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The Business of Venture Capital

SECOND EDITION

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

MAHENDRA RAMSINGHANI

Foreword by BRAD FELD

Afterword by CHRIS DOUVOS

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The Business of Venture Capital

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In the memory of my parents

and

for Deepa and Aria, the light and the song

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Foreword

I often get asked how I ended up becoming a venture capitalist (VC). My wife, Amy, likes to remind me that when I was an entrepreneur, I used to regularly give talks at MIT about entrepreneurship. I'd say—very bluntly—"stay away from venture capitalists." I bootstrapped my first company, and while we did a lot of work for VCs, I liked taking money from them as "revenue" (where they paid my company Feld Technologies for our services) rather than as an investment.

Feld Technologies was acquired about 20 years ago. Over the next two years, I made 40 angel investments with the money I made from the sale of the company. At one point in the process, I was down to under $100,000 in the bank—with the vast majority of our net worth tied up in these angel investments and a house that we bought in Boulder. Fortunately, Amy was mellow about this—we had enough current income to live the way we wanted, we were young (30), and generally weren't anxious about how much liquid cash we had.

Along the way, a number of the companies I had invested in as an angel investor raised money from VCs. Some were tough experiences for me, like NetGenesis, which was the first angel investment I made. I was chairman from inception until shortly after the $4m venture capital round the company raised two years into its life. Shortly after that venture capital investment, the VCs hired a new "professional" CEO who lasted less than a year before being replaced by a CEO who then did a great job building the company. During this period, the founding CEO left, and I decided to resign from the board because I didn't support the process of replacing this CEO, felt like I no longer had any influence on the company, and wasn't having any fun.

But I still wasn't a VC at this point. I was making angel investments with my own money and working my ass off helping get a few companies that I'd cofounded, like Interliant and Email Publishing, off the ground. I was living in Boulder at this point, but traveling continuously to Boston, New York, San Francisco, and Seattle, where I was making most of my investments. During this time, I started to get pulled into more conversations with VCs, helping a few do some diligence on new investments, encouraging some to look at my angel investments, and investing small amounts in some

venture capital funds whenever I was invited to invest in their "side funds for entrepreneurs."

One of the VCs I overlapped with while in Boston was Charley Lax. Charley was a partner at a firm called VIMAC and was looking at some Internet stuff. I was one of the most prolific Internet angel investors in Boston at this point (1994–1995) so our paths crossed periodically. We never invested in anything together, but after I moved to Boulder, I got a call one day in early 1996, which went something like:

"Hey—I just joined this Japanese company called SOFTBANK and we are going to invest $500 million in Internet companies in the next year. Do you want to help out?"

Um—okay—sure. I didn't really know what "help out" meant, but on my next trip to San Francisco I had a breakfast meeting that ended with something like "welcome to the team."

I still didn't really have any idea what was going on, but I was making angel investments and having fun. And soon I was a "SOFTBANK Affiliate," a title that had a small monthly retainer, a deal fee for anything I brought in, and a carry on the performance of any investments I sourced. This was an informal enough arrangement for me to play around with it for a while.

I was in Boston the following week and met with two people who would become close friends to this day. The first was Fred Wilson, who had just started Flatiron Partners (SOFTBANK was an investor in Fred's fund), and the other was Seth Godin, the CEO of Yoyodyne. I vaguely remember a fun, energetic chat as we met a few people at Yoyodyne, ran through the products, and talked about how amazing the Internet and e-mail was going to be as a marketing tool.

My formal report back was short—something like "Seth's cool, the business is neat, I like it." SOFTBANK and Flatiron closed an investment in Yoyodyne a few weeks later.

Suddenly I was a VC. An accidental one. And it's been a very interesting journey over the past 17 years.

When I started investing as an angel investor, I often crossed the boundary between investor and entrepreneur. When I became a venture capitalist and started investing larger amounts in more companies, I continued to cross this boundary. It took a few years for this to catch up with me, but it finally smashed me over the head when I realized I couldn't effectively play the role of both the investor and the entrepreneur. I had to pick one.

Once I chose the role of investor, I also determined it was my job to completely support CEOs or founders. If I lost confidence in them for any reason, my first task was to confront them about it. If we could reconcile this, I'd continue to support them all the way and work for them. If not, it was my job as an investor to address my concerns at the board level.

Over the years, I have realized that it takes a mix of personal attributes and intellectual abilities to become a venture capitalist. While there are some great VCs, as with anything else, there are some awful ones.

Venture capital is a business where each investment teaches you something new—a lot can be learned by doing. In each of the books I've written, I emphasize the basic fact that a book provides only a basic framework, but each one of us has the ability to carve a different path in this universe.

In *The Business of Venture Capital*, Mahendra Ramsinghani has done an excellent job of this. As you read this book, either with the aim of becoming a venture capitalist or trying to understand the dynamics of the venture capital business, recognize that Mahendra has given you a framework for understanding how this all works. While VC personalities, styles, behavior, and effectiveness vary widely, Mahendra helps describe venture capital in a way that is comprehensive, yet easily understood.

—Brad Feld
Managing Director, Foundry Group
March 2014

Preface

"If you are under the impression you have already perfected yourself, you will never rise to the heights you are no doubt capable of."

—*Kazuo Ishiguro,* The Remains of the Day

In venture capital, what matters? Skill or luck? Maureen Wilcox could well be a very successful venture capitalist (VC). She bought two lottery tickets—one in Massachusetts and another across the state border in Rhode Island. Both tickets had winning numbers. Venture capital boils down to the ability of picking winners. Yet, no book can teach you how to pick winners or be a successful VC. At best, this is an attempt to develop and identify the framework for thought and action.

This book addresses the arc of a venture capital investment lifecycle. Fund raising, constructing a portfolio, identifying and investing in opportunities, roles of board members and more. My goal here is to inform, educate and, in some cases, even entertain. Over 50 leading experts have shared their views and practical advise. Findings from academic research papers have also been summarized. Dense formulas that contain Greek characters are not included, sorry nerds. Finally, I have also included lessons from my own experience of over a decade of investments.

Even as we live in the era of big data, nothing about venture capital investments is predictable or persistent. The correlation/causation debate continues. In analyzing performance of more than 2,300 funds between 1974 and 2010, over 250 funds returned more than 2X of paid in capital. These funds are in the $250 million size range. The number of funds above $500 million in size that returned 2X capital is meager: two funds. The bigger question practitioners need to ask—is 2X good enough a return? Over the 2000–2010 decade, venture capital shrinkage or right sizing has occurred across the board. The number of active venture firms dropped by 50 percent.

Average fund sizes declined from $170 million (2000) to $140 million (2012). Smaller venture funds of less than $50 million have dropped by 70 percent between 2000 and 2012. Yet some micro venture capital funds in the $35 million size category are trending upward of 5X cash-on-cash returns. If smaller fund managers are better at picking the right companies, why is this universe shrinking? In analyzing exit values, of the 534 exits that occurred in the decade, 320 exits were less than $150 million in size and had consumed an average of $56 million. It is no wonder then that SuperLP Chris Douvos asks, show me the RTFE or return the fund exit. Investors want to see one big hit in any venture capital portfolio that has the potential to return the entire fund. One investor I spoke with described a 2X return over 10 years as utterly mediocre, and is no longer investing in the venture capital asset class. This sentiment is prevalent as institutional investors now seek proven and experienced venture investors. Size matters, performance even more.

The one question I struggled with was: what makes a great VC? Or is there even such a thing? Like mutual funds and Hollywood stars, venture capital funds tend to cycle in and out of popularity charts—what's hot today is out of favor tomorrow. Do great VCs consistently pick the next big winner? Do they host diligence sessions at vineyards and sail into the sunset on a 40-foot catamaran? Or is greatness defined by immense popularity within entrepreneurial ranks? Is greatness an accidental outcome in the garb of a narrative fallacy? Or is it a thoughtful plan executed with grit and determination? These questions remain—and then, there are a few stories that I have left out. For example, the one about a VC who planted a hidden camera in a portfolio CEO's house. Or the one about an uber-arrogant Sand Hill Road VC whose administrative assistant told me she had a burning desire to kill him. Such gossip stories do not further the intellectual debate and are better narrated after three drinks. But boy, are these good stories!

Coming back to the question of attributes of a great VC, I have included a few examples of those who chose to not accept the status quo. Brad Feld disrupted the way VCs treat and engage with entrepreneurs (with respect, for a start). He co-authored a series of books to empower entrepreneurs, (I am honored to have co-authored *Startup Boards* with him) and co-founded TechStars, a global accelerator network. Dave McClure of 500 Startups wants to build an entrepreneurial ecosystem in every continent. Or consider Andreessen-Horowitz (A16Z). Venture capitalists can use the 2 percent management fee income to fatten their wallets. The management fees for Andreessen-Horowitz's funds are used to build an army of more than 100 team members with the aim of serving entrepreneurs better. By choosing to drop this moral hazard, they have become the sought-after firm by investors and entrepreneurs alike. Even as Sand Hill Road VCs grumble that A16Z is overpaying high valuations, investors gladly invested yet another

$1.5 billion in 12 weeks. These are a few examples of those who chose to make a meaningful contribution to the entrepreneurial ecosystem, well beyond the carry and fees. These are the crazy ones. Such behavior requires dissolution of ego and greed and calls for a sense of service and humility—all of which seem in short supply. My hope is that as practitioners we find our own meaningful ways to fuel the forces of disruption. Success then is aligned with something greater than material possessions—a legacy and a path worthy of emulation.

Part I of this book covers the process of raising a venture fund. The preliminary chapters describe the fund investment cycle, roles of various team members, in any fund and the economics of fees and carried interests, or profits. Part I aims to help decipher the investor universe, fund diligence, the legal terms, fund structures and more.

In Part II, the process of sourcing investments, structuring and negotiating term sheets, adding value as a board member and monitoring portfolio companies is covered. Finally, the last chapter touches upon the foibles of human psychology. I have relied on the insightful and often hilarious and humbling works of David McRaney, author of *You Are Not So Smart: Why You Have Too Many Friends on Facebook, Why Your Memory Is Mostly Fiction, and 46 Other Ways You're Deluding Yourself*. He writes, "You want to believe that those who work hard and sacrifice get ahead and those who are lazy and cheat do not. This, of course, is not always true. Success is often greatly influenced by when you were born, where you grew up, the socioeconomic status of your family, and random chance." Which brings us to the final question – how does luck factor in the venture capital universe?

We started with Maureen Wilcox who bought lottery tickets for both the Massachusetts lottery and the Rhode Island Lottery. Incredibly, she managed to choose the winning numbers for both lotteries but didn't win a penny. In a strange twist, the numbers she picked for Massachusetts lottery were the winning numbers for the Rhode Island lottery. And vice versa. Good picking skills—very lousy luck. That makes her a bad VC, doesn't it?

On the other hand, Evelyn Marie Adams won a $4 million lottery and four months later won another $1.5 million. Even luckier was Donald Smith. He won the Wisconsin State lottery three times in three consecutive years. Chris "SuperLP" Douvos often describe VCs as those with a lottery and a dream. If you think of this business as a game of luck, you should buy 40 lottery tickets instead of this book. If you wish to hone your skills, read on.

Acknowledgments

In preparation of this book, some of the world's leading venture practitioners offered their wisdom and insights. Their names are sprinkled all over this book. Without their participation, support, encouragement, threats, and sometimes the much-needed kick-in-the-rear, this would have remained just another idea. A mere acknowledgement, then, seems inappropriate. Deep gratitude would be more like it. And of course, while all the great ideas and insights are theirs, any mistakes are mine.

After the first edition was released, I was humbled with the positive responses that came from readers across the United States, Europe, and Asia. Thank you to those who took the effort to share your feedback and reviews.

Finally, the world of venture capital would be bereft of its glory, but for the entrepreneurial force. I bow deeply to that force, because it all starts with those "crazy ones" who believe they can change the world.

San Francisco
April 2014

PART One

Raising the Venture Fund

Raising the venture fund, especially first-time funds, is not for the faint of heart. Institutional investors or limited partners (LPs) look for the following:

- Performance track record and background of fund managers
- Investment strategy and its relevance to (a) managers' expertise and (b) market conditions

The LP universe is diverse. It includes pension funds, endowments and foundations, corporations, private family offices, and individuals. The motivations for each are primarily financial returns and asset diversification. LPs expect venture returns to be at least twice those offered by liquid securities, such as public market indices. Top quartile venture returns average upward of 20 percent of the internal rate of return (IRR).

According to Preqin research:

- Fifty-two percent of venture funds complete their fund-raising in 12 months. Others spend as much as 24 to 36 months on the road.
- Of the funds that successfully got off the ground, only 7 percent are first-time funds.
- About 70 percent of the funds successfully reach or exceed their targeted fund amount.

Placement agents are able to offer market intelligence and accelerate the fund-raising process via LP relationships for newer funds. Some LPs shun the venture asset class, as it is harder to establish determinants of consistent

performance. Others play with only a select group of top-tier venture funds. Some choose to invest in a fund of funds or move over into other subclasses of private equity, such as middle market buy-out funds.

Part I covers the process of raising the venture fund. We look at how practitioners can find an entry point into the world of venture capital. Those brave enough to raise their own funds can gain a better understanding of the universe of institutional investors. Their asset allocation strategy and fund due diligence criteria are covered in this section.

CHAPTER 1

The Basics

> *"The key to making great investments is to assume that the past is wrong, and to do something that's not part of the past, to do something entirely differently."*
>
> —Donald Valentine, Founder, Sequoia Capital[1]

A day in venture capitalist's (VC's) life is like that of an entrepreneur—venture capitalists have to pitch a thousand pitches to institutional investors to raise their fund and execute a predetermined plan. If the plan goes well, rewards are distributed; egos are stroked and champagne flows. The partners then go back and raise another fund. If the plan goes really well, which is rare, the partners retire, join local nonprofit boards, or spend time aboard a fancy yacht. A VC's profession is driven by three primary functions: raise the venture fund, find investment opportunities, and generate financial returns.

RAISE THE VENTURE FUND

VCs raise money from financial institutions (called limited partners, or LPs in industry jargon) such as pension funds, foundations, family offices, and high net-worth individuals. (See Figure 1.1.) Investment professionals or general partners (GPs) develop an investment strategy. Based upon this thesis, its timeliness and robustness, investors commit capital to the venture fund. Investors or limited partners seek a blend of strong investment expertise, a compelling investment strategy, and supportive market conditions. Target returns for investors are typically in the range of 20 percent or more on an annualized basis.

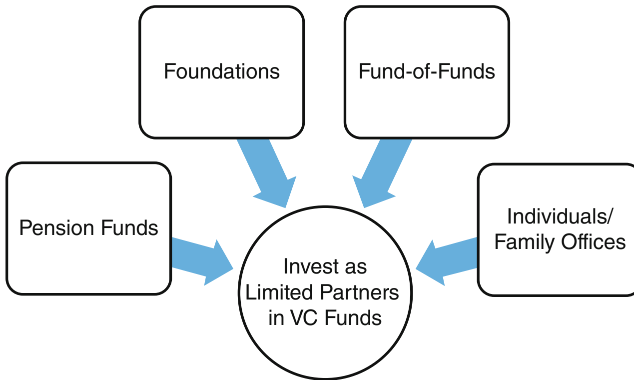

FIGURE 1.1 Limited partners (LPs) in a venture fund.

The fund-raising process can be long and arduous, taking as much as 18 months, and is often compared to an uphill crawl on broken glass. Many a VC is humbled in this process and can empathize better with entrepreneurs when financial institutions do not return their calls, do not ask them to pitch their fund strategy in seven minutes, offer no feedback, and go dark.

A venture fund is a close-ended fund. Once the target amount is raised or the fund is subscribed, no new investors are admitted. The life of such a fund is typically 10 years.[2] The fund is dissolved after the 10th year or when all portfolio investments have been liquidated.

Successful firms do not necessarily wait until liquidation of the previous fund; they raise their next fund as soon as the majority of the capital of the current fund is invested or designated as reserved for existing portfolio companies. Leading venture firms raise a fund every three to five years. Typically, funds are labeled with Roman numerals, such as ABC Ventures Fund I, II, III, IV, and so on. Roman numerals are a soft indicator of a venture fund's ability to survive and to generate returns across the various economic cycles. A firm's true measure of success is its ability to generate consistent returns over multiple economic cycles.

FIND THE RIGHT INVESTMENT OPPORTUNITIES

Once the fund-raising process is complete, VCs are under pressure to deploy the capital. During this investment period, as seen in Figure 1.2, any fund actively seeks Facebook-like opportunities to generate target returns. Investment periods can be three years to five years. In this period, the start-ups come in—the mating dance begins. The pitch deck, term sheets, valuations, and boards

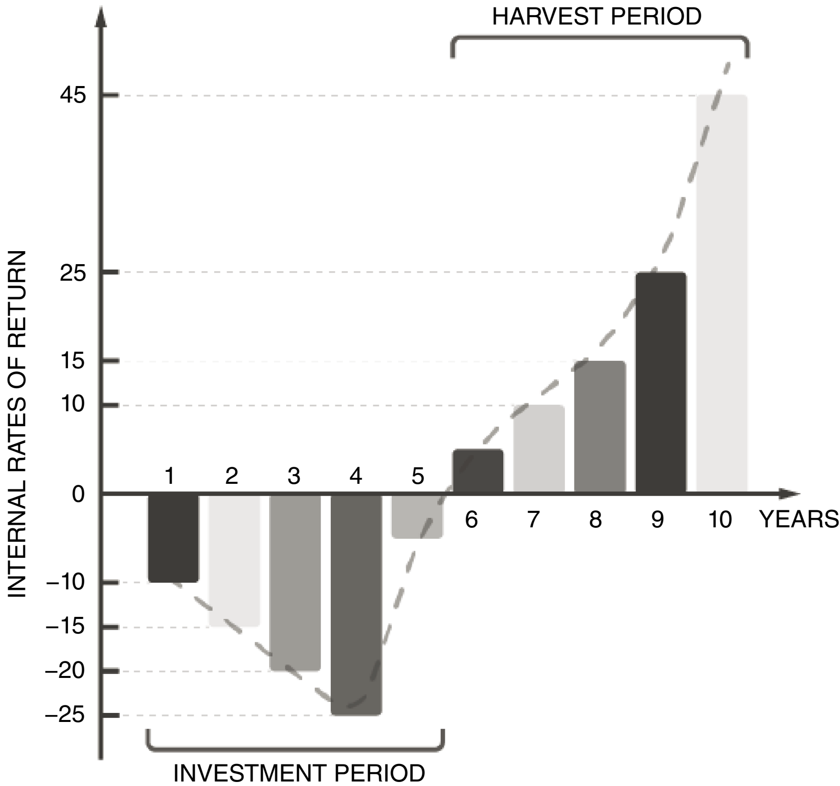

FIGURE 1.2 The J curve of venture fund investments.

are negotiated. A venture fund has to build a portfolio of companies that promise strong returns. Each portfolio company should demonstrate the potential to generate a return that equals a multiple of 8 to 10 times the capital invested. On a portfolio-wide basis, venture funds target a 20 percent annualized rate of return or a minimum of two to three times the invested capital.

A typical portfolio size for any fund can be 10 to 30 companies, based upon the sector and stage of investment. In technology sectors, the capital needs are lower, risks are deemed higher, and growth rate of companies is faster. In comparison, life science companies need larger amounts of capital and time to reach maturation. Hence, a technology venture fund may have as many as 30 companies in its portfolio, whereas a life sciences fund may have a dozen companies.

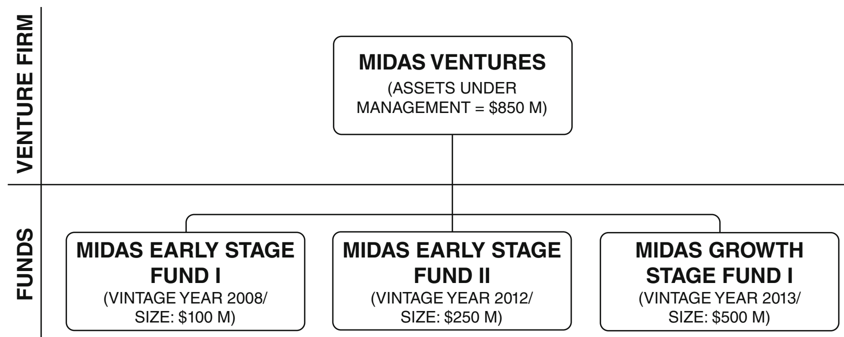

FIGURE 1.3 A successful venture firm raises several funds over time.

After the portfolio is constructed and the fund has been committed, a venture firm gets ready to raise another fund. (See Figure 1.3.)

GENERATE FINANCIAL RETURNS

As they say in the venture industry, any fool can write a check and make an investment; it is the returns that count. Fund returns, measured by internal rate of return (IRR) are a function of two factors: time and capital. The faster a portfolio company is sold, for as high an amount, the higher the IRR. This is often where things can get tricky. A speedy exit involves selling a start-up, and this can clash with the realities of market conditions and lofty entrepreneurial ideals.

Ideally, the exits should occur within three to four years from the date of investment, but only very few follow this hypercurve. Exit horizons are six to eight years, possibly longer based on market conditions. Delays create immense pressures on the fund managers as future fund raising can be jeopardized if the timing is not aligned. The graveyards are littered with plenty of start-ups, as venture capitalists fail fast and move on. If a start-up cannot achieve liftoff quickly, it often ends up in the "living dead" section of the portfolio.

Let us look at some attributes of the business of venture capital:

- **It's a risk–reward game:** The risks of a start-up investment are significant. Almost 80 percent of all investments fail. Venture fund portfolios are inherently risky, as the bets are on unproven technologies, shifting markets, and first-time CEOs. While entrepreneurs pitch start-up dreams, any VC can see the obvious upside—yet they are making a mental list of

TABLE 1.1 The Advantages of Shorter Holding Periods

Company	Capital Invested ($M)	Realized Value ($M)	Holding Period (years)	Gross IRR (%)
Company 1	1.0	5.0	2	123.6
Company 2	1.0	5.0	6	37.9

all the reasons why this start-up will fail. In other words, sizing up the risks and points of failure is essential.

Any venture fund's portfolio will eventually end up with a mix of a few huge successes, some middle of the pack, and some flameouts. Typical rule of thumb is that one-third of the portfolio generates 5 to 10 times the invested capital; one-third will generate 1 to 3 times or so. The final third of the portfolio will be relegated to the "experience" bucket as total losses. Yet at the point of investment, the expectation is to generate a 10-times return in three to five years.

- **Time is not your friend:** The longer a start-up takes to reach a critical value milestone, the more concerned investors become. After all, the one metric that venture funds and professionals live by, IRR, drops rapidly over the passage of time.

  Consider a simple example in Table 1.1. A VC invests $1,000,000 in a start-up in year 1 and generates $5,000,000 in year 3. The IRR yields a healthy 123.6 percent. Now, instead of year 3, assume that the exit occurs at the same value in year 6: the IRR drops down to 37.9 percent.

  Table 1.2 depicts how VCs demonstrate their performance to institutional investors. Notice that most portfolio companies are reduced to a single line statistic, measured primarily by multiple of capital invested and gross IRR.

TABLE 1.2 Fund Performance

Company	Capital Invested ($M)	Realized Value ($M)	Unrealized Value ($M)	Multiple of Capital Invested	Gross IRR (%)
Barn burner	2.0	180.0	—	90×	144
Middle of the road	1.5	0	$6.0	4×	NM
Also-ran	3.0	—	$1.5	0.5×	NM
Dry hole	2.5	0.1	—	—	NM

NM = Not meaningful.

- **Portfolio management:** All VCs love all their portfolio companies as they love their children, and they have many children, as many as 10 or more companies for any fund's portfolio. Even then, the relationship is a bit odd, like that of a friendly farmer feeding and nurturing a turkey for Thanksgiving slaughter. Josh Koppelman of First Round Ventures says, "You've heard the story of the chicken and the pig when it comes to making breakfast. Both the chicken and the pigs are involved, but the pig is fully committed. There's a little bit of truth to the fact. The VCs are the chickens in this relationship."[3]
- **VCs only make money *after* their investors make money:** A venture capitalist makes money in two ways: a base salary and a percentage of the profits (called "carry" or "carried interest"). Typically, funds make 20 percent of the profits generated on any exits. Some funds, thanks to their performance and brand, command as much as 30 percent. Most funds are structured so that the profits are distributed after they have covered *all* the previous losses in the fund. A successful firm raises multiple funds over time: those who cannot perform are relegated to the annals of history as unfortunate victims of Darwin's laws.

ROLES AND RESPONSIBILITIES

In any venture firm, the cast of characters includes the general partners (GPs, managing directors or managing GPs), vice presidents, principals, associates, and analysts. Investment professionals are responsible for making investment decisions, managing the portfolio, and generating returns. Associates and analysts often support the lead investors in due diligence or portfolio-monitoring activities and eventually rise up to leading investment decisions.

The primary responsibilities of the investment team differ along the lines of seniority. On any typical day, the GPs would juggle a number of activities: negotiating terms for investment opportunities, participating in boards of current portfolio companies, responding to any LP/investor requests, and putting out a few fires along the way. On the other end of the spectrum, an entry-level analyst is expected to source investment opportunities and screen these for further deliberations.

Roles such as venture partner and entrepreneur-in-residence positions are created to host proven entrepreneurs. Such professionals may source investments that fit within the fund's investment strategy or offer sector expertise to assist other partners in making decisions. Newer titles have evolved as fund operations have become more focused. For example, in larger funds, roles such as director of business development or head of deal sourcing have emerged.

The administrative team, also referred to as the back office, is responsible for the day-to-day operational and financial aspects. Operations teams manage activities such as payroll, taxes, and investor communications. Depending on the size of the fund, this team may include an office manager, chief financial officer, chief operating officer, and others such as legal counsel, marketing, and human resources.

The typical compensation package includes a salary, annual performance bonus, and a share of the profits, called "carry," or carried interests.

COMPENSATION

To better understand the compensation and financial economics, take the example of a $100 million fund. VCs are compensated by two methods: (1) management fees and (b) share of profits called carried interests or carry.

Investors pay an annual management fee, typically 2 to 2.5 percent of the committed capital per year. The investors also keep 80 percent of the profits, and the fund managers take home 20 percent. The carry model of one-fifth profits evolved from the time of the Phoenicians (1200 A.D.), who commanded 20 percent of profits earned from trade and shipping merchandise.[4]

Thus, for a $100 million fund, annual fees of 2 percent yield $2 million each year. The fees provide for the day-to-day operations of the firm and are used to pay for salaries, travel, leases, and legal expenses. The compensation packages are determined by the professional's responsibilities and experience. One of the perks of being a VC in Silicon Valley includes the privilege of not getting your cars towed. (See Figure 1.4.)

The primary expenses in any fund are salaries. The majority of this budget is allocated to investment professionals (general partners and members of the team, which could include associates and analysts) and the rest of the world (comptroller, operations, and back office). The budget also includes fees (legal, audit, and in some cases, specialized due diligence), travel, and miscellaneous operating expenses.

The typical compensation package includes a salary, bonus, and a share of the profits, the carry. The compensation varies by size of the fund; thus, in a $20 million fund, the scales may differ as compared to a fund with $1 billion under management. For a $20 million fund, the average annual fee income is $400,000, and this is typically split between two professionals. Larger funds have the ability to pay packages as described in Table 1.3.

FIGURE 1.4 In Silicon Valley, the perks of being a VC.

TABLE 1.3 Typical Compensation ($000)

Title	Salary	Bonus	Carry	Total
Managing GP	700	350	101	1,151
Partner	350	130	20	500
Principal	206	75	6	287
Venture partner	185	40	12	237
Analyst	100	10	0	110

Compensation is determined by the size of the fund.