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The Business of VENTURE CAPITAL

Insights from Leading Practitioners on the Art of Raising a Fund, Deal Structuring, Value Creation, and Exit Strategies

Foreword by Mark Heesen, President, NVCA

MAHENDRA RAMSINGHANI

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In the memory of my parents

and

to Deepa and Aria,
the light, the song, and the dance

Foreword

If the business of venture capital is driven by the entrepreneurial forces that cause creative destruction, venture capital is the primary fuel that drives these forces. Armed with this ammunition, entrepreneurs leapfrog toward the new frontiers at a rapid pace. Closely teamed up with these entrepreneurs are venture capital professionals, who bring insights and direction and, at times, act as guardrails for the entrepreneurial energy and enthusiasm. This book, *The Business of Venture Capital,* whose primary audience is an entry-level venture practitioner, addresses the critical elements of the venture capital investment process: raising the fund, sourcing and structuring investments, creating value as a board member, and, finally, leading investments to exits.

The quest for new frontiers has led to the significant growth of venture capital over the past two decades. I was recruited to lead the National Venture Capital Association (NVCA) in 1991. Since then, the venture capital industry has grown significantly and venture capital is now recognized as an asset class with distinctive merits. In the early nineties, annual venture investments in U.S. companies was $7 billion. Fifteen years later, this has grown threefold to $20+ billion. (Of course, we will ignore the 1999–2000 era when investments grew to $100 billion.) Tied to this growth is the flow of capital—assets under management, the number of funds, and the number of professionals in the venture business, all of which have grown at an equal pace. Institutional investors are driven by financial returns. Corporate and government entities invest in venture funds to spur technological development and social change.

Christopher Columbus said,"Following the light of the sun, we left the old world." After all, it's primal for man to seek new frontiers. While those in earlier times sought to discover unknown lands and bring home spices and gold, modern-day entrepreneurs and adventurers seek to break down the frontiers of technology and business. As we know, venture investments started in the late sixties but the nineties experienced rapid growth and formal structures were established into a norm. The first wave of venture investments grew with the advent of the semiconductor industry, closely followed by the growth computing industry. The mainframe and desktop,

software, networking, and the Internet led to the peak of the frenzy in the year 2000 with venture investments reaching $80–$100 billion. This frenzy also generated triple-digit returns for venture funds for a brief period, leading to more capital flows into this asset class. However, recent years have created a new set of demands on venture professionals. As the technology wave shifts to mobile computing and social networks, energy and clean-tech sectors have attracted much attention. While these sectors have different return dynamics as compared to the technology era, a steady flow of capital and opportunities is drawing the battle lines for the next wave of creative destruction. Life sciences and health care, sectors that have largely remained steady, have seen a spurt of recent activity. The underlying drivers of cost and insurance premiums combined with aging demographics will sustain the pace of investments. However, in recent years, political drive to reform health care has spurred adoption of technology in areas such as medical records, where venture investments may see growth. Drug discovery—the other end of the life sciences investment spectrum—also continues to see considerable opportunities due to consolidation within the industry and the growing cost of drug development combined with pressures of generics.

On the geographic front, the United States continues to lead the venture activity due to underlying structural advantages of a judicial, taxation, and regulatory environment peppered with innovation and entrepreneurial mind-set. Despite several challenges, the European Union, China, India, Israel, and other countries in the Middle East have experienced growth in venture capital, private equity, and infrastructure investments. Venture professionals know the importance of a supportive government in paving the way for growth—be it through research grants or tax incentives. Several countries are closely following the proven recipe of success that the United States has experienced. The entrepreneurial drive combined with the set of market conditions gives the United States the edge that is not easy to replicate across cultural nuances. For example, the rate of formation of anchor companies (companies that started from scratch and are listed in the 1,000 biggest companies by market capitalization over the past 20 years) in the United States is four times as many as are found in the European Union. In the European Union, entrepreneurs are perceived as "exploiters" of resources at twice the rate that they are so perceived in the United States. Despite which, successful companies like Skype have generated wealth for venture professionals. Singapore leads governmental reform and investments in technology research parks. Five percent of companies in Singapore are venture backed. Israel leads in entrepreneurial drive and innovation, especially in security and defense, turning the political issues into opportunities. Creating a stable

political environment combined with a strong legal infrastructure that speedily addresses corporate, shareholder, taxation, and intellectual property concerns is the foundation on which venture investments can be established. The harder challenge is not government mandates, but social acceptance and change. A government cannot create, but only support, entrepreneurial drive as it's largely a complex interplay of emotional and social dynamics. For instance, while Japan leads the world in filings of intellectual property, the linkages with venture capital and start-up formation have not been visible. The Global Entrepreneurship Monitor (GEM) global report gives Japan the lowest score for entrepreneurship of any large country, largely due to its risk-averse orientation. Bankruptcy in Japan equates largely to being ostracized and in the extreme, leads to suicide. Eventually, some regions will march, some will drift, and some will be dragged into the entrepreneurial domain. And no matter what your zip code is, the basics of the business remain the same—the ability to raise capital, invest it prudently, add value as a board member, and generate exits. *The Business of Venture Capital* seeks to offer valuable insights to a rookie venture practitioner or a business school student aspiring to pursue a career in venture capital. While parts of the subject have received attention from publishers in the past, this book promises to be the first comprehensive attempt to focus on the four critical elements of the venture capital business. Raising a venture fund calls for a deeper understanding of what investors (Limited Partners) seek in venture funds. The art of sourcing investments is dependent on the team's operating expertise, the fund's past successes, and brand identity. While structuring term investments may appear fairly straightforward, Mahendra Ramsinghani touches on the underlying logic that is embedded in term sheets. And most professionals learn how to be good board members by watching the senior partners at work. This book helps the reader to understand the basics of boardroom behavior and the ways value can be added in the arc of a portfolio company's growth. And while exits occur as acquisitions of public offerings, this book helps with understanding the underlying aspects that lead to the final step in return creation. Mahendra's career progression as a venture practitioner, former limited partner, and entrepreneur encompasses the 360 degrees of venture capital. He has sought insights of leading venture capitalists and compiled their views in this book, which can be a good starting point for any practitioner. These insights combined with experience allow him to structure the contents of this book in a relevant manner. This book not only informs and educates on the process of venture investments, but also balances the glory with the reality—this is a business where only returns matter and time is not your friend! Venture capital is a lifelong apprenticeship. The business of investing requires equal parts logic and

intuition; the yin and the yang; the alpha and the omega. As in life, much can be taught by books but most is learned on the battlefield, where a few earn the honors, most become martyrs, and the rest carry the scars for a lifetime.

MARK HEESEN
President—National Venture Capital Association
August, 2011

Preface

Life is continually a creation—a formation of new higher forms. When this formation comes to stop in our view, or goes backward—when existing forms are destroyed, this only means that a new form is taking shape, invisible to us. A caterpillar sees itself shrivel up but does not see the butterfly which flies out of it.
—Leo Tolstoy in *Tolstoy Diaries*, Kochety, October 27, 1900

A leading U.S. pension fund manager was flummoxed when recently some venture capitalists called for a meeting. Those seasoned venture capitalists (or General Partners, GPs) did not walk in with a presentation slide deck or a fund memorandum. "I walked in fully prepared for a fund-raise pitch," he recalls. "But here was a group of proven VCs with over 25 years of venture investment expertise telling me that the venture model is broken." What they brought instead was a candid assessment: that they did not see a future in this business. Lack of exits and poor performance, regulatory challenges, and shrinking capital pools had led to structural challenges; hence, significant investor disillusionment.

The pension fund manager walked away from the meeting scratching his head and asking himself, "Did that meeting just happen?"

It seemed to the pension fund manager that the venture model must be broken, but within walking distance of the office where this happened, a different picture (or as Tolstoy puts it, a new form) emerges. Andreessen-Horowitz, an up-and-coming venture firm had raised over $1.6 billion in 22 months across three funds. As LPs beat a path to this door, neither Marc Andreessen nor Ben Horowitz asked themselves if the venture model is broken. Instead, they were busy investing in Facebook, Twitter, and Zynga. As this book was being written, one of their portfolio companies, Skype was acquired by Microsoft for over $8.56 billion.[1]

But the underlying challenges of the business of venture capital are significant. Investors (Limited Partners, or LPs) seeking venture funds have been

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disillusioned by the aggregate performance over the past decade—an industry that has not produced meaningful "risk-adjusted" returns. Peter Dolan, Director of Private Equity for Harvard Management Company, once said, "When I ask a VC to explain a fund's poor performance, he just says: 'Be patient—the cycle will turn.' Society, venture capitalists, and entrepreneurs would all be better off if VCs quit their jobs and started doing something different."[2]

So which is it, a broken model or a booming asset class? As with most things, the answer depends on where you stand. Any practitioner keen to dip their toes in this business of venture capital may stand on a stronger foundation if the following characteristics are considered.

VENTURE CAPITAL IS A SMALL ASSET CLASS WITH A LOT OF PIZZAZZ

Despite its powerful impact on innovation and economic impact, venture capital is a very small portion of any institutional fund's assets. Any institution typically sets aside no more than five to six percent of its entire asset class for private equity (PE). Within this PE universe, VC is an even smaller subset; other private equity players like buy-out, mezzanine, and distressed investing eat up a significant chunk of this PE allocation, leaving a tiny bit for the VCs. Why do LPs even care? "LPs come to venture capital for sex and blood—it's that dark alley—everyone is intrigued and wants in—the curiosity and interest level is very high, but very few LPs know what truly goes on," says Chris Douvos, an LP with investments in some of the leading venture funds in the country.

Take an example of a $50 billion pension fund, which typically sets aside 10 percent, or $5 billion, for alternative investments. Of this pool, about 15 percent, or $750 million, would fall into the PE asset class. This PE pool is subdivided in multiple funds, sliced by sectors and geographies—you could end up with 20 to 50 different funds. A typical investment amount in a venture fund would be, say, $25 million. Should this venture fund yield a 5x return in 10 years, the impact of this outcome on a $50 billion fund on an annualized basis may be good, but not enough to move the needle (or as one LP wryly puts it, just about enough to get a flower basket from the chief investment officer). The asset class is deemed risky, thanks to the fact that at last three out of every 10 investments are total losses and another third of the investments generate a modest outcome. This, combined with illiquidity risks and the fact that only a few funds have generated such strong returns, consistently across economic cycles, keeps the VC pool small. In contrast,

hedge funds have grown to as much as 10 percent of any alternative assets portfolio, swelling from $39 billion in 1990 to $1.9 trillion in 2007.[3]

ONLY A SMALL SUBSET ARE CONSISTENT PERFORMERS; THE REST IS NOISE

According to the National VC Association 2010 yearbook, there are at least 800 firms with 1,188 funds in existence managing about $179.4 billion. Of these, funds actively investing may be far lower—as much as half. In any given year, VC funds raise about $25 billion from limited partners. Consider 2009, which was a challenging year for VC by any standards. LPs deployed about $15 billion in all venture funds but the amount raised by the top seven VC firms was a staggering $7.08 billion, or as much as 46 percent of the total. At least 127 venture funds were in the market at this time, fighting for the other 54 percent of the pie. If seven funds can attract as much capital, there were as many as 15x of "not-so-fortunate" funds trying to kick down LP doors without much success.

LPs seek top performers that demonstrate consistently superior returns across economic cycles. The universe of top performers is small and can absorb as much as 50 percent of the total LP capital. The rest of the capital is being sprinkled in subpar funds, which yield subpar returns, which creates more noise for the top performers.

ACCESS TO THE BEST-IN-CLASS IS LIMITED

LPs have limited access to the top quartile managers. In a 2010 J.P. Morgan survey of 325 institutional investors, as much as 42 percent of the respondents described top-manager access as an advantage of this asset class.[4] We saw earlier that a $50 million investment does not do much for a larger institutional investor. But once LPs gain access to a top-performing fund, not only do they heave a sigh of relief, but they gradually try to up their position and seek a larger investment size. This creates an interesting problem—those on the inside seek bigger bites, and yet, those on the outside are eager to get in. The top quartile funds start to expand in size to accommodate this growing demand, but few funds can maintain performance. Success begets bloated funds, and thus lower performance. Research shows that a 50 percent increase in fund size leads to 1.5 percent decline in IRR. Performance peaks with $200 million fund and declines once funds cross $500 million.[5]

"It's a swell offer, Brad, and you're a great guy, but I've just got out of a bad limited partnership, and I'm not ready for that kind of commitment yet."

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Size is not the only problem. Strategies shift (think cleantech). Stage-related dynamics (early-stage investors become later-stage or multistage investors) cause LPs to walk away from funds. With stronger performance come GP-friendly investment terms (high carry structures, fatter fees per partner, little reporting, or minimal LP control provisions). As LPs shift away, the dance starts all over again.

CAPITAL SUPPLY AND DEMAND

Every good VC investment a la Facebook, Twitter, and Google leads to a mad scramble for LPs to invest more capital. This leads to emergence of

subpar LPs who do not fully comprehend the dynamics of this asset class and end up investing in GPs who do not deserve to be in this business.

Chris Douvos, who blogs as SuperLP, draws an interesting analogy:

> *If the public markets are like an ocean with trillions of dollars at play, the private equity as an asset class is like a bathtub (LPs invest ~$300 billion each year in PE in United States). Venture is like a tiny sink or a bucket—at $20 billion each year—and when you pour a lot of capital in a small bucket, you end up making a big mess.*

Douvos is alluding to the $100 billion that eager LPs invested in VC during the 1999–2000 bubble era. Such excesses will need another few years for cleanup.

But with every triple-digit IRR a Facebook, Zynga, Groupon, and Twitter generates, the hoi polloi jumps back in the asset class and throws a lot of fresh water in the sink. The level rises but, unfortunately, there is no ringing of alarm bells to alert LPs that the overall bucket is about to overflow—that the capital supply-demand curve is shifting. Several LPs bemoaned the fact that over supply of capital causes a mess and it takes upward of a decade to mop things up. On the other hand, eager GPs argue that more capital is better, and the market can expand with technological trends. After all, LPs invested about $2 billion each year in the early 1980s in VC—a number that has now grown to $20 billion a year.

Embedded within this debate is the inherent cyclical nature of all investment trends—with more money, valuations go up, returns go down, and LPs scream that the venture model is broken, take their toys away, and go home. And the ones who know how to play the game grin silently—stay consistent and generate strong returns in the down markets and the cycle starts all over again.

THE CHALLENGES OF FUND PERFORMANCE MEASUREMENT

Often it feels like every GP who walks in the door is in the top quartile. FLAG Capital, a fund-of-funds, calls it the Lake Wobegon effect: where all VCs are above average. The first problem is fundamental; past performance does not guarantee future results. The second is that public benchmarks are of little help because the "private" in PE translates to lack of meaningful datasets. While this has improved significantly over the years, the sample size and returns reporting (largely sourced via Freedom of Information Act

requests of public pension funds) can create challenges for any LP. Compare data from two highly respected sources:

Vintage Year	Top Quartile IRR (Data source #1)	Top Quartile IRR (Data source #2)
2002	3.8%	6.2%
2004	8.9%	4.8%
2007	0.3%	(13.0)%

To position themselves in the best light, GPs choose one data source over another.

Additionally, the best performers do not have any incentive to report their data and the worst of the GPs quietly leave through the back door. Thus, sample size for most datasets is small, making this debate spirited, to say the least.

The other challenge is the propensity of the media to create "news" using premature data. For any vintage year, all IRR data in the first three to five years will be negative (it's called the J-Curve), but try explaining that to a green journalist who is bent on getting a byline on the front page. This hurts the entire VC asset class. And for VC associations across the board, this is an opportunity—ensuring data quality is relevant and the media thoughtfully presents it would mean less noise and more opportunities. Quarterly reporting on a 10-year fund is like trying to gauge the performance of a marathon runner at each mile; the data is great but not as relevant till the race is complete.

COMPETITION FROM WITHIN IS HIGH

Venture is an asset class that competes for LP mind-share. The line at the door includes other private equity players (Buy-outs, Mezzanine, Distressed Debt), hedge funds, real estate, oil and gas, and more. And risk-return profiles of other asset classes can be compelling, if not better. While some LPs dedicate a portion of their assets to venture capital, even within venture, LPs have ample choices.

According to the NVCA, there are approximately 800 active venture firms in the United States. In 2010, there were over 120 funds in the market seeking over five times the capital that is typically invested in this asset class. Only an average of 10 percent would successfully raise their funds. Of these, a smaller portion will actually deliver some meaningful performance.

No database captures trends of those who tried and lost in this game. And there are no barriers to entry in this business—every entrepreneur who sells their company successfully wants to raise a venture fund, but there is only one Marc Andreessen. Performance remains concentrated within the few pockets of expertise.

A BUSINESS OF HOME RUNS

Each year, VCs invest as much as $20 billion in some 2,500 companies (and that is not even counting Yuri Milner's investments, a Russian investor who exploded in the VC arena with investments in leading social media companies such as Facebook and Twitter). Competition for good opportunities can be intense. VCs do not seek also-rans—companies that could end up with modest revenues. Each year about 600,000 start-ups are launched. Less than 0.5 percent attract VC. Of *Inc.* magazine's annual list of the 500 fastest growing companies in the United States assessed over a decade (1997–2007), less than 20 percent of companies were venture backed.[6] Obviously, VCs seek the ones that have proprietary technologies, can scale up quickly, and can become big winners, the kings of new categories—not "also-ran" companies.

Despite all the due diligence, the loss-ratios are significant. According to Professor William Sahlman of Harvard Business School, 62.4 percent of VC investments were completely lost while 3.1 percent of the investments accounted for 53 percent of the profits for roughly 600 investments.[7] According to the National VC Association data, as many as 35 percent of the venture-backed companies may have quietly failed. But a few big hits make up for all the losses—as Gordon Hargraves of Rho Capital, a fund-of-funds, puts it, "We should count ourselves as very lucky a 'Facebook' comes along once every five years. VC is a home run business, and our experience, the roughly 20 percent capital-weighted success rate of winners makes up for the 80 percent of losers. In 2010, less than $12 billion was raised in the U.S. for VC, yet the valuation of Facebook was $50 billion while Groupon, Zynga, and Twitter were all around the $5 billion mark and, given that, it was surprising more money wasn't going to VC."[8]

Exits, from a quick three-year flip in 1999, have stretched to an eight-year arduous journey in 2008. But at the same token, it took only three years for Zynga to reach a $3+ billion valuation. Squeezed in between these investment-exit dynamics are some seven thousand venture professionals, some hugely successful and some in between. Promod Haque of Norwest Venture Partners, one of the leading venture practitioners, once summarized a presentation with this New Testament James 4:13 quote, which I hope

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