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.

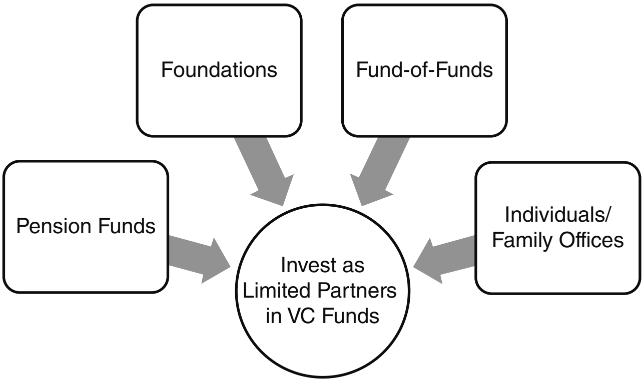

FIGURE 1.1 Limited partners (LPs) in a venture fund.

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

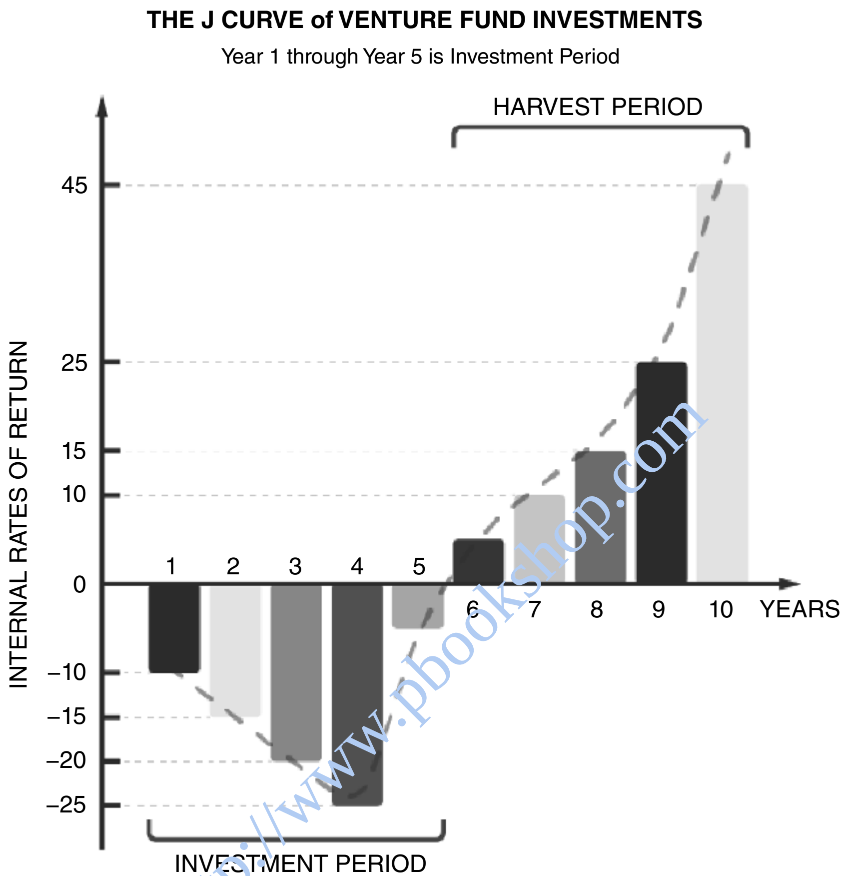

FIGURE 1.2 The J curve of venture fund investments.

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.

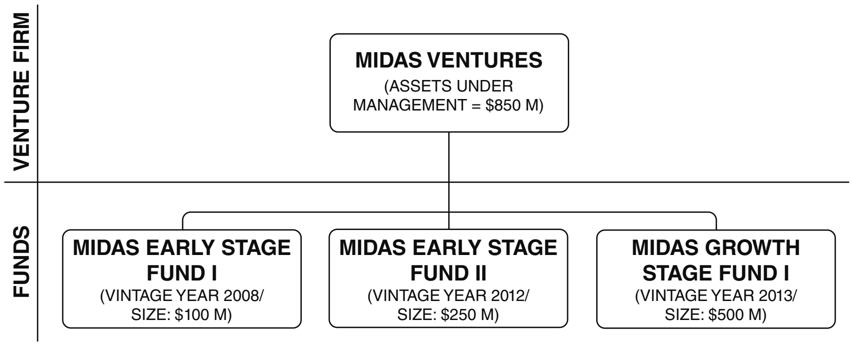

FIGURE 1.3 A successful venture firm raises several funds over time.

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.

TABLE 1.4 Sample Carry and Vesting Schedule

	Carry	Y1	Y2	Y3	Y4	Y5	Y6–Y10
Managing director 1	8%	20%	15%	15%	15%	15%	20%
Managing director 2	7%	20%	15%	15%	15%	15%	20%
Principals, associates, and staff	5%	20%	20%	20%	20%	20%	

Carried Interests

Carried interests, or carry split, can occur on the basis of experience and performance. In the example presented in the Table 1.4, carry is determined by roles and responsibilities. The vesting schedule is often spread out over (1) the investment period, or the first five years, and (2) the harvesting period, or years 6 through years 10, when the portfolio is being divested. To keep professionals engaged, carry is often released at the end of the life of the fund.

Pace of vesting is tied to investment period of the fund. Typical investment period is four to six years. Vesting schedules can match investment period on a straight-line method vesting yearly in equal shares. A 20 percent withholding released at final dissolution of the fund induces professionals to remain engaged throughout life of the fund.

Vesting clawback occurs when a partner gives up their carried interest for cause or disability per standard industry practices.

COMMUNISM, CAPITALISM, AND PARTNERSHIP OF EQUALS

Benchmark Capital is a partnership of equals. Matt Kohler, 31, Benchmark's newest member, gets an equal share of carry, as does Bob Kagle, who founded the firm 15 years ago. This philosophy fosters a team-oriented approach to the business—internal competition is eliminated. When this structure was announced by Benchmark, another venture capital industry veteran protested that such behavior is tantamount to "communism." Bruce Dunlevie of Benchmark promptly pointed out that the guy who said that "must have been a senior partner."[*]

At Bessemer Venture Partners, a balanced approach to financial rewards, performance feedback, and team spirit has fostered an environment where "not a single partner has left the firm."[**]

[*] Randall E. Stross, *eBoys: The First Inside Account of Venture Capitalists at Work* (New York: Crown Business, 2000), 89.

[**] Source: David Cowan, speaking at VCJ Alpha Conference (Half Moon Bay, CA, October 2013).

NOTES

1. "VC Titans Tom Perkins and Don Valentine Articulate What Makes a Good VC." Disrupt SF 2013 Conference Web site. Sept. 11, 2013. http://techcrunch.com/2013/09/11/vc-titans-tom-perkins-and-don-valentine-articulate-what-makes-a-good-vc.
2. While venture capital funds are structured as finite partnerships with a life span of 10 years, extensions of a year or two are standard, depending on the portfolio status.
3. Author interview, January 2012.
4. Lauren Fedor, "A History of Hedging," *Wall Street Journal*, June 12, 2010.