Management 425 Course Pack

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Chapter 7
Private Equity: Venture Capital Advantages and Disadvantages

In the previous chapters, we detailed the history and dynamics that make venture capital a viable sector of the alternatives market. Now we will maneuver the discussion toward providing investors with what they will need to both understand and surf the waves ahead.

Advantages

In surfing venture capital waves, here are ten compelling advantages for investors:

1. Unique Investment Opportunities

The emerging nanotechnology, cleantech, and cardiovascular trends discussed in the previous chapter capture the essence of the unique opportunities venture capital investment has to offer. As discussed, venture capital firms' investments in cleantech have increased dramatically. Cleantech companies are likely to become a vast new industry like the railroads or the market (see Figure 7.1). John Cassidy, author of *dot.com : The Greatest Story Ever Told,* puts these types of waves in a familiar perspective, focusing on the Internet and comparing it with the American gold rush of the nineteenth century. "The discovery of gold on the Internet can be dated, with some precision, to

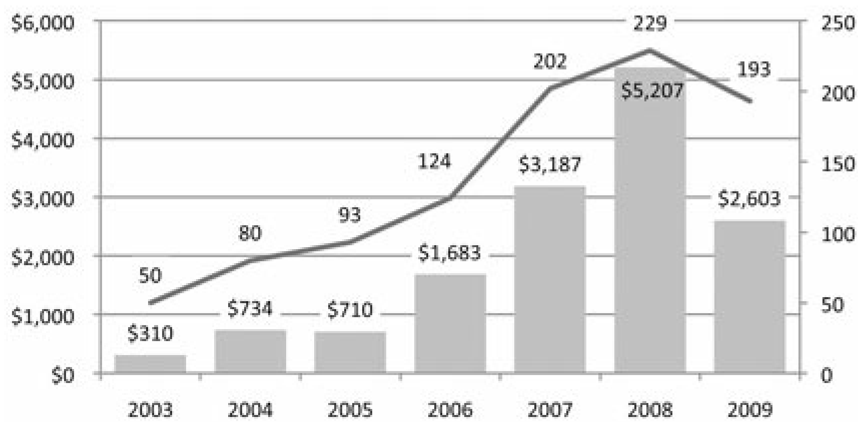

Figure 7.1 Cleantech Venture Capital Investments United States

August 1995, when Netscape, the maker of Netscape Navigator Web browser, held its initial public offering (IPO). Like the strike in the Sierra Nevada, the Netscape IPO attracted a host of prospectors.. Z'[1] Cleantech, cardiovascular, or all three areas might very well be the next gold rush.

2. Distributions

Funds or individual companies will make distribution in cash, as seen in Table 7.1, which shows a sample venture fund schedule of distributions since inception through June 30, 2009. Investors like receiving periodic payments. Unlike a bond, venture capital payments vary in amount and are unpredictable.

3. Vintage Year

Vintage year can be the most important determinant of private equity returns as evidenced during the 1975-2005 period where the best vintage years have tended to be those in which funds were able to invest in the immediate aftermath of a capital markets dislocation.[2] Similar to wine, venture capital has its vintage years. Every year will not be a banner year, and vintage years frequently occur after very bad periods, which is why one might hear of either a bad or good year for wine such as a Bordeaux. Each year wine writers head to Cercle Rive Droite to taste new wines such as the

Table 7.1 Sample Schedule of Distributions

	Date of Distribution	Total Amount ($)	Per $1 Million Investor $
Initial distribution (final close)	22-Aug-01	448,125.00	2,508
Second distribution	10-Jun-02	2,714,545.00	15,367
Third distribution	15-Apr-03	3,646,404.00	20,642
Fourth distribution	22-Dec-03	8,878,635.00	50,525
Fifth distribution	27-Jan-05	10,263,779.00	58,102
Sixth distribution	30-Nov-05	8,000,000.00	45,287
Seventh distribution	10-Apr-06	8,000,000.00	45,545
Eighth distribution	14-Aug-06	4,000,000.00	22,773
Ninth distribution	22-Dec-06	5,973,081.00	33,809
Tenth distribution	19-Mar-07	11,993,800.00	67,896
Eleventh distribution	17-Jul-07	14,018,723.00	79,358
Twelfth distribution	03-Dec-07	6,500,000.00	36,796
Thirteenth distribution	18-Mar-08	7,461,426.00	42,238
Fourteenth distribution	30-Jan-09	4,282,346.00	24,242
Total amount distributed as of June 30, 2009:		96,175,864.00	545,085
Percentage of total commitment distributed:		61.80%	61.80%

Source: Author.

2009 Bordeaux en primeur. En primeur or "wine futures" is a way to purchase wine while a vintage is still in a barrel. Some vintages are better than others. The best venture capital firms are adept at selecting vintage years, which enables them to raise money even in troublesome markets:

> The newcomers raised just $20.3 billion in total capital down 65% from $58.2 billion in all of 2008, according to Preqin. David Sze, a general partner at Greylock Partners, says the San Mateo, Calif., firm allotted more time than usual to fund raising because of the uncertain market, but ended up raising money for a new $575 million fund in four to six weeks.[3]

4. Professional Management

By selecting a venture fund, one can hire a top-quartile venture professional who is experienced negotiating valuations that your typical investor might not be able to negotiate for themselves. Venture firms also have the expertise to ferret out the best deals.

5. High-Compound Annual Growth Rates over Long Periods

There are times when venture capital does not do well, such as investing at the peak of a bull market. However, venture capital annual growth rates (both in nominal and real returns) tends to outpace publicly traded equity over longer periods of time covering multiple market cycles. As a market recovers, investments in venture capital can even lead to substantial outperformance.

6. Low Correlation

Venture capital has a low correlation of returns with other asset classes. Part of the reason for this low correlation is that venture capital is private and not public. The *Wall Street Journal* article detailed the benefits of low correlation by reporting that "a strength of venture capital is that its investments are held for many years, so the valuations are not as important on a short term basis with returns being realized only when assets in the portfolio are sold or go out of business."[4]

Venture funds invest in unique and often first-of-a-kind or new areas that are not publicly traded. The largest and most well-known microbrewery, Sam Adams (Boston Beer Company), accepted venture capital. Even after the Boston Beer Company went public, it was different from the other beer companies in that it was the only microbrewery.

7. Access to Pre-IPO Companies

Good IPOs are difficult to get unless you know someone or are extremely wealthy. Investing in venture capital not only gives one access to the IPO market when the company files to go public, but it is financially rewarding; the valuation and share price will most likely be lower before the IPO. If the private company performs well, the IPO shares are often set at a higher price.

8. Lower Fees and/or Carried Interest

The management fee is the carried interest for a fund. Carried interest is derived from profits taken when a venture-backed company is sold or taken public. Fees on carried interest range from 20% to 30%.

Venture firms are becoming more competitive with carried interest. Battery Ventures, for example, lowered their carried interest in 2009. Battery Ventures is incorporating a performance hurdle into their new $750 million venture capital fund, which will charge a carried-interest fee of 20% (down from the previous 25%) until it returns three times its capital, whereby, the fee will climb to 30%.[5] Venture funds can be very expensive but typically offer lower expenses in bad markets, enabling attractive or far better terms than normal. Fees vary but usually are around 2%. Greylock Partners recently offered investors the ability to approve a yearly budget instead of paying a 2% fee. Draper Fisher Jurvetson, which backed hits such as Skype and Hotmail, sent a letter to prospective investors that said the firms would charge a premium carried-interest fee only if their new $400 million fund met certain performance targets.[6]

9. Access

A top-tier venture fund will see deal flow that an ordinary investor will not see. If a technology company needs venture funding, they will turn to the best possible venture firm they can find. The venture capitalists who took Google public see a huge number of business plans. Your typical investor will never see such volume nor have the opportunity to see the best companies.

10. Performance

Depending on the investment(s) as well as the vehicle used, venture capital has the potential for huge returns. The upside is virtually unlimited.

Disadvantages

Here are some of the disadvantages to investing in venture capital:

1. Illiquidity

Financial venture capital waves are difficult to measure and explore because one is dealing with private companies and the information is not readily available. Venture capital is not as easy to invest in as a large growth mutual fund; you are dealing with private companies, not public ones.

2. Timing Is Difficult

A number of venture firms put money into companies at the peak of the market before the tech market blew up. Perhaps they will learn from their mistakes. The market was low but not at the bottom. Some venture capital firms invested heavily but the market was not at its low. The market corrected for two more years.

It is impossible to time when you will find a great company or idea, nor can you even tell if you will be able to invest in one if you ultimately find one. Wave Theory is based on trying to find the best possible time to invest. If a venture capital firm, high-net-worth individual, or institution were going to invest after the tech correction, they should examine where the venture capital waves and the broad market are at the time. Venture capital waves are difficult to measure and explore because you are dealing with private companies, and the information is not readily available. Even professionals can make mistakes.

3. Unfair Advantages

To an extent, both entrepreneurs and venture firms have the upper hand over an individual investor. Hypothetically, if an individual investor invests $100,000 in a $20 million round for a private company versus a venture firm that takes half the round and puts in $10 million, the individual will not have much say in anything. The individual will most likely not be given a board seat and will be more or less a passive investor.

Like any industry, nothing is perfect. That is, not all venture capital firms act in the best interest of their investors. Venture capitalists look out for their investments, and they do everything they can to protect them. Based on today's legal system, it is costly should a dispute rise. A venture firm might shut down a company, wipe out your investment, and then move the assets to another company they own, sell it, and make money while you have already been wiped out. Unfair? Yes. Real world? Yes. Sad? Yes.

For instance, a number of investors felt mistreated by S.R. One. A report on the troubles surrounding the company recalled the following events:

> The venture-capital arm of British pharmaceutical giant Glaxo-SmithKline PLC has been sued by 21 investors who claim it cheated them out of their stake in Herndon, Va., software company Clareos. The lawsuit, which was filed Feb. 9 in U.S. District Court in Alexandria, Va., accuses S.R. One Ltd. of West Conshohocken of defrauding 21 investors in Clareos Inc. It seeks at least $400 million from S.R. One — $100

> million in compensatory damages and $300 million in punitive damages.[7]

If you do not know the other investors (like those who knew each other in Clareos), one could file his or her own lawsuit, but it is not very cost-effective. The venture capital firm might have $20+ million at stake and will commit more than you can in legal fees. If the investor put in $100,000, he or she could fly through legal fees and spend far more than the original investment.

Just like one can encounter a disreputable venture firm, one can find a bad CEO. Charles Goodyear admonished those who merely sought to make money rather than grow a company:

> Life should not be estimated exclusively by the standard of dollars and cents.. I am not disposed to complain that I have planted and others have gathered the fruits. A man has cause for regret when he sows and no one reaps.[8]

Have there ever been any CEOs that went to jail? Yes. Enron. Worldcom. Adelphia. Tyco. There are hundreds of cases involving CEOs of publicly traded companies in which there was wrongdoing. Are all CEOs of publicly traded companies morally bankrupt? Absolutely not. There are 10,000+ honest, hardworking CEOs, but that does not mean it cannot happen. A few bad apples can spoil the whole bunch. Risk will increase with an investment in a small, privately held company because private companies are not regulated like publicly traded companies. Most entrepreneurs are honest and hardworking, but not all of them.

What happens if a dispute arises with an entrepreneur running a private company you invested in? One would refer to the huge pile of legal documents you signed, such as an investor's agreement. Justin Kline, a securities lawyer and senior partner at Ballard Spahr, told the author, "If you are not a securities lawyer, odds are you might not know what you are signing." Blindly signing these documents would be about the same as surfing naked without sunscreen at a crowded resort. Protect your investment and have a good attorney who knows security law. In the passage below, the *Boston Business Journal* describes exactly what can go wrong with a poorly worded agreement:

> Venture capitalists investing in later rounds will often require changes

> to the terms of the preferred stock issued in earlier rounds. Typically, the preferred stock issued in the earlier rounds is protected by provisions requiring the company to obtain the consent of the holders of a requisite percentage of such stock before any changes are made to the terms of the stock. Poorly drafted protective provisions can be insufficient to preclude change to an existing preferred stockholder's essential economic, voting and other rights.[9]

If an investor disagrees with something the entrepreneur did, he or she can take legal action. According to author Karl Vesper, "Some ventures are legally frauds, whereas others may be more morally than prosecutably fraudulent."[10] However, there is a huge disadvantage to the investor. In essence, the investor is spending money to protect his/her rights via legal fees. Ironically, you are also paying the legal fees of the entrepreneur because you invested your money in the company. The entrepreneur will not be using his/her own money. He or she will be taking it from the company that you invested in. Ever shoot yourself in the foot? You do not get very far. The vast majority of venture capitalists and entrepreneurs fly straight, but not all of them.

4. Capital Calls/Additional Rounds

If you elected to invest in either a venture fund or a single company, there will most likely be capital calls. Few funds take all the money up front today. As the venture fund identifies new opportunities, they will call on their investors to put more money into the fund (draw down). Because these calls are random and over long periods (years), it can be burdensome to an investor. Should the investor (for whatever reason) decide not to invest, there are normally severe penalties. For example, if a client commits $1 million, there will be an initial call and subsequent ones of varying amounts over time. Table 7.2 displays a sample schedule of capital calls with calls since inception through June 30, 2009:

Table 7.2 Sample Schedule of Capital Calls

	Date of Call	Total Amount ($)	Per $1 Million Investor $
Initial capital call (final close)	01-Feb-01	52,995,000.00	300,000
Second capital call	22-Aug-01	17,665,000.00	100,000
Third capital call	10-Jun-02	17,665,000.00	100,000
Fourth capital call	15-Apr-03	17,665,000.00	100,000
Fifth capital call	22-Dec-03	6,427,232.00	36,384
Sixth capital call	28-May-04	8,516,083.00	48,209
Seventh capital call	27-Aug-04	8,516,083.00	48,209
Eighth capital call	27-Jan-05	5,204,851.00	29,464
Ninth capital call	30-Nov-05	15,669,592.00	88,704
Tenth capital call	22-Dec-06	2,938,749.00	16,636
Eleventh capital call	19-Mar-07	1,477,147.00	8,362
Twelfth capital call	17-Jul-07	988,887.00	5,598
Total amount called as of June 30, 2009:		155,728,624.00	881,566
Percentage of total commitment called:		91.40%	91.40%

Source: Author.

If an investor puts money into a single company as opposed to a fund, there is a distinct possibility that the company will need more money and require future capital. The investor can choose to participate and maintain his/her pro rata share. If he/she declines, he/she will be diluted (depending on valuation and series or number of rounds) and own less of the company because new investors are buying more shares.

5. Down Rounds

What happens when you miss the wave for venture capital? If one throws money into a private company or venture fund without paying attention to the wave, he or she could be investing at a bad time or an all-time high. According to *Business 2.0,* "Some Silicon Valley VCs estimate that as many as 80% of all financings in 2001 were down rounds, meaning that the VCs had slashed their estimate of a company's value since its previous funding round."[11] What happens to your money? The funds you invested in a company or companies (if it is a fund) will be worth less, similar to a publicly traded company declining in value. For example, if a publicly traded medical device company is worth less since its stock price dropped in a market downturn, a comparable private medical device company will likewise have a lower valuation. Private shares are frequently valued less than public shares because of illiquidity. The value might actually even be less than public comparables.

Private companies will also require more money to grow over time. Raising more money is not necessarily a bad thing. Racing cars need fuel. If your company raises a subsequent round of financing (after your initial investment), the company will ask you to invest more money in this down round (a round of financing done at a lower valuation than the last round). If one is given a pro rata share of company ownership, he or she can maintain ownership. However, the decision is immensely tricky. Envision putting a $100,000 into a start-up or early-stage private company. The market turns on you. What looked like a brilliant idea now looks like a grotesque nightmare you cannot escape.

Back in 1999, the tech bubble was on fire. Hundreds of Internet companies were going public. When the bubble burst, 800 to 900 Internet companies went bankrupt. The ones that did not, struggled like the passengers who scrambled after life preservers as the *Titanic* sank. Unless a company raised a lot of cash (to get through the storm), it needed to raise more funds. Your investment in the last round has a fair market value (according to the new round being raised) of $20,000. Essentially, your $100,000 investment lost $80,000. You are given the chance (according to a several-inch-high legal packet sent to you by the company's attorneys, which, incidentally, you paid for) to invest more money.

The amount one can invest will depend on what you put in the last round. An investor will be given a chance to invest a pro rata amount. Hypothetically, you might be given the opportunity to invest $10,000 (a pro rata amount), but the valuation of the company is now far less. If you elect to invest, you will own more illiquid shares of the company but at a lower valuation. Instead of investing $100,000, your new, combined total investment is now $110,000. You own two different baskets of stock, one higher valuation and one lower. The company will need to do really well going forward to make a return. However, if it does not, you will lose all or part of your money. Only once can I recall breaking even. Venture capital is normally two directional: up or down. The decision to put more money into a down round is extremely complex. If you decide not to invest in maintaining your pro rata share, your investment will be worth a lot less because other investors (who came in after you) are buying company shares at a much more attractive valuation than you and will own a lot more of the company.

Another complication might arise and that is that the company might need more than one financing round. In other words, a company can have multiple rounds of financing (e.g., Series A, Series B, Series C, Series D). I invested in a private company in 1999. It is now 2009. Godot might show up before I actually get any money out of the deal. The company had numerous management changes and went through two market declines. I invested in some rounds and passed on others. To date, the company is still struggling to grow. My investment remains illiquid and the CEO refuses to give any inkling as to valuation or exit strategy. Given the history, I am waiting for another opportunity to invest in another down round by the same company. Down rounds are problematic.

6. Exit Strategy

Venture capital is fast paced, and there never is a dull moment. One of the areas within venture capital that changes is how an investor can exit or become illiquid. Figure 7.2 charts the changes in exit strategy that the venture world has seen over time.

As one can see from Figure 7.3, one of these strategies is not like the other.

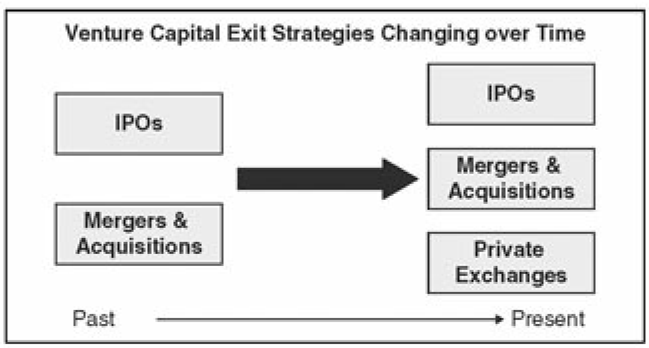

Figure 7.2

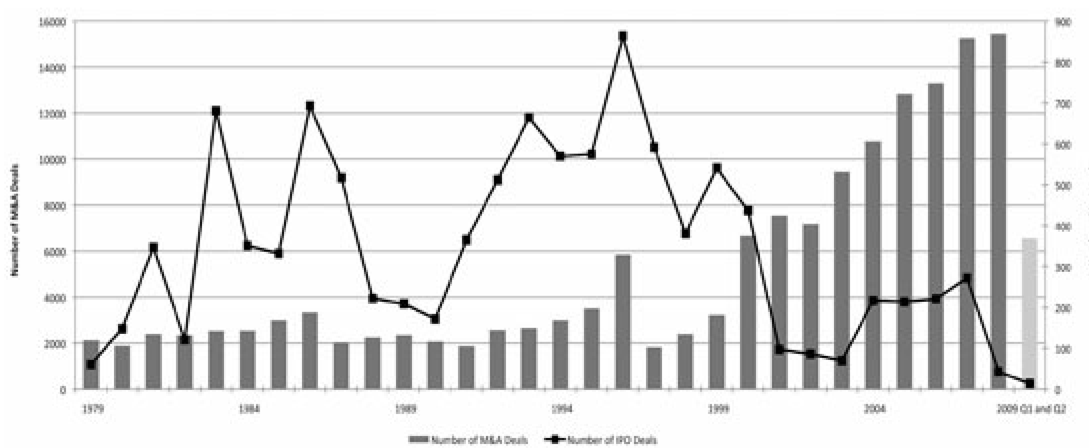

Figure 7.3 30 Years of Global M&A versus U.S. IPO Activity

Source: Author.

Rarely does the mergers and acquisitions (M&A) world equal the IPO market in activity and vice versa. Usually, one does better than the other. From 2000 until mid-2009, M&A far exceeded the lackluster IPO market. The 1990s, however, had an abundance of IPOs. It is important to observe exit strategies in the marketplace because that is the only way you will get your money back.

7. Restricted Securities

According to the Securities and Exchange Commission (SEC), restricted securities are defined as the following:

> Restricted securities are acquired in unregistered, private sales from the issuer or from an affiliate of the issuer. Investors typically receive restricted securities through private placement offerings, Regulation D offerings, employee stock benefit plans, as compensation for professional services, or in exchange for providing "seed money" or startup capital to the company. Rule 144(a)(3) identifies what sales produce restricted securities.[12]

If the private company that you invested in goes public and does extremely well during its first day trading, it might be a moot point. The reason why it is irrelevant is because your shares are "locked up" or restricted unless you elected to sell shares at the IPO price. If an investor desires to sell restricted shares, a number of steps need to be taken. First, there is a holding period:

> Before you may sell any restricted securities in the marketplace, you must hold them for a certain period of time. If the company that issued the securities is subject to the reporting requirements of the Securities Exchange Act of 1934, then you must hold the securities for at least six months. If the issuer of the securities is not subject to the reporting requirements, then you must hold the securities for at least one year. The relevant holding period begins when the securities were bought and fully paid for. The holding period only applies to restricted securities...[13]

Second, an investor must remove the legend from the certificate. Transfer agents remove the legend after receiving consent of the issuer or an opinion letter from the issuer's counsel. Removing a legend is not instantaneous, and you are at the mercy of the lawyer removing the legend as well as the transfer agent. Even if an investor works for a bank, the process can be arduous if not frustrating. In some cases, an investor might even need to hire an attorney if the issuer's counsel is burdensome. Other investors will want to sell as well, and you might not be of any importance to them—that is, there could be foot dragging or stonewalling.

I once ran into an in-house counsel who tried to charge investors a legal fee for removing the legend. Although the in-house counsel maintained it was in the company's right, many investors (who backed the company) were affected. I am not certain, but I believe the real reason was that the lawyer owned shares (he was employed by the company) and did not want to see the stock decline in value because of a lot of investors wanted to sell. Investors were finally able to sell and, not surprisingly, the company had bad earnings and the stock crashed. For the most part, the issuers' counsel is courteous and helpful. Complications can happen, but the SEC will not intervene:

> If a dispute arises about whether a restricted legend can be removed, the SEC will not intervene. The removal of a legend is a matter solely in the discretion of the issuer of the securities. State law, not federal law, covers disputes about the removal of legends. Thus, the SEC will not take action in any decision or dispute about removing a restrictive legend. If the company that issued the securities is subject to the reporting requirements of the Securities Exchange Act of 1934, then you must hold the securities for at least six months. If the issuer of the securities is not subject to the reporting requirements, then you must hold the securities for at least one year. The relevant holding period begins when the securities were bought and finally paid for.[14]

IPOs in the mid- to late 1990s were the favored exit strategy for private companies. But from 2000 to 2009, M&A was the dominant strategy. IPOs started coming back in 2009, but it is far too early to tell if this is an enigma or a new wave.

8. Herd Mentality

Frequently, venture capital firms move in packs. Monkey see, monkey do. Venture funds invest all the time, which might not be prudent. Yet, certain funds have better timing than others. Table 7.3 relays a number of investments from venture firms (from March 2000-February 2001) as the market started to break down.

No one could have foreseen September 11th, which put the market into another vicious downturn. Quite a few venture-backed companies in 1999-2000, later collapsed due to the market. The stock market did poorly until 2003. Market bottoms are extremely difficult to judge even for the smart money, which is why an investor might want to deploy assets piecemeal and not all at once.

9. Size Matters

With regards to venture capital, size plays a significant role or determinant with private equity returns because if the venture firm is too small, they might not be able to ride through the storm. In other words, larger venture firms tend to be better capitalized. Further, larger venture firms will be more diversified and have multiple types of funds or series of funds. Regardless, the investor should be cognizant of when they are investing.

Table 7.3 Top Investors in Early-Stage Venture Investments (March 2000–February 2001)

Company	Investments
Bessemer Venture Partners	$ 38 million
St. Paul Venture Capital	32
Austin Ventures	32
Atlas Venture	31
Chase Capital Partners	29
New Enterprise Associates	29
3i Group	27
Polaris Venture Partners	26
Goldman Sachs Group	24
Draper Fisher Jurvetson	24
Accel Partners	23
Crescendo Ventures	23
Advent International	23
Battery Ventures	23

Source: Lark Park, "Where the Seed Money Is," *The Industry Standard* (February 26, 2001).

10. Long-term Investments

Whether one is investing in a private company, a venture fund, or a private-equity fund-of-funds, your money will most likely be tied up for 8 to 10 years or longer. Although a single investment might be shorter in duration (and the odds are better for a faster liquidity event with an individual company), one cannot count on it. Illiquidity for such a long time is far different from buying liquid securities, such as stocks or index funds.

11. Management

Part of the risk of investing in venture capital is putting faith and money behind an entrepreneur. A lot can go wrong. Bo Peabody, author of *Lucky or Smart?: Secrets to an Entrepreneurial Life,* summed it up this way:

> There are entrepreneurs who start fundamentally silly, morally bankrupt, and philosophically negative companies...These destined-to-self-destruct companies are, first and foremost, about the entrepreneur trying to make a million dollars rather than about doing anything interesting or valuable.[15]

With that in mind, it is imperative that an investor in venture capital find an entrepreneur that he or she both likes and trusts.

12. Government Action

Depending on government action, venture capital can do extremely well or languish. The National Federation of Independent Business states that for many, a "major concern is the level of uncertainty being created by government, the [usual] source of uncertainty for the economy."[16] Before investing, attempt to get a read on government policies:

> Government policies can have a strong impact, both by setting the regulatory stage, and by galvanizing investment during downturns.... Many governments have begun to recognize the benefits of venture capital and have made efforts to fund startup businesses. Government spending on venture capital may hinder the development of a private venture capital sector. Furthermore, many are skeptical about the government's ability to appropriately target healthy ventures.[17]

13. Unreliable Benchmarks

Unlike mutual funds, money managers, hedge funds, and other asset classes in which there are clear or well-defined benchmarks, venture capital does not have easy to access data. There are a number of services, such as PricewaterhouseCoopers Money Tree, Thomson Reuters (VentureXpert), Cambridge Associates, and Dow Jones Venture Source. Performance data are extremely unreliable because of private entities, which might view the value of their investments differently from others. In other words, it is hard to set a valuation on a private company. Even with publicly traded companies and securities, valuation can be inaccurate, as we witnessed in 2008-2009 when various securities markets froze.