

## WHAT IS VENTURE CAPITAL

### The Venture Capital Industry

#### An Overview

Venture capital is money provided by professionals who invest alongside management in young, rapidly growing companies that have the potential to develop into significant economic contributors. Venture capital is an important source of equity for start-up companies.

Professionally managed venture capital firms generally are private partnerships or closely-held corporations funded by private and public pension funds, endowment funds, foundations, corporations, wealthy individuals, foreign investors, and the venture capitalists themselves.

Venture capitalists generally:

- Finance new and rapidly growing companies;
- Purchase equity securities;
- Assist in the development of new products or services;
- Add value to the company through active participation;
- Take higher risks with the expectation of higher rewards;
- Have a long-term orientation

When considering an investment, venture capitalists carefully screen the technical and business merits of the proposed company. Venture capitalists only invest in a small percentage of the businesses they review and have a long-term perspective. Going forward, they actively work with the company's management by contributing their experience and business savvy gained from helping other companies with similar growth challenges.

Venture capitalists mitigate the risk of venture investing by developing a portfolio of young companies in a single venture fund. Many times they will co-invest with other professional venture capital firms. In addition, many venture partnership will manage multiple funds simultaneously. For decades, venture capitalists have nurtured the growth of America's high technology and entrepreneurial communities resulting in significant job creation, economic growth and international competitiveness. Companies such as Digital Equipment Corporation, Apple, Federal Express, Compaq, Sun Microsystems, Intel, Microsoft and Genentech are famous examples of companies that received venture capital early in their development.

#### Private Equity Investing

Venture capital investing has grown from a small investment pool in the 1960s and early 1970s to a mainstream asset class that is a viable and significant part of the institutional and corporate investment portfolio. Recently, some investors have been referring to venture investing and buyout investing as "private equity investing." This term can be confusing because some in the investment industry use the term "private equity" to refer only to buyout fund investing. In any case, an institutional investor will allocate 2% to 3% of their institutional portfolio for investment in alternative assets such as private equity or venture capital as part of their overall asset allocation. Currently, over 50% of investments in venture capital/private equity comes from institutional public and private pension funds, with the balance coming from endowments, foundations, insurance companies, banks, individuals and other

entities who seek to diversify their portfolio with this investment class.

### What is a Venture Capitalist?

The typical person-on-the-street depiction of a venture capitalist is that of a wealthy financier who wants to fund start-up companies. The perception is that a person who develops a brand new change-the-world invention needs capital; thus, if they can't get capital from a bank or from their own pockets, they enlist the help of a venture capitalist.

In truth, venture capital and private equity firms are pools of capital, typically organized as a limited partnership, that invests in companies that represent the opportunity for a high rate of return within five to seven years. The venture capitalist may look at several hundred investment opportunities before investing in only a few selected companies with favorable investment opportunities. Far from being simply passive financiers, venture capitalists foster growth in companies through their involvement in the management, strategic marketing and planning of their investee companies. They are entrepreneurs first and financiers second.

Even individuals may be venture capitalists. In the early days of venture capital investment, in the 1950s and 1960s, individual investors were the archetypal venture investor. While this type of individual investment did not totally disappear, the modern venture firm emerged as the dominant venture investment vehicle. However, in the last few years, individuals have again become a potent and increasingly larger part of the early stage start-up venture life cycle. These "angel investors" will mentor a company and provide needed capital and expertise to help develop companies. Angel investors may either be wealthy people with management expertise or retired business men and women who seek the opportunity for first-hand business development.

### Investment Focus

Venture capitalists may be generalist or specialist investors depending on their investment strategy. Venture capitalists can be generalists, investing in various industry sectors, or various geographic locations, or various stages of a company's life. Alternatively, they may be specialists in one or two industry sectors, or may seek to invest in only a localized geographic area.

Not all venture capitalists invest in "start-ups." While venture firms will invest in companies that are in their initial start-up modes, venture capitalists will also invest in companies at various stages of the business life cycle. A venture capitalist may invest before there is a real product or company organized (so called "**seed investing**"), or may provide capital to start up a company in its first or second stages of development known as "**early stage investing**." Also, the venture capitalist may provide needed financing to help a company grow beyond a critical mass to become more successful ("**expansion stage financing**").

The venture capitalist may invest in a company throughout the company's life cycle and therefore some funds focus on **later stage investing** by providing financing to help the company grow to a critical mass to attract public financing through a stock offering. Alternatively, the venture capitalist may help the company attract a merger or acquisition with another company by providing liquidity and exit for the company's founders.

At the other end of the spectrum, some venture funds specialize in the **acquisition, turnaround or recapitalization** of public and private companies that represent favorable investment opportunities.

There are venture funds that will be broadly diversified and will invest in companies in various industry sectors as diverse as semiconductors, software, retailing and restaurants and others that may be specialists in only one technology.

While high technology investment makes up most of the venture investing in the U.S., and the venture industry gets a lot of attention for its high technology investments, venture capitalists also invest in companies such as construction, industrial products, business services, etc. There are several firms that have specialized in retail company investment and others that have a focus in investing only in "socially responsible" start-up endeavors.

Venture firms come in various sizes from small seed specialist firms of only a few million dollars under management to firms with over a billion dollars in invested capital around the world. The common denominator in all of these types of venture investing is that the venture capitalist is not a passive investor, but has an active and vested interest in guiding, leading and growing the companies they have invested in. They seek to add value through their experience in investing in tens and hundreds of companies.

Some venture firms are successful by creating synergies between the various companies they have invested in; for example one company that has a great software product, but does not have adequate distribution technology may be paired with another company or its management in the venture portfolio that has better distribution technology.

### **Length of Investment**

Venture capitalists will help companies grow, but they eventually seek to exit the investment in three to seven years. An early stage investment make take seven to ten years to mature, while a later stage investment many only take a few years, so the appetite for the investment life cycle must be congruent with the limited partnerships' appetite for liquidity. The venture investment is neither a short term nor a liquid investment, but an investment that must be made with careful diligence and expertise.

### **Types of Firms**

There are several types of venture capital firms, but most mainstream firms invest their capital through funds organized as limited partnerships in which the venture capital firm serves as the general partner. The most common type of venture firm is an independent venture firm that has no affiliations with any other financial institution. These are called "private independent firms". Venture firms may also be affiliates or subsidiaries of a commercial bank, investment bank or insurance company and make investments on behalf of outside investors or the parent firm's clients. Still other firms may be subsidiaries of non-financial, industrial corporations making investments on behalf of the parent itself. These latter firms are typically called "direct investors" or "corporate venture investors."

Other organizations may include government affiliated investment programs that help start up companies either through state, local or federal programs. One common vehicle is the Small Business Investment Company or SBIC program administered by the Small Business Administration, in which a venture capital firm may augment its own funds with federal funds and leverage its investment in qualified investee companies.

While the predominant form of organization is the limited partnership, in recent years the tax code has allowed the formation of either Limited Liability Partnerships, ("LLPs"), or Limited Liability Companies ("LLCs"), as alternative forms of organization. However, the limited partnership is still the predominant organizational form. The advantages and disadvantages of each has to do with liability,

taxation issues and management responsibility.

The venture capital firm will organize its partnership as a pooled fund; that is, a fund made up of the general partner and the investors or limited partners. These funds are typically organized as fixed life partnerships, usually having a life of ten years. Each fund is capitalized by commitments of capital from the limited partners. Once the partnership has reached its target size, the partnership is closed to further investment from new investors or even existing investors so the fund has a fixed capital pool from which to make its investments.

Like a mutual fund company, a venture capital firm may have more than one fund in existence. A venture firm may raise another fund a few years after closing the first fund in order to continue to invest in companies and to provide more opportunities for existing and new investors. It is not uncommon to see a successful firm raise six or seven funds consecutively over the span of ten to fifteen years. Each fund is managed separately and has its own investors or limited partners and its own general partner. These funds' investment strategy may be similar to other funds in the firm. However, the firm may have one fund with a specific focus and another with a different focus and yet another with a broadly diversified portfolio. This depends on the strategy and focus of the venture firm itself.

### **Corporate Venturing**

One form of investing that was popular in the 1980s and is again very popular is corporate venturing. This is usually called "direct investing" in portfolio companies by venture capital programs or subsidiaries of nonfinancial corporations. These investment vehicles seek to find qualified investment opportunities that are congruent with the parent company's strategic technology or that provide synergy or cost savings.

These corporate venturing programs may be loosely organized programs affiliated with existing business development programs or may be self-contained entities with a strategic charter and mission to make investments congruent with the parent's strategic mission. There are some venture firms that specialize in advising, consulting and managing a corporation's venturing program.

The typical distinction between corporate venturing and other types of venture investment vehicles is that corporate venturing is usually performed with corporate strategic objectives in mind while other venture investment vehicles typically have investment return or financial objectives as their primary goal. This may be a generalization as corporate venture programs are not immune to financial considerations, but the distinction can be made.

The other distinction of corporate venture programs is that they usually invest their parent's capital while other venture investment vehicles invest outside investors' capital.

### **Commitments and Fund Raising**

The process that venture firms go through in seeking investment commitments from investors is typically called "fund raising." This should not be confused with the actual investment in investee or "portfolio" companies by the venture capital firms, which is also sometimes called "fund raising" in some circles. The commitments of capital are raised from the investors during the formation of the fund. A venture firm will set out prospecting for investors with a target fund size. It will distribute a prospectus to potential investors and may take from several weeks to several months to raise the requisite capital. The fund will seek commitments of capital from institutional investors, endowments, foundations and individuals who seek to invest part of their portfolio in opportunities with a higher risk factor and commensurate opportunity for higher returns.

Because of the risk, length of investment and illiquidity involved in venture investing, and because the minimum commitment requirements are so high, venture capital fund investing is generally out of reach for the average individual. The venture fund will have from a few to almost 100 limited partners depending on the target size of the fund. Once the firm has raised enough commitments, it will start making investments in portfolio companies.

### **Capital Calls**

Making investments in portfolio companies requires the venture firm to start "calling" its limited partners commitments. The firm will collect or "call" the needed investment capital from the limited partner in a series of tranches commonly known as "capital calls". These capital calls from the limited partners to the venture fund are sometimes called "takedowns" or "paid-in capital." Some years ago, the venture firm would "call" this capital down in three equal installments over a three year period. More recently, venture firms have synchronized their funding cycles and call their capital on an as-needed basis for investment.

### **Illiquidity**

Limited partners make these investments in venture funds knowing that the investment will be long-term. It may take several years before the first investments starts to return proceeds; in many cases the invested capital may be tied up in an investment for seven to ten years. Limited partners understand that this illiquidity must be factored into their investment decision.

### **Other Types of Funds**

Since venture firms are private firms, there is typically no way to exit before the partnership totally matures or expires. In recent years, a new form of venture firm has evolved: so-called "secondary" partnerships that specialize in purchasing the portfolios of investee company investments of an existing venture firm. This type of partnership provides some liquidity for the original investors. These secondary partnerships, expecting a large return, invest in what they consider to be undervalued companies.

### **Advisors and Fund of Funds**

Evaluating which funds to invest in is akin to choosing a good stock manager or mutual fund, except the decision to invest is a long-term commitment. This investment decision takes considerable investment knowledge and time on the part of the limited partner investor. The larger institutions have investments in excess of 100 different venture capital and buyout funds and continually invest in new funds as they are formed.

Some limited partner investors may have neither the resources nor the expertise to manage and invest in many funds and thus, may seek to delegate this decision to an investment advisor or so-called "gatekeeper". This advisor will pool the assets of its various clients and invest these proceeds as a limited partner into a venture or buyout fund currently raising capital. Alternatively, an investor may invest in a "fund of funds," which is a partnership organized to invest in other partnerships, thus providing the limited partner investor with added diversification and the ability to invest smaller amounts into a variety of funds.

### **Disbursements**

The investment by venture funds into investee portfolio companies is called "disbursements". A

company will receive capital in one or more rounds of financing. A venture firm may make these disbursements by itself or in many cases will co-invest in a company with other venture firms ("co-investment" or "syndication"). This syndication provides more capital resources for the investee company. Firms co-invest because the company investment is congruent with the investment strategies of various venture firms and each firm will bring some competitive advantage to the investment.

The venture firm will provide capital and management expertise and will usually also take a seat on the board of the company to ensure that the investment has the best chance of being successful. A portfolio company may receive one round, or in many cases, several rounds of venture financing in its life as needed. A venture firm may not invest all of its committed capital, but will reserve some capital for later investment in some of its successful companies with additional capital needs.

### **Exits**

Depending on the investment focus and strategy of the venture firm, it will seek to exit the investment in the portfolio company within three to five years of the initial investment. While the initial public offering may be the most glamorous and heralded type of exit for the venture capitalist and owners of the company, most successful exits of venture investments occur through a merger or acquisition of the company by either the original founders or another company. Again, the expertise of the venture firm in successfully exiting its investment will dictate the success of the exit for themselves and the owner of the company.

### **IPO**

The initial public offering is the most glamorous and visible type of exit for a venture investment. In recent years technology IPOs have been in the limelight during the IPO boom of the last six years. At public offering, the venture firm is considered an insider and will receive stock in the company, but the firm is regulated and restricted in how that stock can be sold or liquidated for several years. Once this stock is freely tradable, usually after about two years, the venture fund will distribute this stock or cash to its limited partner investor who may then manage the public stock as a regular stock holding or may liquidate it upon receipt. Over the last twenty-five years, almost 3000 companies financed by venture funds have gone public.

### **Mergers and Acquisitions**

Mergers and acquisitions represent the most common type of successful exit for venture investments. In the case of a merger or acquisition, the venture firm will receive stock or cash from the acquiring company and the venture investor will distribute the proceeds from the sale to its limited partners.

### **Valuations**

Like a mutual fund, each venture fund has a net asset value, or the value of an investor's holdings in that fund at any given time. However, unlike a mutual fund, this value is not determined through a public market transaction, but through a valuation of the underlying portfolio. Remember, the investment is illiquid and at any point, the partnership may have both private companies and the stock of public companies in its portfolio. These public stocks are usually subject to restrictions for a holding period and are thus subject to a liquidity discount in the portfolio valuation.

Each company is valued at an agreed-upon value between the venture firms when invested in by the venture fund or funds. In subsequent quarters, the venture investor will usually keep this valuation intact until a material event occurs to change the value. Venture investors try to conservatively value their

investments using guidelines or standard industry practices and by terms outlined in the prospectus of the fund. The venture investor is usually conservative in the valuation of companies, but it is common to find that early stage funds may have an even more conservative valuation of their companies due to the long lives of their investments when compared to other funds with shorter investment cycles.

### **Management Fees**

As an investment manager, the general partner will typically charge a management fee to cover the costs of managing the committed capital. The management fee will usually be paid quarterly for the life of the fund or it may be tapered or curtailed in the later stages of a fund's life. This is most often negotiated with investors upon formation of the fund in the terms and conditions of the investment.

### **Carried Interest**

"Carried interest" is the term used to denote the profit split of proceeds to the general partner. This is the general partners' fee for carrying the management responsibility plus all the liability and for providing the needed expertise to successfully manage the investment. There are as many variations of this profit split both in the size and how it is calculated and accrued as there are firms.

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