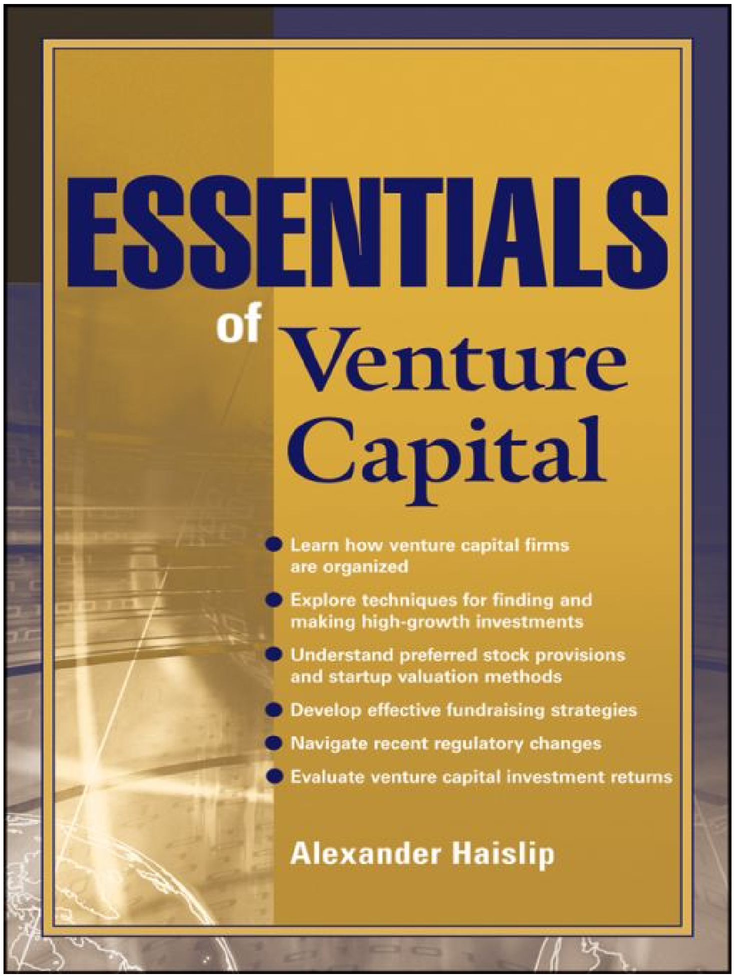
ESSENTIALS of Venture Capital

- Learn how venture capital firms are organized
- Explore techniques for finding and making high-growth investments
- Understand preferred stock provisions and startup valuation methods
- Develop effective fundraising strategies
- Navigate recent regulatory changes
- Evaluate venture capital investment returns

Alexander Haislip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Preface

I left New Jersey in June of 2004 and drove my white Toyota across America on Interstate 80. After five days on the road, I pulled into the parking lot of a Residence Inn in Mountain View, California. It was the middle of the night.

Mountain View is in the heart of Silicon Valley, north of San Jose and south of San Francisco, and just a town over from Stanford University. It is a city of mixed residential buildings, low-slung apartment complexes, quarter-acre lots, and 1970s-style office parks. Tall redwood trees pop up between the buildings, punctuating an unremarkable skyline.

The city abuts Moffett Federal Airfield, which features the single most notable building in Mountain View, a 1930s dirigible hanger shaped like a gigantic caterpillar, three football fields long and 200 feet tall.

Giant gray C-130 Hercules turbo-prop planes buzz the town on Air National Guard training days, their massive bodies hanging fat and heavy against the blue sky.

Mountain View is a place practiced in the art of launching massive endeavors and has served as home to several large technology companies. Google was king while I was there and its employees seemed to have invaded the city. You couldn't walk down Castro Street, the city's main drag, without going past five or six people wearing T-shirts with the company's colorful logo.

They appeared so self-assured in the summer of 2004. Google was poised to go public and it was easy to imagine the employees smugly calculating the value of their stock options in their heads. The dot-com boom had come and gone, but the techies were going to cash in one more time. Google promised to be a phoenix flying out of the ashes of excess from four years before.

“Every few years, there must be that spectacular reminder that the merry-go-round still offers riders the brass ring,” writes Silicon Valley Journalist Michael Malone.[a] After the dot-com bust, Google’s initial public offering (IPO) was surely that: proof that entrepreneurs, engineers, and financiers could still launch lucrative new industries.

The process of going from idea to multibillion-dollar business fascinated me and I decided to learn as much about it as I possibly could. I spent my first year in Mountain View interviewing anybody who could teach me the business of technology.

One of the first lessons I learned was that there are two types of technology start-ups: those that *had* raised money from venture capitalists and those that were *trying* to raise money from venture capitalists.

Google raised over $25 million from Sequoia Capital and Kleiner Perkins Caufield & Byers, and was worth $27.2 billion the day it went public. Kleiner Perkins’s John Doerr and Sequoia’s Michael Moritz had invested when Google was little more than two computer science dropouts in a garage. Five years later, it was an Internet juggernaut.

It snapped the Silicon Valley ecosystem into focus for me and helped me understand why venture capitalists were treated with such reverence. They were both technological clairvoyants and the gate-keepers to great wealth.

But the success of Google was a bright spot in an otherwise cloudy and confusing time for venture capital. The basics of the business were under constant question as investor performance waned.

What had once been a cottage industry of casual partnerships had been transformed by the dot-com boom but had yet to find a firm footing in its new role. Technology was no longer a part of the U.S. economy, it was *the* U.S. economy, and venture capital was one of its most important catalysts.

Venture capitalists raised over $100 billion in 2000, and the traditional models of investment were no more built for that kind of boom than a Volkswagen Beetle is built for the Indy 500. The industry was forced to evolve.

This book will help you understand how the venture capital industry is changing. It will show you the incentives that individual investors face and how those incentives dictate the evolution of the industry. If you're uncertain about how venture capital works, or want to understand recent developments in the business, this book is designed to quickly get you up to speed.

You can read the book straight through or pick out the chapters that interest you most.

Chapter 1 serves as an overview of both the basics of venture capital and the major changes and challenges the industry has faced during the past decade. This chapter will help you get up to speed on how venture investors operate and what makes them successful. You will learn how government regulation, industry consolidation, and new technologies have changed the finance of technology start-ups.

In Chapter 2, you will learn how to build a career as a venture capitalist. You'll see how different firms manage their staffing, growth, and succession, and understand how best to fit in.

Chapter 3 will show you several key fundraising strategies that work even in challenging macroeconomic environments. These will help you craft your pitch to potential investors. Understanding how firms market themselves will allow you to differentiate your approach and increase your chances of successfully connecting with cash.

Chapter 4 will introduce you to the basics of making investments. You will learn what venture capitalists look for in an investment and what factors affect their financing decisions. This chapter also describes how professional investors create special kinds of stock to protect their money.

Chapter 5 will show you how to find good investments. You will learn that venture capitalists have three major strategies for connecting with the best entrepreneurs and how to execute each strategy. Whether you are interested in how to make smart investments or in how to raise money for your own start-up from venture capitalists, this chapter will help you.

Chapter 6 is all about getting your investment dollars back. It compares taking a start-up public to selling it, which are the two major ways venture capitalists get their money back. It will help you evaluate the ongoing IPO crisis and introduce you to innovations designed to overcome it.

Chapter 7 is your guide through the ups and downs of the venture capital business. You will learn what drives the continual process of boom, bubble, and bust. You will be able to spot each part of the business cycle and execute strategies for investing effectively at any point in it.

Chapter 8 will walk you through the path to going global. You will see how successful firms have taken what works well in Silicon Valley and modified it to pursue opportunities abroad. This chapter will help you appreciate the difference between doing business in Israel, China, India, Russia, and other emerging markets.

Acknowledgments

Thanks to Larry Aragon, editor-in-chief of Thomson Reuters's *Venture Capital Journal,* for his mentorship and the opportunities he has afforded me while writing for VCJ. The magazine would not be the best in the business without his vision and tireless work.

Alastair Goldfisher, Joanna Glasner, Connie Loizos, and Dan Primack each provided me with invaluable research through their gold standard reporting and writing. I can always trust their stories to be well researched, thorough, and informative. They've helped me set high standards for what I do each day.

This book is informed by more than half a decade of research, and reporting on every aspect of venture capital and technology finance. I have spoken with well over a thousand investors, executives, entrepreneurs, and technologists, as well as a myriad of lawyers, accountants, and public relations executives too numerous to name. I am grateful to them all.

Still, there are those who have gone out of their way to help me. They invited me into their homes, took my calls at odd hours, read chapters, tipped me off to great stories, and selflessly offered me the benefit of their experience. A brief list of those I would like to specifically thank: Patrick Chung, Morten Lund, Alexandra Johnson, Mark Cecil, Venky Ganesan, Chris Douvos, Stewart Guenther, and two other high-ranking sources who wish to remain anonymous.

Knowing what to write is one thing. Putting words on paper is another. Thanks to Brian Caulfield, Joel Achenbach, Jim Willse, and Steve Isaacs for their mentorship and editorial encouragement throughout my reporting and writing career. Thanks to Ed Zschau for opening the world of Silicon Valley to me while I was an undergraduate at Princeton. Thanks to Sheck Cho, Helen Cho, and Laura Cherkas at John Wiley & Sons for their guidance and careful edits on this book.

Thanks to my parents for their constant encouragement, guidance, and support during this project.

Thanks to my lovely wife for sharpening the focus and logic of this book through her insightful edits. Her love fills my sails and carries me forward always.

CHAPTER 1

Industry Overview

After reading this chapter, you will be able to:

- Distinguish venture capital from other asset classes.
- Recognize the key functions and processes of venture capital investing.
- Differentiate between general partners and limited partners.
- Estimate typical investment returns for venture funds.
- Understand the seven reasons for the current performance crisis in venture investing.

What Is Venture Capital?

The best definition of venture capital comes from the man who created the industry. General Georges Doriot, a Harvard Business School professor and early venture capitalist, said that his firm would “invest in things nobody has dared try before.”

Venture capitalists, sometimes called “VCs,” look for new technology emerging from a government laboratory, a university research department, a corporate incubator, or an entrepreneur’s garage that disrupts a big market. It may even create entirely new markets. Such disruption presents fertile ground for rapid growth and wealth creation, or wealth redistribution. Venture capitalists professionally invest money in businesses that are neither proven nor safe.

They advise and assist growing companies to achieve extraordinary investment returns. Venture capitalists often say they are “value-added investors” who offer important services to start-ups beyond just writing a check.

The three most common things they do to help start-ups are to give strategic advice, recruit executives, and make introductions to customers. Venture capitalists make their presence known in a company via the corporate board. A venture investor may sit on several boards of directors and can take an active role in company direction, finance, and staffing.

Venture capitalists professionally invest money raised from large institutional investors. They typically buy a minority share of any company they invest in, though a syndicate of venture capital investors might own the majority of a start-up’s stock after several years. It is unusual for venture investors to push debt obligations onto their start-ups. Start-ups seldom have a predictable revenue stream to pay off the debt and few, if any, tangible assets that a lender could foreclose on.

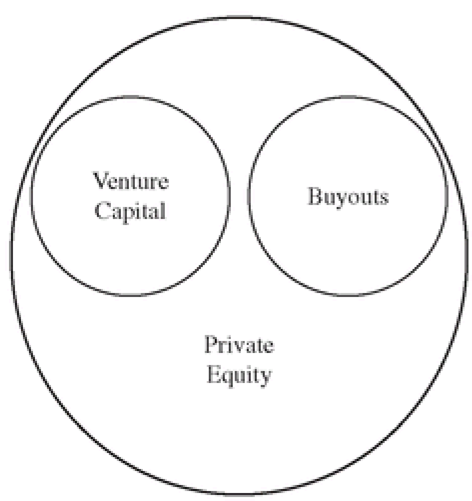
Venture capitalists should be distinguished from “angel investors,” who use their own money to invest in newly formed companies. Angels are typically retired executives who can give advice and between $50,000 and $500,000 of early investment capital. They do similar things as venture capitalists but are not professional investors.

Venture capital is a specific type of private equity investing. Private equity investors bankroll companies that do not have stock traded in public markets, such as the New York Stock Exchange or NASDAQ.

The distinction between venture capital firms and buyout shops, the other group of investors lumped into the private equity category, is the ownership level that they take in the companies they invest in. Buyout shops will buy up enough stock in a target company to be majority owners so that they can make serious changes to a company's operations. Exhibit 1.1 shows the differences between venture capital, buyouts, and private equity.

EXHIBIT 1.1

Private Equity Family



I think of venture capital as investing money into small, private technology companies expecting rapid growth. But there is no formal definition of what kind of deal a venture investor can or can't do. They invest in corporate spinouts, leveraged buyouts, public stock, and just about anything else they think they can turn a buck on. A typical year may see anywhere from 2,500 to 3,500 venture capital deals, and no two are identical. Still, there are some norms that prevail and you can get a sense of what type of companies venture investors look for.

IN THE REAL WORLD

Done Deals

What types of investments do venture capitalists make? Here's a sample of representative deals from top-flight investors.

CANADIAN FUSION STARTUP POWERS UP WITH $22 MILLION[b]

A Canadian-based startup that is experimenting with fusion energy technology has quietly raised $22 million in early stage funding from venture capitalists.

Burnaby, British Columbia-based startup General Fusion plans to develop a prototype that will show its fusion technology can produce energy cheaper than coal-fire plants and safer than standard nuclear fission plants.

“What General Fusion is working on is game changing,” says investor Rolf Dekleer, vice president of investments for Canadian venture capital firm GrowthWorks Capital. “If they were working on this 10 years ago, we wouldn’t be talking about global warming today.”

GrowthWorks Capital, Braemar Energy Ventures, Chrysalix Energy Ventures, and The Entrepreneurs Fund combined to provide $9 million for General Fusion. The Sustainable Development Canadian Technology Fund, a government entity charged with financing environmentally friendly technology projects, additionally kicked in more than $13 million, contingent on General Fusion’s ability to meet key milestones.

MOTALLY RAISES $1 MILLION TO MONITOR MOBILE WEB TRAFFIC[C]

Metrics matter. That’s especially true on the Web, where the number of “eyeballs” a site attracts helps to establish what a company charges advertisers.

But as people move from desktop browsing to accessing sites via mobile phones, tracking the exact number of visitors has become more difficult.

San Francisco-based Motally is working to help online publishers determine who is accessing their content and how visitors are interacting with their websites. The startup recently raised $1 million in early-stage venture funding from BlueRun Ventures and angel investor Ron Conway, according to regulatory filings and the company.

BIOTECH STARTUP RAISES $8 MILLION FOR ASTHMA TREATMENT[d]

Newton, Massachusetts-based NKT Therapeutics is looking for ways to subdue Natural Killers and now has $8 million in fresh funding to do that.

The company recently raised its first round of venture capital funding from SV Life Sciences and MedImmune Ventures to help it develop treatments for asthma and other diseases.

The company focuses on researching so-called Natural Killer T-Cells, which the company describes as a central component of the human immune system, playing a role in human health and disease. Natural Killers play a very different role in the 20 million asthmatics estimated to be living in the United States, waging war on otherwise normal lung tissue.

“By selectively activating or depleting the function of NKT (Natural Killer T-Cells), NKT Therapeutics’ approach has the potential to treat a wide range of important diseases and provide new avenues for vaccine creation,” says investor Michael Ross, a managing partner at SV Life Sciences.

Companies that raised money from venture capitalists contributed 21 percent of the U.S. gross domestic product (GDP) and employed 11 percent of the workforce in 2008, according to a study financed by a venture capital lobbying group.[1] It cites several prominent examples of companies that relied on venture capitalists to get their start: Microsoft, Intel, Oracle, Google, Amazon, Staples, Netscape, AOL, FedEx, eBay, Apple, Cisco, YouTube, and others.

Venture capitalists have come to be associated with technology start-ups and California’s Silicon Valley because the technology industry there has yielded some of the largest growth opportunities in the past three decades. Before that, the epicenter of technology innovation was the greater Boston area.

During the past 20 years, the majority of venture investors were white males in their late thirties to early fifties, educated at either Harvard or Stanford Business School with a background in either operations or entrepreneurship. They typically work in partnerships of 3 to 10 investors with offices within five miles of Sand Hill Road in Menlo Park, California, and make $774,000 a year, according to data from Thomson Reuters. These characterizations are changing as firms diversify and expand beyond their roots. The next 20 years of the venture capital business will see a new generation of investors that reflect the diversity of every other industry.

TIPS AND TECHNIQUES

Venture Capital Spotting

If you spend enough time in Silicon Valley, you'll learn to spot the venture capitalists in any crowd. Here are a few tips on how to pick them out:

Clothes. Male venture capitalists wear blue button down shirts and khaki pants. Navy blazers are optional, though sometimes you'll see windowpane-style checkered jackets. I've never seen them with herringbone jackets or leather patches on their elbows. Most venture capitalists don't wear ties. Vinod Khosla has a closet full of mock turtlenecks. There are two notable exceptions: Kleiner Perkins's John Doerr and Draper Fisher Jurvetson's Tim Draper. Doerr has one tie he's worn for at least a decade that has broad black and silver stripes. Draper wears red ties from the Save the Children Foundation.

Early stage and seed investors dress more casually. Marc Andreessen wears flip-flops and shorts. European seed investor Morten Lund wears a blue Adidas hooded sweatshirt and Birkenstock sandals.

Female venture capitalists wear a range of styles. Blouse and slacks combos seem to be the norm, though one periodically sees variation ranging from pantsuits to a black Lacoste polo shirt with jeans.

Communication. Investors love buzzwords and love to look intelligent. Here's a typical venture capital sentence that one might encounter in casual conversation: “His go-to-market strategy wasn't going to help him cross the chasm and deliver a scalable, robust solution in real time.”

Eating. Favorite feeding spots tend to persist over time, and Buck's of Woodside is one which investors consistently favor. It's not unusual for the waitstaff at this rustic flapjack shop located in the suburbs around Stanford University to automatically bring whatever a venture capitalist typically orders. The place is full of real Silicon Valley history, from boxcar racers hanging from the ceiling to framed semiconductors and a California license plate that says GOOGLE.

Buck's has become well known to the point where it's unhip to be seen there. Other venture capitalist favorites in the Silicon Valley area include the laid back Palo Alto Creamery; Redwood City's upscale Chantilly (down the street from the Ferrari dealership); Menlo Park's Kaygetsu, a hot sushi spot right off Sand Hill Road; and Menlo Park's Dutch Goose, which makes killer deviled eggs.

Exercise. Venture capitalists could exercise like normal people, but don't. Consider Brad Feld, a managing director at The Foundry Group, who is shooting to run a marathon in every state before he turns 50. To balance his strenuous training regimen with work, Feld invented the Treadputer, a computer with three screens mounted to his treadmill. It's an IBM ThinkCenter with 19-inch flat screen monitors and voice recognition software.

How Venture Capital Works

A venture capitalist's job is generally broken down into three major functions:

1. Fundraising
2. Finding start-ups to invest in

3. Reaping the rewards

Fundraising

Venture firms are usually set up as investment partnerships rather than corporations or companies. Venture capitalists split the earnings from their work among themselves rather than giving it to shareholders. There are two components to a venture capital investing partnership, the *general partners* (GPs) and the *limited partners* (LPs).

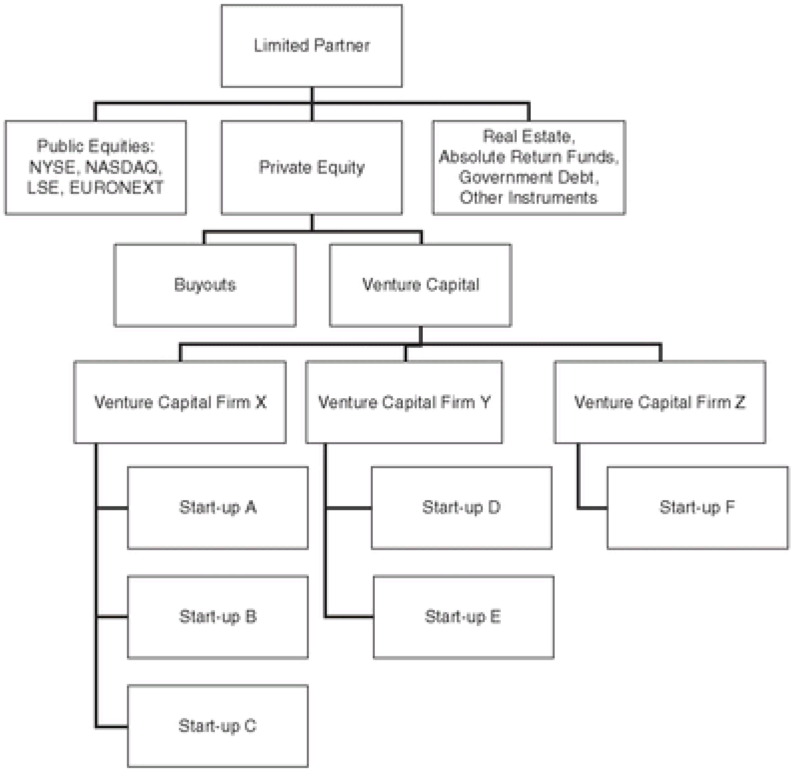
The general partners are the venture capitalists. They are the active participants of a partnership agreement, investing in start-up companies. The money they invest comes from limited partners.

Limited partners are the passive participants in a venture capital partnership. They entrust their money to GPs and expect to get it back and more in several years. Limited partners are institutions, endowments, pension funds, or other large pools of money. They invest in a wide range of asset classes, such as stocks, bonds, real estate, and "alternatives," such as venture capital, private equity, and hedge funds. Examples of big limited partners include the Harvard University Endowment, the California Public Employees Retirement System (CalPERS), the J. Paul Getty Trust, and HarbourVest.[2]

Exhibit 1.2 shows the way in which limited partners invest in various asset classes and how the money eventually trickles down to start-ups.

EXHIBIT 1.2

Limited Partner and Venture Capital Investment Map



These limited partners entrust the venture capitalists to invest money on their behalf for a period of time through a legal structure called a *fund*. The fund sets the parameters for the partnership, including what financial commitments the LPs will make, what compensation the GPs will get, and what types of investments GPs will make. A typical venture capital fund usually spends three to five years investing in companies and another five to seven years reaping the rewards and distributing the returns to its limited partners. The standard venture fund agreement is designed to terminate after ten to twelve years.

Many people have some small level of investment exposure to venture capital through pension funds, but most individuals cannot buy into a venture capital fund because they do not meet the requirements set by the Securities and Exchange Commission (SEC). The SEC requires individual investors to be accredited before they may invest in a venture capital fund. The rules for accreditation are complicated and subject to interpretation, but a good rule of thumb is that if you don't have a net worth of $1 million, you are unlikely to be able to invest in a venture capital fund.

From an individual investor's standpoint, venture funds are likely to be a poor choice. The main reason is that they are illiquid. Once you're in a fund, you should expect to hold that position for 10 years. There are a handful of firms that will buy positions in venture capital funds, but only at a steep discount. Even then, good venture capital firms may be able to choose the type of investors they allow into their funds and may prefer institutions that are stable instead of individuals whose commitment may fluctuate.

There's no formula for what percentage of an institution's money should be invested into venture capital, but it generally only accounts for a small portion of its overall portfolio. A big institution might invest as much as 15 percent of its capital in private equity funds.

IN THE REAL WORLD

Pension Fund Holdings

The California Public Employees' Retirement System (CalPERS) is the granddaddy of pension funds, managing around $175 billion on behalf of 1.6 million retired Californians. CalPERS is one of the more transparent retirement systems. Below is its portfolio allocation at the end of January 2009:[e]

- Domestic Fixed Income: 22.4 percent
- Domestic Equities: 21.3 percent
- Global Equities: 18.4 percent
- Alternative Investment Management (AIM): 13.8 percent
- Real Estate: 12.1 percent
- Cash Equivalents: 7.6 percent
- International Fixed Income: 2.3 percent
- Inflation Linked: 2 percent

The CalPERS Alternative Investment Management (AIM) program is the vehicle the pension fund uses to invest in venture capital and other private equity. The $23.9 billion CalPERS allocated to its AIM program only counts the money the pension fund has actually invested to date. It does not include commitments that CalPERS has made to general partnerships but has yet to actually write checks for. When you put the value of the investments CalPERS has already made together with the value of the commitments that it has made to write checks in the future, you arrive at the pension fund's "total exposure," to the AIM program: $47.9 billion.

Investing

Once a venture firm raises a fund, it invests in companies. Some venture firms have specific rules about what type of companies they can invest in, others are more flexible. Typically, venture firms invest in small, recently incorporated companies called start-ups.

When I think about start-ups, my first thought is two young guys in a garage. After all, it’s Bill Hewlett and Dave Packard founding HP, Steve Jobs and Steve Wozniak founding Apple, and Sergey Brin and Larry Page founding Google. But the truth is that about twice as many U.S. tech entrepreneurs are in their fifties than in their twenties. And the average number of people employed in a start-up isn’t 2—it’s 42, according to a study by the Kauffman Foundation.[3]

Finding good start-ups to invest in isn’t easy. Venture capitalists churn through thousands of business plans, hundreds of company presentations, and fund just a handful of start-ups. Picking the right handful relies on careful research and vetting called *due diligence*. The term comes from the standard of care a trustee must bring to the process of investing. In practice, it means interviewing the entrepreneur several times, testing the proposed technology, and speaking to potential customers or experts in the applicable technology field. Most venture capitalists feel more comfortable investing in companies that were introduced to them by someone they know or have worked with in the past.

Once a venture capitalist identifies a start-up to invest in, there are competitive issues and deal structuring concerns to be considered. One of the biggest things to think about is whether to syndicate or share an investment with one or more other firms. Venture investors will choose to syndicate based on the macroeconomic environment and their beliefs about the risk of an investment.

A venture capitalist may write a small check to a start-up in the beginning, doing what is called an early stage or Series A investment round. The financing is intended to carry the company through a year or 18 months of operation and to a significant milestone. For example, an

Internet start-up might use its Series A round to get its site up and running.

Once that major milestone has been achieved, some of the risk is removed. An Internet start-up with a working web site is a more stable investment than one without. The company may then decide to raise more money from venture capitalists in a Series B financing.

The first venture capitalist involved in the company’s financing may want to participate again, though he or she is not obligated to. An entrepreneur typically looks to an outside firm to objectively determine the value of its stock before inking a new deal. The price of a company’s Series B shares usually represents an increase in its value. Most start-ups don’t go beyond raising a Series D or E.

Deal structures that worked well for semiconductor and software investments may not fit companies installing solar panels, hunting for cancer cures, or building hot new consumer applications. Venture capitalists tailor their deal structures to accommodate new technologies and evolving market opportunities.

Reaping the Rewards

Of course it doesn’t matter where you find great deals or how you structure an investment if you can’t get a healthy return. Venture capitalists typically plan to hold onto an investment for five to seven years. They used to rely on initial public offerings (IPOs) to value their companies and provide stock that they could distribute to their limited partners. That avenue has been all but inaccessible since the dot-com downturn, due in part to increased government regulation.