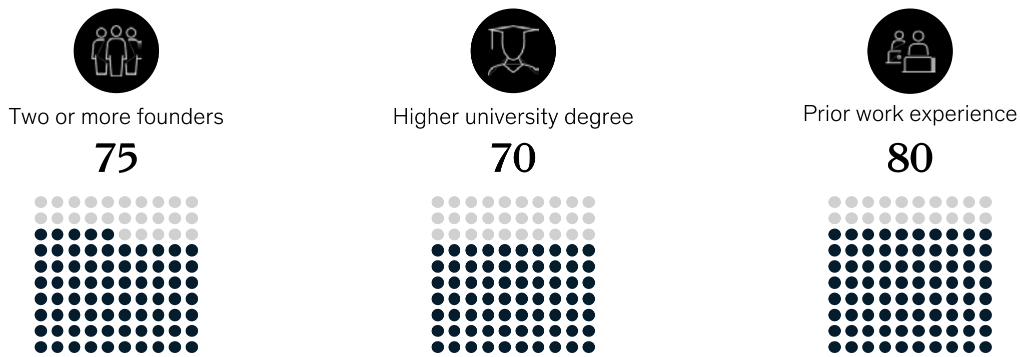
Exhibit 1

VCs look for founder teams with diverse backgrounds and skills.

Team setup, education, and work experience of unicorn founders, %



2. Total addressable market (TAM): Is it big enough to be worth it?

When deciding whether to fund a new business, the VC investor wants to know if the investment can become big enough to be worth it. Assessing the potential comes down to two things:

— *Size matters.* The biggest sectors have the greatest number of successful scale-ups. Three sectors with annual revenues greater than $5 trillion—technology, media, and telecommunications; industrials; and healthcare—account for almost a third of the top 100 unicorns. Playing in a large enough market, therefore, improves a venture's chances of hitting it big. Similarly, significant trends have an impact on TAM volumes and, in some cases, even open up a "blue ocean"—entirely new, large market spaces. One such trend is sustainability, in which governments and companies are expected to invest nearly $10 trillion per year for the next 30 years. With 11 investment areas, ranging from green transportation to decarbonization, we expect the climate economy to see the launch of hundreds of new unicorns (Exhibit 2).

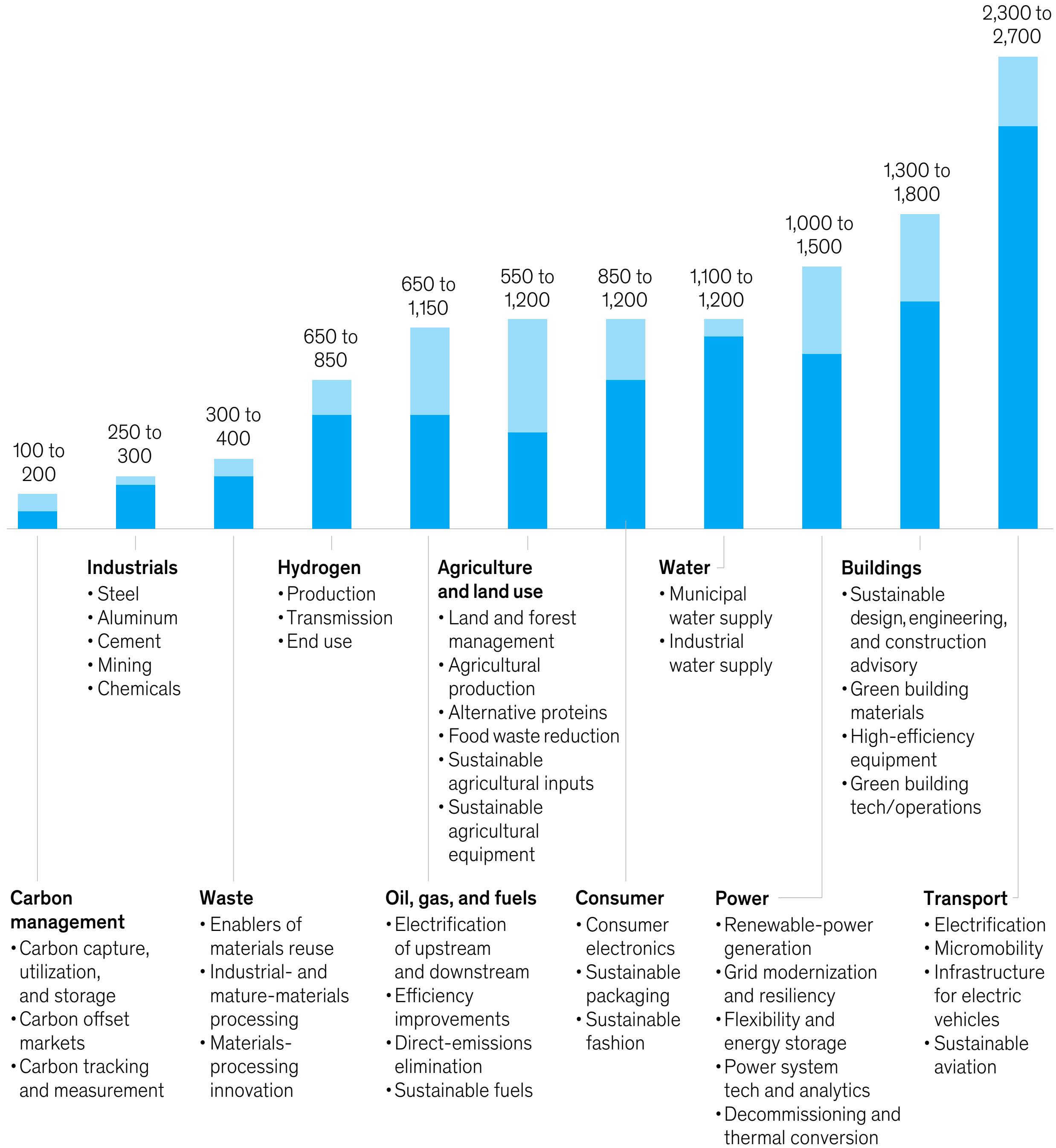
Smaller markets or sectors can also be the homes of successful start-ups as long as the potential for market disruption is significant. While AI and big data, for example, are relatively small fields today, accounting for less than 5 percent of total value creation across all segments, they include 16 of the top 100 unicorns.

— *There's a clear market opportunity.* A large enough market is table stakes. It is essential that the market also offers significant growth potential for new entrants. To determine whether a market is "crackable," VCs typically assess whether there is an opportunity for a product or service to take advantage of a market weakness. Strong fragmentation is one example of such a weakness: if a market has many players and no clear leaders, it is often easier for a new entrant to disrupt it and build up significant market share. A young market without dominant companies and with relatively low barriers to entry also can offer an attractive opportunity.

Exhibit 2

There are eleven high-potential value pools in the climate economy.

Addressable market size in 2030, selected categories, $ billion



Note: Preliminary, not exhaustive.
Source: Michael Birshan and Anna Moore, "Four front-foot strategies to help create value in the net-zero transition," McKinsey, September 2, 2022

3. Timing: Too late, too early, or just right?
In comedy, they say timing is everything. That's equally true of investing in start-ups:

— *Leaders recognize trends first and benefit from early moves.* Correctly identifying new trends and their impact early on allows first movers to enter uncontested spaces and build a strong position—which typically results in higher margins and faster growth. For this reason, ventures at the forefront of trends benefit from greater capital availability and more-attractive valuations. As first movers in the climate market, for example, sustainable brands and net-zero-focused products exhibit faster growth and significantly higher price premiums—for example, we expect a green premium for steel of $200 to $350 a metric ton by the middle of this decade.[1] Furthermore, we see two to five times the uplift in valuation multiples for companies with a strong climate focus.

— *The start-up operates in a two-to-three-year window.* VCs look for that "Goldilocks" spot where a business isn't so far ahead of the market that it will die before it has enough customers or so far behind that its market opportunity is lost to competitors. They look to invest in start-ups where the product or service not only works but also has early indicators of market interest. The expectation among VCs is that start-ups travel significantly along this innovation curve within two to three years. In line with this view, the maximum amount of capital that is generally raised supports a run rate of about two and a half years.

4. Technology: Does it work at scale?
VCs evaluate whether a business can go from selling and supporting a hundred products to a million without breaking. Technology is often at the heart of a company's ability to scale:

— *Software drives the scale.* When assessing the potential for scale, VC investors typically want to confirm a company's ability to operate efficiently and stably with millions of customers and thousands of employees, often while growing at a rapid pace. For this reason, they favor software over hardware, which has complex logistics, maintenance, and development profiles. Software, in contrast, can scale almost instantaneously, if it is well built and supported.

This logic drove Enpal, a leading European green-tech player valued at more than $1 billion, for example, to invest in a fully online purchase model and develop an operating system and app that allows customers to manage solar panels, heat pumps, and other products all in one.[2] Similarly, Infarm, the world's largest urban vertical-farming network, started with a strong focus on hardware but has shifted its focus to software.[3]

— *Tech foundations can support scale*. Some VCs have dedicated technology teams to review and assess a start-up's tech profile to ensure it is scalable. They are on the lookout, for example, for high degrees of automation so costs don't escalate as revenues grow. Having a tech foundation that's ready to scale requires developing a modular tech stack built around microservices and APIs that create simple and well-defined interfaces to data, algorithms, and processes. In the same way, partnering with the right hyperscaler to take advantage of platform as a service (PaaS) and infrastructure as a service (IaaS) enables scale.

5. Traction: Is there a clear path to profit?
The start-up needs time to grow, but VCs want evidence that it's on the right track:

— *The business is uniquely positioned to solve a real need.* Too often, founders start with an idea or a product and then try to find a market for it. This typically does not lead to success. Instead, successful ventures provide unique solutions (for example, intellectual property that's hard to replicate) that change an unacceptable status quo. While it is common for successful start-ups to develop completely new technologies, they can also develop a novel combination of existing technologies, market existing technologies with

[1] Michael Birshan and Anna Moore, "Four front-foot strategies to help create value in the net-zero transition," McKinsey, September 2, 2022.
[2] "From vision to green-tech unicorn: Lessons from Enpal," McKinsey, July 8, 2022.
[3] "Inventing and scaling the world's largest urban vertical farming network," McKinsey, June 8, 2021.

new ones, radically improve user experiences, or simply operate far more efficiently than competitors.

— *Revenues indicate traction in the market.* VC investors expect revenues of new businesses to grow rapidly. One European VC leader expects new ventures to follow the 3-3-2-2-2 pattern to demonstrate good traction—revenues should roughly triple each year in the first two years after founding and then double for at least three years after that (Exhibit 3). Our analysis broadly corroborates this rule of thumb: successful start-ups at least doubled their revenues every year for eight years. More important than total revenue is the *type* of revenue. VCs favor annual recurring revenues (ARR) over one-off sales and look for customers who buy more than one product and whether per-customer revenue increases over time.

— *The path to profit is clear.* While it is typical for start-ups to show significant net losses in early years, a clear path to profit is essential. VC investors generally look at customer acquisition costs (CAC) and customer lifetime value (CLV) as key indicators. While the CAC are often steep for new businesses, trend lines should clearly show improvement. Historically, VC investors have considered a CLV:CAC ratio of three times at scale a good indicator of strong traction.

Implications for incumbents

What can incumbents learn from unicorns and VCs? Two elements stand out.

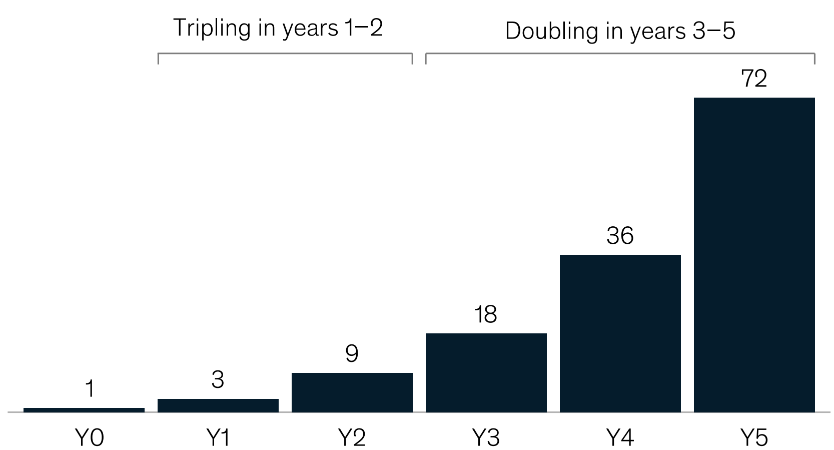
Set up an innovation board with a mix of experience

An innovation board prioritizes investments in new ventures based on a business's strategic growth agenda. These are active organizations that go well beyond basic reviews and approvals. They are most effective when acting as true coaches who can bring to bear the breadth of their experience. For example, they bring on people with the specific skill sets that the new business needs, set challenges for the business—

Exhibit 3

Consistent revenue growth over several years indicates a company has traction and a clear path to profitability.

Revenue growth expectation, 1 = revenue in first year



in one case, they asked the start-up team to come back with two signed letters of intent from committed customers to prove the willingness to pay—and identify potential M&A targets.

The innovation board needs representatives from three separate interests and areas of expertise:

— The incumbent/business unit representative, who can best judge if the company has unique advantages to offer to the new business and provides the new business with access to them

— The VC, who brings an unbiased perspective in evaluating the start-up and provides access to capital, talent, and experience

— Experts that the incumbent lacks. One agriculture company, for example, needed technologists, while an engineering firm needed marketers and go-to-market experts to help it reach thousands of customers.

Understand what VCs are looking for as part of a joint venture

VCs can provide significant advantages to an incumbent. But for any kind of collaboration to work, VCs will insist on an important set of requirements. For one thing, they want to be involved from the start so they can ensure, for example, that the run rate stays within reason. They will also insist that the founders have equity in the new business. In most cases, incumbents reward and incentivize their start-up people with bonuses, but VCs know that you will get the best talent only if you offer them shares. On the flip side, the VC will also look to ensure that no single investor has a dominant share in the new business and could potentially block it later for whatever reason.

Beyond the initial phase, VCs have a clear eye on future growth and, while most incumbents only think about incentivizing the initial founders, will eventually want to see a stock-option pool for key hires and will look for an explicit willingness from the incumbent to potentially bring in other investors after two to three years. VCs are looking to protect and maximize the chances for a large payout from their investment, and unless incumbents can adapt to this reality, they will not collaborate effectively with VCs.

Two industrial companies with a strong focus on manufacturing and manufacturing technology decided to work together on building a new business. They also brought in early a financial VC with experience working with large companies. This VC had a network of other VCs and crucial knowledge, such as investment structures and equity allocation models. The venture was able to secure eight-digit seed funding.

A unicorn is, by definition, unique and hard to build. But by understanding what success factors to look for and how VCs think and operate, incumbents launching new businesses can increase their chances of hitting it big.

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