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Eric Yuan's Leadership Lessons for Building Lasting Enterprise Value

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Zoom’s first quarter of fiscal 2021, ending April 30, was characterized by an analyst as “the best quarter in the history of enterprise software.” Reported revenue of $328 million increased by 169% year-over-year compared to the prior year period. Unlike recent technology IPOs, Zoom reported earnings per share of $0.09 compared to $0.00 in the first quarter of fiscal 2020, both measured on generally accepted accounting principles (“GAAP”). Its margins and cash flows from operations and business strategy all point to a model that will build lasting enterprise value.

The story of Zoom’s success as a technology company is in some ways a classic story of the entrepreneurial vision of its founder, funded by prominent Silicon Valley venture firms, who achieved the holy grail of both hypergrowth and a successful IPO. However, in significant ways, it is distinctly different. By traveling in time from Eric Yuan’s early days as a student through his company's success today, we want to point out some lessons for entrepreneurs at different stages of their journey.

Have a Dream and Find Your Passion

Born in the province of Shandong, China in 1970, Eric took his undergraduate degree in applied mathematics, and subsequently completed a master’s degree in engineering, with a specialty in mining -- like his parents, who were also engineers. In 1994, he traveled to Japan on business where he heard Microsoft founder and CEO Bill Gates talk about software and the promise of the Internet. After hearing this talk, a spark was kindled in Eric. He knew he wanted to be in the software business, and it had to be in the United States, where he dreamed of eventually starting a business.

The first step in his journey to the United States was to gain a visa and a work permit, and Eric’s application was denied nine times. Budding entrepreneurs should not be shy about letting people know of their interests, passions and plans. Eric came into the orbit of a famous Chinese entrepreneur Min Zhu, who founded Future Labs a collaboration company that developed a multi-point document sharing system; Zhu’s company was acquired by Quarterdeck.

Land and Expand

After the sale of Future Labs, Mr. Zhu and Subrah Iyar co-founded a Silicon Valley startup called Webex, whose first product allowed multiple users to share screens and presentations. In 1997, at age 27, Eric landed in the United States to begin his career in the software business as an engineer and as employee #20 at Webex. Eric worked hard to expand his knowledge of the company’s product, and to understand the guts by doing lots of coding himself to make Webex better. Soon, everyone in the company knew of Eric because of his work ethic, humble manner, and intense curiosity about all aspects of the startup’s business. The two founders of Webex who hired him as a software engineer watched as Eric developed qualities of diligence in solving problems, domain competence in software development, initiative in identifying and solving problems, and vision as he started putting forward ideas to improve the Webex platform.

In 2007, 10 years after Eric joined Webex, the startup was acquired by Cisco Systems, (NYSE: CSCO) a multinational technology giant for $3.2 billion and it renamed the company Cisco Webex. Eric became a corporate Vice President of Engineering for Cisco Webex

Learning About Culture and Innovation Within A Large Tech Enterprise Takes Time

Cisco has been one of the most acquisitive firms in the technology sector, averaging perhaps a dozen or so companies a year. Because of its high margins and large cash flows, this was perceived by shareholders as a good use of the balance sheet.

The goal was to help transform the company from a hardware company into a company that unified software and hardware into broad customer solutions like collaboration. Cisco Webex was bought to be the cornerstone for integrating various acquisitions into a collaboration platform with a full suite of features.

When leaders of an entrepreneurial company come into a multi-billion public company, there is always culture shock on both sides, as the entrepreneurs find decision-making processes slow, complicated and intensely political, while career executives see the entrepreneurs as naïve about the corporate strategic and financial picture into which their acquired company must fit.

Eric Yuan's inquisitive nature, desire to understand the Cisco Webex assets deeply, and diligence in pursuing new opportunities ran into opposition within Cisco, where there were pressures to honor promises made around the company's many other prior acquisitions like Jabber. In a large multinational company, different acquisitions may have different executive champions.

When Eric talked to customers of Cisco Webex, he found that they were "unhappy." The Webex platform was not cloud native, which is where users wanted to go with their phones and tablets. However, the motto in tech is, "The user is not the customer." The corporate decision to buy and integrate software like Webex is the purview of the Chief Technology Officer. To a CTO, security and ability to integrate a new app into the primary user interface and logon are critical, whereas features, ability to use products on different devices and user experience are not important to the CTO purchase decision. These were invaluable lessons for an entrepreneur to learn first-hand about larger public enterprises like he would be leading in the future.

Finally, Eric presented the fruits of all his experience, research, and customer feedback to Cisco management. He presented a cloud-based phone with collaboration functions like chat and access to video conferencing. The idea was rejected. Having spent 14 years at Webex/Cisco Webex building out his industry business network, deepening and expanding his software domain knowledge and acquiring real-world leadership skills, Eric started his new business at age 41.

Tech Insiders Invest In a Leader, Rather Than In a Business.

Eric Yuan's first business, incorporated in 2011, was called Saasbee, a collaboration tool built on top of chat. The initial financing, or seed round raised $3 million, but in reality I would call it a "friends and family" round.[1] Bill Tai, a prominent angel and VC investor and founder, knew Eric well. Subrah Iyar hired Eric as employee #20 at Webex and saw his work and knew his character. Several other investors, including Maven Ventures, made up the round.

Some 20 engineers at Cisco Webex either wrote checks, or volunteered to work on Eric Yuan's venture over the next two years simply because they believed in him, and certainly not because they were enamored of a collaboration tool built on chat, which wasn't yet built and which had no TAM, business development model or PowerPoint deck. This fundraising round breaks the model of fundraising in Silicon Valley. Eric requested that $250,000 checks were deployed quickly to hire coders and developers in China to start building out a product.

At the time of the funding, Apple had just launched FaceTime for its phones and tablets. Microsoft's Skype had been around for years. Cisco Webex was still selling in the marketplace, and Blue Jeans, a San Jose, CA cloud-based communications start-up had already raised millions. The consensus among venture capital firms in Silicon Valley was that video conferencing was a "race to the bottom," and most firms wouldn't take a meeting with a founder looking to fund that product.

Here are a couple of lessons for entrepreneurs. The consensus, especially in financial markets, is most often wrong. Sometimes, the consensus view of how a company is classified, e.g. corporate video conferencing is erroneous. An entrepreneur just needs to find the right investors. In this way, a friends and family round can often bridge to a seed round. If investors know you, your family, and your personal qualities, who would be more willing to seriously consider investing in your venture? If they are not interested, then why would dispassionate strangers, like angels of VCs, be so inclined? This kind of round can provide good feedback about the business concept.

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Zoom Begins Its Journey and Real Fundraising

Saasbee's product concept died between 2011 and 2012, when Zoom was incorporated, and it pivoted to developing a frictionless video conferencing as a SaaS offering. Both Sassbee and Zoom were housed in very unimpressive real estate, where the stories are that the elevator didn't work, and that boxes and files were everywhere. Workers coming into the office sometimes used stacked boxes for their laptop stands. A culture of economy and frugality just sprung up, as investor funds were used first to advance the product launch and to support the customers who came early to Zoom, in 2012. Zoom was focused on very large enterprises, where the disconnect between users and CTO decision-making was the greatest.

Sometimes, a trend outside the target market comes and drops customers in the laps of a company that is well prepared. In 2012, with the success of Massive Open Online Courses ("MOOCs") like Coursera, Stanford University decided for competitive reasons that it quickly needed to establish its own unique distance learning option, and it chose Zoom for its platform. The Stanford University Continuing Education Department became Zoom's large institutional paying customer. Now, Zoom has established a very strong presence within universities, akin to Apple's share in the education market. Its recent signing of a contract with the Los Angeles School District, the largest in the nation, shows that Zoom landed in this market by being there, but they have greatly expanded their presence over eight years.

The Issue of Free vs. Subscription Accounts.

Because Zoom's avowed goal was to land in very large corporate enterprises, Zoom immediately went to a so called "freemium" account, where anyone with access to a Web browser, whether on a phone, tablet or laptop, could sign up for an account with up to 15 individuals on a videoconference, with a forty minute limit.[2] The Zoom user interface was simple: lots of white space, and very intuitive. Conversion to a paid subscription simply required a personal credit card.

The freemium account was a perfect fit for Zoom's target market. Users streamed in, especially from Cisco, where employees declined to use the Cisco Webex installed on their corporate desktops! Once word got out about Zoom, the raging stream became a flood of users. In this particular target model and with the disconnect between users and IT as the customer, the freemium model is a form of viral marketing, which produced a fast ramp, often leading conversions to subscriptions. At some point, when Zoom had become ubiquitous inside a very large enterprise, as the era of BYOD dawned, the door was opened to a full corporate sales effort on the organization, which is better for cash flow, as corporate accounts pay annually, and they do not have the churn that is the hallmark of individual users, free or paid.

Freemium accounts are not a tool to be adopted without thinking through your business model, target customers, and your value proposition. Angie's List began as free service provider directory, gained national recognition and then, some 20 years after establishing some scale, went to a monthly subscription, which failed. Its value proposition was flawed. Angie's removed the subscription, then added a Homeowners Service that takes fees from providers. Zillow, a nationwide real estate directory, is trying to escape from its free offering, but it is in the midst of trying to segment paid offerings, which is confusing its customers and diluting its maverick brand equity. Twitter is rumored to be moving to a paid user model, which would wall off the great unwashed Twittersphere from its better-placed paid users and move away from reliance on its advertising model. The company clearly doesn't have a binary choice—pay or free—and its revenues are roiling as a result of its exploring this radical change.

Two startups I advise went to free accounts from the outset. In one construction-related company, it didn't work; the company radically pivoted and is now billing six figures annually. In the second, a mental health app, the early investor jury is out as how well the needed conversion to paid subscriptions will go.

Zoom's freemium model, which fits well with its very large enterprise target market, has very different implications and creates problems when the customer base takes a seismic shift, as we will see later.

The Cadillac Venture Capital Firms Arrive, With Cash In Hand!

As Zoom continued to attract users at a very rapid rate, it piqued the interest of a General Partner at venture firm Emergence Capital, Santi Subotovsky[3]. His firm was interested in SaaS as a broad area of interest but had

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not considered videoconferencing until Santi and his wife started using the product in 2012. From there he started paying personal visits to Zoom headquarters. Eric Yuan wasn't looking to raise more capital since the 2013 Series A $6 million round.

Over many visits and conversations, as opposed to grilling Eric and asking for numbers, Santi and Eric built a relationship based on mutual trust. Santi's pitch to his partners at Emergence certainly noted that Zoom's user growth seemed exponential, though he had no numbers, but he felt that Eric Yuan was the kind of leader who could effectively deploy investor capital because of his commitment to building a quality platform, working hard, creating a culture of caring in his company, doing things the right way, and owning the consequences of his decisions.

When Santi finally asked about capital raising through Emergence, Eric hurriedly gave him a huge packet of internal numbers to examine. This is unheard-of behavior for a CEO of a fast growing startup. Startups usually burn cash in pursuit of hypergrowth of revenue. When Santi and the Emergence analysts decoded the numbers, they were shocked by the exceptionally high growth, but also at the churn within segments. Santi felt that Emergence Capital, as a partner to Zoom, could offer some help and insight into future decisions, which would benefit the existing business model and focus. A good venture firm really is a partner: neither running the firm nor checking weekly cash balances, but really helping the founder and senior executives.

For the final meeting before making commitments, Emergence Capital partners and investors each were invited to sign onto Zoom for a Zoom Webinar! Again, this breaks the Silicon Valley model completely. If the experience didn't go well that would have been the end of the fundraising story, and trust in Eric and in his judgment would have been broken.

This high-risk demonstration of the Eric's unwavering belief in all his team's work and their commitment to Zoom's success made investors eager to invest their cash.

Emergence Capital, along with existing Zoom investors, led a $30 million Series C Round in 2015, which raised more money in total than all prior funding rounds. In 2017, Sequoia Capital eagerly led a $100 million Series D Round, in which Emergence Capital participated, along with Zoom investors from prior rounds. To date, Zoom has not touched this $130 million of capital despite its unprecedented hypergrowth, because of its profitability, cash flow, and ability to manage its margins to this point.

Looking at the Future: Issues in the Best Quarter and a Raft of Competitors

In that first quarter of fiscal 2021, where we began, a huge margin shift towards individual users took place. Many of them were free accounts, due to stay-at-home schooling; the GAAP gross margin rate plunged to 69.4% from 80.9% in the comparable prior-year period; expenses rose as well. This historically unprecedented intra-quarter customer mix shift -- from enterprise users to individuals -- was absorbed financially, but there are consequences that require future moves to get the margins right again.

The good news is that Eric, as the CEO, has built his senior leadership through appointing a Chief Operating Officer, a larger security operation with a Chief Security Officer and Advisory Boards. The security organization will report to the Chief Operating Officer. Zoom has also hired a President of Product and Engineering, with deep domain and large enterprise experience. The venture investors -- especially Emergence and Sequoia, but also the early investors and mentors to the CEO -- are there to help the CEO and to be a resource for him. It is a loaded stable of talent on the company's side, all of whom believe in the CEO's leadership, having seen it firsthand over the years.

The future mission is to turn Zoom into a Unified Communications as Service ("UCaaS") platform, and it is well underway. There are a host of competitors and potential competitors, from Microsoft, Amazon, and Google, to Cisco, Salesforce, Ring Central, Blue Jeans, 8x8 and several others.

Conclusion

The entrepreneurship journey isn't unlike other career journeys. It takes time to build a personal foundation of skills, experience, competence, emotional intelligence, character and self-confidence. Building a personal network in your chosen area, whether it's business or the arts, is part of building your personal foundation. A strong work ethic and commitment to your goal is "table stakes" for the entrepreneurial journey. Leading by

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example and the ability to garner the trust of others is essential in business, especially where financial investment is involved. Watching Zoom's journey among the lions and tigers of collaboration software will be a good investment in your own entrepreneurship education.

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1. A friends and family round raises funds from family members, their professional and social contacts, and friends in the founder's network. Among companies which used this tool include Amazon, Office Max, and many others.

2. Eric Yuan believed, from his experience at Cisco Webex, that no productive meeting need last more than 45 minutes, if well structured and managed.

3. https://www.emcap.com/thoughts/i-trust-zoom

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