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**MINNESOTA BUSINESS**

St. Paul Venture Capital founder Pat Hopf has billions of dollars to give to early-stage entrepreneurs. Curious to know what makes him tick?

# Kingmaker

By Mark Druskoff

**V**enture capital. For entrepreneurs there's nary a sweeter word. Like old E.F. Hutton, mention the VC-word and conversations lull; write it down and it leaps off the page. Businesspersons who've obtained it walk a little taller and talk a little louder. And that was when there were scads of it to be had. Now? *Fuhgeddaboutit*. Venture capital is scarcer than a tan Minnesotan in January, increasing its status all the more.

Meet Pat Hopf. This 51-year-old father of four and native of Winona, Minn. is president, founder, and managing general partner of one of the Twin Cities' most well-known and well-respected venture capital firms. And while you might not recognize his

name, you certainly know the firm—St. Paul Venture Capital, Inc. ([www.stpaulvc.com](http://www.stpaulvc.com)).

Now, admittedly, some might question the title of "founder" for a firm that began as a division of local insurance giant The St. Paul Companies ([www.stpaul.com](http://www.stpaul.com)), but Hopf

says the relationship with the insurer has always been unique.

The genesis of St. Paul Venture Capital came in 1987 when the insurer decided to add venture capital to its investment portfolio, which included public equities, fixed-income securities, real estate, and oil and gas investments. Compared to today, the venture capital industry back then was a small, specialized industry where fewer players with less money chased a smaller pool of candidates. (According to Venture Economics and the National Venture Capital Association, for example, there were just 82 VC funds with a total of \$3.1 billion in 1990, compared to 494 funds with \$92.6 billion in 2000.)

After conducting a national candidate search, The St. Paul Companies offered Hopf the job. At that time, he was managing

general director of T. Rowe Price Venture Capital. But Hopf didn't accept the offer right off the bat.

## Driving a Hard Bargain

“I actually spent about six months negotiating with them as to whether I was going to take the job or not,” recalls Hopf. There were three main sticking points.

“I was warned by a number of people, ‘Don’t affiliate yourself with an insurance organization,’” says Hopf. “Large insurance organizations were known, and except probably for The St. Paul, are still known for changing their investment allocation mix fairly quickly.” He says many insurers have a five-year investment horizon, but that wasn’t going to cut it. “In the venture capital business, you typically need five to ten years to even show whether you’re going to be successful or not.”

Another reason behind Hopf’s tough negotiating came from his own entrepreneurial experience. He was founder, chairman, and CEO of Family Entertainment Centers (FEC), a franchise of Chuck E. Cheese’s Pizza Time Theatre. Hopf originally became interested in the family-based, eat-ertainment chain when the company approached him seeking venture capital. He wound up becoming their original venture capital investor. But, he left the VC world to start FEC.

Starting in 1981, Hopf grew FEC to become Chuck E. Cheese’s largest franchisee, with 18 outlets throughout Maryland, Virginia, and North Carolina. But he says when the pizza chain declared Chapter 11, customer traffic plummeted. So even though his business had been booming, he had to sell out for a low price. It made a lasting impression: “I learned that you shouldn’t tie your fortunes to a parent where you had no control, and that you shouldn’t invest in highly fashionable and trendy businesses.”

So Hopf’s first requirement for The St. Paul Companies was that it make a long-term capital commitment, and that it leave the specific investment strategy to Hopf. The second was to give Hopf complete hiring authority.

“Over the years, we’ve hired extraordinarily capable people who would never have seen themselves working for an insurance

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—Pat Hopf, founder and managing general partner, St. Paul Venture Capital

company,” explains Hopf, noting the entrepreneurial character of venture capitalists. “It was something where they would love to join a venture capital organization, but an insurance organization was just a little bit different than their mindset.”

The third and final issue was compensation. Hopf demanded that the firm’s compensation be tied to venture industry standards rather than insurance industry standards. The St. Paul Companies eventually agreed with all three points, but in return they expected significant returns. Because of the perceived risk of venture capital investing, The St. Paul Companies expected to generate a return at least five percentage points higher than its equity portfolio every year.

Having worked out the details, Hopf became the head of St. Paul Venture Capital, a division of St. Paul Fire & Marine, the property/casualty arm of the insurer. He had the title of vice president of private equities and one employee. He also had a \$70 million fund to work with. Hopf admits that sum may sound small given today’s standards, but he says the entire venture industry was a lot smaller then. (The entire industry raised just \$3.8 billion in that year.)

Hopf’s specialty was in retail, consumer products, and education. His first investment was in Biz Mart, an office supply superstore similar to Office Depot, which Hopf says returned three to four times the money when it was sold. But as the firm grew, it increasingly shifted its emphasis to technology. (Today, the firm focuses on four main areas: communications, business Internet, consumer technology, and health care.)

By the mid-1990s, the arrangement between St. Paul Venture Capital and The St. Paul Companies changed significantly.

“We jointly agreed that we would spin ourselves out as of Jan. 1, 1997. We’ve had a different relationship with them since then,” says Hopf. The firm became a separate management company, St. Paul Venture Capital, Inc., which according to documents filed with the SEC is 77 percent owned by The St. Paul Companies. The firm manages venture capital assets for the insurer on a contractual basis. “St. Paul still owns a majority of the firm, but they don’t exhibit any operating control.”

The main reason for the change was compensation. As employees who did not own the assets, the venture capitalists had to pay personal income taxes on their share of the profits. But as a partnership, the VCs had an ownership stake. That meant they only needed to pay capital-gains tax, cutting the tax burden in half. Hopf adds that there was the intangible benefit of being able to say that the firm was truly a partnership of equals, and not a hierarchy, as is typical of large corporations.

## Becoming an Intrapreneur

Although in the beginning, Hopf was officially an employee of The St. Paul Companies, and St. Paul Venture Capital was a subsidiary of the company, he says he viewed the firm as a start-up business in its own right from the get-go.

So he approached the task as if he were starting from scratch. “We had to do what any start-up has to do—that is, to define what are your long-term objectives.” (Take note entrepreneurs who are seeking funding.)

The first objective he set for the firm

was to have superior long-term investment performance. That meant delivering the returns SPC expected, as well as becoming a top player on the national venture capital scene.

"To use a baseball analogy, we were not then and we are not now trying to be the Minnesota Twins, which is basically to try to stay in existence," Hopf explains, revealing some of the understated humor for which he is known. "We want to put a team of players on the field that we think can beat the Yankees or the Red Sox or anybody else. We're not just trying to say, 'Boy, a good year would be if we could win just half of our games.'"

The key was establishing a strong value system, based on integrity, to provide a cultural framework for the organization. In fact, he puts a strong value system at the top of the list of the firm's competitive advantages. Now, talking about things like "cultural values" and "integrity" can sound like public relations fluff, but Hopf seems to be dead serious about its importance—and for practical reasons.

As Hopf sees it, his job as leader and strategist is to set the general course for the firm—not to be a policeman. "You can't manage venture capitalists forcefully. And I think the only way you can do it is to say you've got to have the same value system up-front, you've got to have the same objectives up-front."

Hopf asserts that not only does having a strong value system make his job easier, but it also is crucial to the work of being a venture capitalist. "If you conduct yourself in a certain way in the investment business—people are more likely to come to you with future deals. If they respect you, they're more likely to come to you with higher quality deals..., and they won't bring you the crap."

## Laying Down the Rules of the Game

**A**ll of the companies [we see] want to change the world in some way or another," says Hopf, "and most of them fail." According to Hopf, they usually fail because they haven't developed a strategy

that clearly lays down how the business will win in the marketplace. From the hundreds of companies he's evaluated, Hopf believes there are two main ingredients to creating a successful strategy.

First, the product or service the company has developed has to work and solve a real need. Hopf says, "A lot of entrepreneurs will come in and they will have some concept about an idea and the product may actually not work." And it may not be a design flaw, but rather an operational issue, such as being too difficult to manufacture. Even, it can be manufactured, the next question is "Should it?" After all, Hopf says, ideas may be practicable, but not necessary.

The second, and maybe the most important, issue for entrepreneurs to figure out is how to cost-effectively market and distribute their product or service. "Too many people, especially engineers, assume 'I have a better mousetrap, people will come running to my door,'" observes Hopf. "Most of the time people are too busy, they're too unaware, and unless you hit them over the head, they're not going to come running to your door." He estimates that half of the business failures he's seen stem from inefficient or overly expensive marketing and distribution systems. It's not a process to be taken lightly, he adds. "It's probably more complicated than developing the product in the first place."

Entrepreneurs who are savvy or skilled enough to find solutions to these challenges may receive funding from St. Paul Venture Capital. However, Hopf says his firm expects to work closely with the entrepreneurs it gives money to, usually requiring a seat on the board of directors. "If you're investing in a company," explains Hopf, "you have a responsibility to help build that business, and help use the things you've learned from past deals to help make critical decisions..."

But not all entrepreneurs like the idea of ceding so much control by placing a venture capital partner on their board. Hopf responds to such concerns this way: "Most smart entrepreneurs are saying, 'I know 50 percent of what I need to know to make this enterprise successful; I don't care who the other input comes from.' They could come from a next-door neighbor, they might be my spouse, my good friend, my uncle, it may be my banker, but if it's from venture capitalists or independent board members that's good too. But for anybody to say, I just

# Walking the Talk

St. Paul Venture Capital says it believes in Minnesota companies, and it seems to have put its money where its mouth is.

Adaytum Software  
Aetrium  
Aravox  
Avecor  
DirectAg.com  
Disc Dynamics  
 Fargo Electronics  
HeartStent  
HighJump Software  
IDeaS  
Information Advantage  
Internet Broadcasting Systems  
Lawson Software  
Medicode/United Healthcare  
Net Perceptions  
nQuire Software  
ObjectFX  
Optical Solutions  
Select Comfort  
Sistina Software  
Spine-Tech  
SPS Commerce  
Tricord Systems  
XIOtech

# the Crew

## St. Paul Venture Capital's General Partners

### Rick Boswell

Telecommunications equipment  
and enterprise computing

### Bill Cadogan

Communications

### Everett Cox

Communications technology and  
enterprise software applications

### Michael Gorman

Business-to-business Internet  
and communications

### Pat Hopf

(Managing general partner)  
Retailing, consumer products,  
and education

### Zenas Hutcheson

Telecommunications

### Brian Jacobs

Consumer technology and  
business applications

### Mary Jeffries

(Chief operating officer)

### Rod Randall

Communications equipment  
and software

### Jim Simons

Consumer and business Internet

### Dave Stassen

Medical devices

don't need any help, it's highly unlikely that we would even think about making that investment. [And] I think there's a questionable aspect to that kind of a personality."

Then there's the issue of being fired. Hopf admits that, as an industry, venture capitalists have gotten a cutthroat reputation because they sometimes have to replace management teams. He acknowledges that it's necessary, but he believes most of the friction can be avoided by being clear and up-front about expectations.

"For instance, if an entrepreneur comes in and they have a great idea, and they think they should be the entrepreneur and CEO forever, we're going to try to dissuade them from that," explains Hopf. "In our history, very few entrepreneurs can go from start-up to \$50 million in revenues to \$500 million in revenues... So we try to go through a heart-to-heart conversation up-front... We don't want to walk in and say, 'Today's the day' and you've never even contemplated the fact that you're not the person for the job anymore.

"I'm not sure that we change management teams any less than anybody else, but I would hope we do it differently. [I believe] that they are prepared, that they see the reason, they understand what we're doing, and they understand that this will be mutually beneficial for the organization, for them, and for us. And a lot of times they don't go away; they just have a different role in the company."

For Hopf, most of these issues come down to having respect for the efforts of the entrepreneurs, which he believes can be lacking in some VCs.

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Steven Sneider, president and CEO of Edina-based Net Perceptions [see "IPO Sweetheart," September 1999] ([www.netperceptions.com](http://www.netperceptions.com)), which received significant funding from St. Paul Venture Capital, says the firm actually delivers on their partnership claims. "They are truly beyond the money. They add value in the advice they give, the introductions they make, and the way that they support their portfolio companies." And he says that's not always typical behavior within the industry. "A lot of venture capital-

"The Silicon Valley VCs... would not do an investment in Minnesota. They literally would tell you, 'Hey, it's so busy, if it's more than 30 minutes from my doorstep, I won't even look at you.'"

—Phil Soran, CEO, XIOTech

ists say they do it, but I can tell you that St. Paul Venture Capital does do it."

Maintaining a partnership attitude goes hand-in-glove with the St. Paul Venture Capital's investing style, which is decidedly long-term in focus.

## Investing, Not Gambling

For Hopf, there is only one true kind of investing—everything else is high-profile gambling. "Our value system focuses on strong, fundamental, real businesses, not hype, concepts, stories, or a pitchman. A number of people have made a lot of money that way. We don't think we're good at making money that way. It's a dangerous game... And it's just not something we felt we wanted to attempt to participate in."

However, Hopf admits that by not competing in the momentum investing of the late 1990s—where firms invested in a company in the hopes someone would take it off their hands for a gain—that his firm may have missed out on some of the big scores. "In the top of the market we did not do as well as some people who were very nimble. If you

could get in and get out in 12 to 18 months—and that up-cycle lasted about three years—they would have outperformed us.”

The firm also probably missed out on some “hot” deals because it was not willing to pay the valuations that some entrepreneurs were demanding. “I think we probably did not see some deals because we were not doing some of the other hot deals. We had some internal discussions about that, but the conclusion was always the same: You have to do well what you have proven you can do well in the past... High-profile gambling is not something that we do well.”

To reinforce that message, Hopf says he purchased copies of a 140-year-old book for every member of the firm. The book, *Extraordinary Popular Delusions & The Madness of Crowds*, written by Charles Mackay, surveys popular hysterias and irrational exuberances throughout history, from Tulipmania and the South Sea Bubble to Alchemists and the Witch-Hunts. “It’s written in a way that you could read it today and say, ‘Let’s just add the Internet chapter.’ It fits perfectly well with all these other things.”

Given the current environment, Hopf believes his firm’s investing discipline will soon pay dividends. “At the end of 1999, a number of venture firms had very inflated valuations,” says Hopf. “They had a whole bunch of Internet stocks, then they declined by 50 percent or more, if not 90 percent or more.” The problem, Hopf adds, was that, “The securities that a number of these folks were buying had no intrinsic value, they were tied to a company where the company was primarily concept or story, but it had no material fundamental value underneath it.”

So far, St. Paul Venture Capital’s investment strategy seems to have been successful. Hopf says over the last 13 years, the firm has generated a return of approximately 40 percent a year, and has never had a down year. However, that’s not to say the firm’s Midas touch is infallible

Select Comfort Corp. [see “Mark de Naray’s Hypergrowth of Select Comfort” December 1995] is a case in point. According to former-CEO Mark de Naray, Hopf himself decided to invest in the company in 1991 after the company’s bed solved his back problem. However, the company soon caused Hopf pain of a different kind.

Initially Select Comfort’s revenues soared, going from \$4.5 million in 1992 to

\$70 million by 1995. The company went public in early 1999 and initially its stock did well, trading as high as \$35 a share. However, since then the stock has plummeted to around \$1 per share, even with revenue near \$270 million, with a low of 66 cents. As a result, Hopf assumed both the role of chairman of the board and interim-CEO. Recently the firm has been working to stage a comeback, which includes hiring a full-time CEO, acquiring a sleeper sofa manufacturer with complementary products, and increasing efforts to sell online. These moves are important because, according to company proxy statements, St. Paul Venture Capital currently owns about 30 percent of Select Comfort’s stock.

## Buying Low, Selling High

**W**ith much of the venture industry still busy counting their losses, Hopf believes his firm is positioned to take advantage of the new marketplace. “A lot of venture capital firms are putting their tail between their legs and looking for cover. We’re doing the opposite.”

In October of last year, the firm closed a \$1.3-billion venture fund directed at early-stage technology companies, making it one of the ten largest early-stage funds in the history of the industry. (The company also plans to set aside \$100 million to invest in public companies who have been roughly treated by the markets, yet are still solid companies.) The new fund almost doubled St. Paul Venture Capital’s total capital under management to \$3.0 billion, moving it into the top ranks of the venture capital industry, which is exactly where Hopf wants to be.

“I think we can be one of the top ten funds in the U.S.,” Hopf states. With that goal in mind, the firm has recently brought in some heavy hitters as partners, including Bill Cadogan, ex-ADC chairman and CEO [see “Broadband Harvest,” November 2000]; Rod Randall, former chief marketing officer for Lucent Technologies; Kurt Winters, former chief investment officer for American Express Financial Advisors; and Tom Rowbotham, former director of technology at British Telecom. (Hopf adds that he plans to hire two more deal-making part-

# Galilean Strategy

St. Paul Venture Capital’s satellite funds consist of investors willing to make preliminary investments in companies, from \$100,000 to \$500,000, using their own money or funds from St. Paul. The satellite fund venture capitalists mentor the entrepreneurs, and if a company shows promise, the satellite fund offers St. Paul Venture Capital the opportunity to make an investment in the several-million-dollar range.

**Annapolis Ventures** (Annapolis)  
Doug Hickman

**Flying W Capital** (Bryn Mawr)  
Carl Witonsky

**Fog City Fund** (San Francisco)  
Nancy Olson

**Perspective Capital** (San Francisco)  
Molly Barger Wuthric

**Quatris Fund** (Minneapolis)  
Steve Goldstein, Erwin Kelen,  
John Rollwagen, Gary Smaby

**Upper Lake Growth Capital**  
(Eden Prairie)  
Keith Eastman

**Windamere Venture Partners**  
(San Diego)  
John F. Burd, Ph.D.; Scott L. Glenn;  
Kenneth J. Widder, M.D.

ners over the next six months, as well as additional support staff.)

In addition to bringing in new money and talent, Hopf wants to improve the firm's geographical coverage. Currently, the firm has three partners in Boston, two in Silicon Valley, and four in the Twin Cities. By early 2002, the firm will have four partners in each office. Plus, St. Paul Venture Capital has struck informal deals with seven so-called satellite funds in Maryland, Pennsylvania, California, and here in the Twin Cities (see sidebar) to generate proprietary deal flow.

Even with national expansion, Hopf says Minnesota will continue to be important going forward. "I believe that if you're going to be recognized nationally, you certainly have to be recognized locally. And you've got to be the best firm in town." He acknowledges that historically Norwest Equity Partners has been the kingpin in the Twin Cities. But he points out that Norwest's venture operations have all moved out to California, leaving St. Paul Venture Capital with the opportunity to become the undisputed leader here.

It also makes good business sense since Minnesota has been a good source of companies for St. Paul Venture Capital. Michael Gorman, a general partner in the firm who focuses on the business-to-business Internet and communications companies in the Upper Midwest, says, "We have had historic success in this market, and have been fortunate to partner with some great teams that translated into some great outcomes. And we believe the future also looks bright."

One of those past successes was data storage company XIOtech [see "Undiscovered Country," March 2001] ([www.xiotech.com](http://www.xiotech.com)). Phil Soran, co-founder and CEO, says St. Paul Venture Capital was the lead investor for the company's first round, and ultimately invested \$7.3 million (out of a total of \$37 million raised from nine VC firms). That investment multiplied nicely when XIOtech was acquired for \$360 million by

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—Michael Gorman,  
general partner,  
St. Paul Venture Capital

Seagate, making it one of St. Paul Venture Capital's "Hall of Fame" investments.

Soran notes that having a firm like St. Paul Venture Capital based in Minnesota directly benefits Minnesota's entrepreneurs. He points to his own experiences in raising capital when XIOtech launched in 1996 as an example.

"Back then, the Silicon Valley VCs, where a lot of the money was, would not do an investment in Minnesota. They literally would tell you, 'Hey, it's so busy, if it's more than 30 minutes from my doorstep, I won't even look at you.' " The only way around that bias, says Soran, was to have a credible local lead investor like St. Paul Venture Capital. "You've got to have a big local lead, and since you didn't have many, St. Paul played a pretty big role."


For his part, Hopf appreciates the char-

acter of the typical Minnesota technology entrepreneur. "They're not looking for fame and fortune... Instead, their focus is on, 'I could build this into a successful business.'" That's not the attitude with the entrepreneurs on the coasts, he says.

Gorman agrees, pointing out that Minnesota technologists are actually too humble. "I think lots of companies in the Midwest have terrific technology, but are less immersed in the culture of marketing and business development than some of the companies on the coast. And a part of what we try to bring is a perspective from our national investing profile to our portfolio companies in the Midwest because there are great stories to tell here, and we need to make sure we tell them loudly and clearly."

## Looking Down the Road

Critical to the execution of the firm's strategies is the recent hiring of Mary Jeffries as chief operating officer and the firm's first woman general partner. Jeffries, former COO of Shandwick International, won't be doing deals, but she will be gearing up the company's marketing efforts here in the Twin Cities as well as in Boston.

Jeffries' addition brings the number of partners up to eleven, ten of them deal-makers. "By the time we get to twelve investing partners, that's a lot," considers Hopf. "I don't know what the magic ceiling is, but we're probably fairly close to there." But he believes that he has the right group of people, a sound strategy, and a solid value system in place to take the firm to the next level. "Today we are ready for prime time. I think we will be a very significant force in the venture capital business over the next decade." 

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