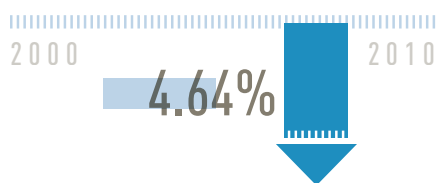


What Ever Happened to Venture Captial?

FINANCING INNOVATION SERIES

A RESEARCH BRIEFING FROM THE UNIVERSITY OF VIRGINIA'S DARDEN SCHOOL OF BUSINESS



OVER THE PAST DECADE, VENTURE CAPITAL HAS RETURNED NEGATIVE 4.64%.

Source: Cambridge Associates

IN BRIEF

"The future ain't what it used to be."

Lawrence Peter "Yogi" Berra, American baseball player and manager

For the first time in venture capital's history, ten-year average fund returns have been negative. Not since 1997 have U.S. venture capital firms returned more cash to their investors than they have dedicated to startups. To make matters worse, the market for initial public offerings, where venture capitalists have traditionally found the most lucrative exits, has largely evaporated, leaving venture firms over-weighted with cash-hungry companies they cannot sell.

Even if current economic conditions represent a cyclical downturn, it is likely that venture capital—one of the most vibrant (and successful) forms of venture financing ever created—is at an inflection point. Many long-time observers believe that venture capital has become a victim of its own success, and some VCs who were present at the industry's beginnings say it has grown too far beyond its roots.

Drawing from personal interviews with the founders and principals of the largest and most successful VC firms in the world, supplemented with insights from leading academics and industry observers, this Batten Briefing will look at what's happened to the business of risk capital since its "golden age"—and what this may mean for its future.

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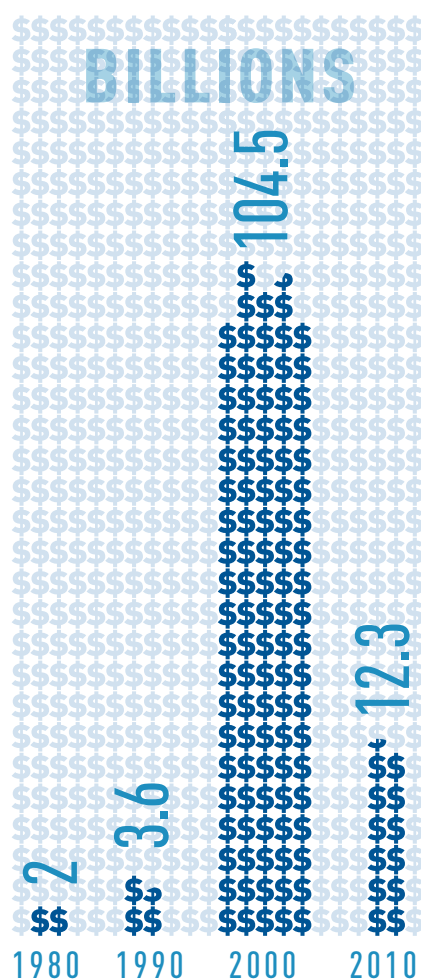
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Too much of a good thing?

FUND SIZE

CAPITAL COMMITMENTS TO U.S. VC FUNDS IN SELECT YEARS

Source: NVCA



When William H. Draper, III, partnered with Franklin P. (“Pitch”) Johnson in 1962, they started Draper & Johnson Investment Company, in Palo Alto, California, with just \$450,000. “We were pretty frugal and pretty focused on making sure the companies we participated in were frugal with our money,” Draper said. “But also, salaries were low and expectations were not so great ... It was kind of a grunt, step by step, plodding and working.”

In the past, venture capital had been considered something of a small business, even a cottage industry of sorts. Close-knit partnerships of venture capitalists, such as Draper & Johnson—mostly located around San Francisco, Boston, and New York—would invest just a few million dollars in new ventures each year. In fact, prior to the 1980s, the overall amount of money flowing into new VC funds each year oscillated around \$200 million.¹

In 1979, all that changed. That year the U.S. Department of Labor amended a ruling to permit pension funds to invest up to 10% of their capital in high-risk assets. Consequently, pension-fund commitments to venture capital skyrocketed, causing an unprecedented increase in money flowing into that sector.² By the mid-1990s, individual venture funds were raising hundreds of millions of dollars. In 2000 alone, at the peak of the dotcom bubble, the industry raised a record \$104.5 billion.

In general, the widespread availability of capital was good, but the influx of money had drawbacks. Too many similar start-ups were getting funded; inexperienced VCs brought companies to the public market too early; and monitoring of start-ups deteriorated. Even after the dotcom bust, the venture capital sector continued to be flooded with cash, with so-called “mega VC funds” managing billions of dollars at a time. Critics have suggested that today’s venture capital firms, which had been small and capital efficient in the 1960s and early 1970s, have become huge bureaucratic organizations, weighted down by expensive infrastructures. This was when the systemic problems started to arise.

1 Gompers, P. 1994. The Rise and Fall of Venture Capital. *Business and Economic History*. 23 (2): 1-26.

2 In 1978, when \$424 million was invested in new VC funds, individuals accounted for the largest share (32%) and pension funds supplied just 15%. In 1986, when more than \$4 billion was invested, pension funds accounted for more than 50% of all contributions. Gompers, P. and J. Lerner. 2001. The Venture Capital Revolution. *Journal of Economic Perspectives*. 15 (2): 145-168.

Fees, carried interest, and (mis)aligned incentives

COMPENSATION

When Silicon Valley's legendary VCs Arthur Rock and Tommy Davis formed Davis & Rock in 1961, their first fund was \$5 million. Their total management fee was a mere \$75,000 a year, and it covered their salaries and operating costs.³ For Rock and Davis, and for their contemporaries, the most significant part of their compensation as VCs was their share in the fund's profits. They made personal fortunes because their investments in innovative companies, which later became the backbone of Silicon Valley, had been mind-bogglingly successful.

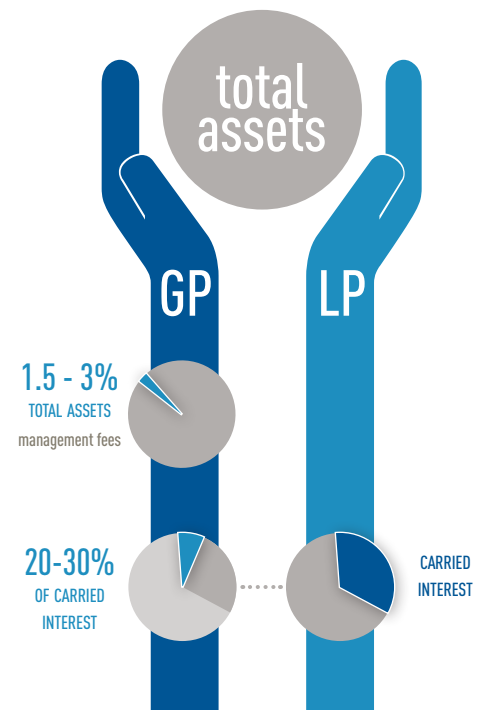
One such legendary investment was Scientific Data Systems, a computer maker that Davis & Rock helped start with \$257,000 in 1961. The two VC giants reaped their reward in 1969, when Xerox bought the company. "We made about thirty times our money on that investment," Rock said. "The company was sold for just short of a billion dollars—\$980 million as I recall, which was unheard of in those days."

Until the financial meltdown of 2008, VCs were raising larger and larger funds, some worth more than \$2 billion.⁴ A \$2 billion fund could gross \$40 million a year in fee income for several managing partners, plus other staff, for the duration of the partnership, which is typically 10 years or more. As recent critics have noted, however, top-tier VC firms had an incentive to raise mega funds—an annual management fee, which allowed them to rake in astronomical amounts of money, irrespective of fund performance.⁵

In the early days of VC, most returns were generated by successful investing. In the so-called mega-fund era, many venture capital firms started to resemble asset-management firms, where income was generated by fees, regardless of the investment results.⁶ All of this, of course, has had implications for the deals and the ventures that VCs pursue.

VC FUND STRUCTURE

Most VC funds are structured as **limited partnerships**, with the VCs acting as **general partners** (GPs) and the investors as **limited partners** (LPs).



COMPENSATION

The fund charges investors annual management fees—between 1.5% and 3% of total assets under management—to cover its operating costs. Management fees are not tied to the fund's performance.

The part of LPs compensation that is tied to performance is carried interest—a share in the profits of a fund. GPs typically receive a 20% carried interest, with some receiving as much as 30%.

3 Zider, B. 1998. How Venture Capital Works. *Harvard Business Review*. 76 (6):131-139.

4 Buckman, R. 2006. Tracking the Numbers / Street Sleuth: Venture Firms Are Doling Out Large Pay Deals. *The Wall Street Journal*. 248 (63): C1-C3.

5 Buckman, R. 2009. Venture Capital's Coming Collapse. *Forbes Magazine*. 183 (1): 66.

6 Gupta, U. 2010. Back to the Future for Venture Capital. *Institutional Investor Magazine*.

Undoing due diligence

SCREENING

VENTURE CAPITAL ORAL HISTORY PROJECT

Interviews

We are grateful for the access to the interview transcripts provided by the Venture Capital Oral History Project at the University of California at Berkeley's Bancroft Library and by the National Venture Capital Association's Venture Capital Greats oral history project.

Paul Bancroft, III

Draper, Gaither & Anderson, general partner
Bessemer Securities Corporation, CEO and director

James C. Blair

Rothschild Inc., managing director
Domain, partner

William K. Bowes

U.S. Venture Partners, founder
Amgen, cofounder

Peter O. Crisp

Venrock Associates, founder and managing partner

Walter J. P. Curley

J. H. Whitney & Co., partner

Reid Dennis

Institutional Venture Associates, founder
Institutional Venture Partners, founder

William H. Draper, III

Draper & Johnson Investment Co., cofounder
Sutter Hill Ventures, cofounder
Draper Richards, founder
Draper International, founder

William C. Edwards

Bryan & Edwards, founder

Anthony B. Evnin

Venrock Associates, partner

In the early days, deal screening was considered a crucial step in VC investing. Since investing in high-growth businesses is fraught with uncertainty, VCs would traditionally mitigate the risk by conducting extensive due diligence, examining market size, strategy, technology, customer adoption, competition, and the start-up's management team.⁷

Prior to backing Federal Express in 1973, Charles Lea, then managing partner at New Court Securities, made several trips to Memphis, Tennessee, to assess FedEx's fledgling operation in person. "Fred Smith [the founder of FedEx] had been a captain in the Marines in Vietnam, a lot of heavy combat; he'd also been a pilot for a tour," Lea said. "[The management] all had serious business experience," Lea added. "We watched the airplanes go in the air and bring back packages, and sort them." Yet even after this review, New Court invested only after FedEx passed muster with several other VC firms.

After the VC industry was first flooded with money in the 1980s, however, some VCs started to abandon the time-intensive screening process. With even more money to invest at the height of the Internet bubble, they were pumping capital into undisciplined startups with half-baked ideas, counting on lucrative IPOs. Vinod Khosla, a prominent entrepreneur-turned-VC, voiced concern about the "greed cycle" and its negative effect on entrepreneurship in Silicon Valley. As Khosla said in 2000, the entrepreneurs with an idea for a new business were getting funded in a week, without having to critically examine the strengths and shortcomings of their business plans.⁸

"We used to have more time to make up our minds. We put much more emphasis on knowing the people and being comfortable with them"

Reid Dennis, pioneer of the VC industry on the West Coast

⁷ Kaplan, S. and P. Strömberg. 2001. Venture Capitalists As Principals: Contracting, Screening, and Monitoring. *American Economic Review*. 91(2): 426-430.

⁸ Champion, D. and N. G. Carr. 2000. Starting Up in High Gear: An Interview with Venture Capitalist Vinod Khosla. *Harvard Business Review*. 78 (4): 92-100.

Hogging the Sandbox

SYNDICATION

Back in the 1960s and 1970s, when the VC community was still small and tight-knit, sharing deals was the norm. A VC who identified a promising company would bring in other VCs, forming a consortium or syndicate of investors. “You had a deal, you’d call up your friend and say, ‘I’m working on this thing; it looks interesting. Would you like to join us?’ And they would suit up and we’d do some of the due diligence together,” said Peter O. Crisp, a veteran of Venrock Associates, the Rockefeller family’s VC firm. “If we’d do the deal, we’d both go on the board, and we’d work with the company and bring it along,” Crisp added.

Syndicating investments has many benefits. Each VC firm can invest in more diverse deals, which limits risk. Syndication also provides an invaluable second opinion, which lowers the possibility of funding bad deals. In addition, deal sharing helps to monitor and manage portfolio companies more effectively.⁹

As venture capital grew beyond its cottage-industry roots, the practice of sharing deals dried up. According to some insiders, the business went from collegial to competitive. “In the 1980s and 1990s these bigger funds got created,” Crisp explained. “They’d have a \$2 million deal, and they didn’t want to share it with anybody, because they had \$40 million to invest. Success polluted the business. People got greedy.”

“Success polluted the business. People got greedy.”

Peter O. Crisp, pioneer of the VC industry on the East Coast

Alan Frazier

Frazier Healthcare Ventures, founder

Edward F. Glassmeyer

Oak Investment Partners, cofounder

J. Burgess Jamieson

WestVen Management, cofounder & partner
Institutional Venture Associates, cofounder & partner
Sigma Partners, founder & partner
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Franklin P. Johnson

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James R. Swartz

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Paul Wythes

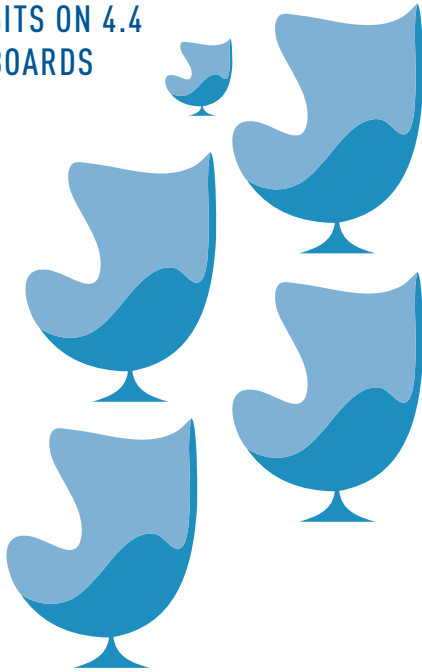
Sutter Hill Ventures, cofounder

⁹ Lerner, J. 2006. There’s Nothing Wrong With Sharing. *Wall Street Journal*. 248 (134) A 18.

So many boards, so little time

MONITORING

ON AVERAGE,
A VENTURE CAPITALIST
SITS ON 4.4
BOARDS



Source: NVCA and VentureSource

“WE WERE PRETTY FRUGAL
AND FOCUSED ON MAKING SURE
THE COMPANIES [WE FUNDED]
WERE FRUGAL WITH OUR
MONEY.”

William H. Draper, III, founder of
Draper & Johnson, one of the first VC
firms on the West Coast

In 1946 American Research & Development Corp. (ARD), considered the first modern VC firm, set the standard for venture capital by seeking to add value to each of its portfolio companies. ARD’s cofounder, Georges Doriot, and his staff took seats on the boards of directors of the companies they backed in order to monitor their progress and assist in their management. This post-investment practice became known, in fact, as the “Doriot style” of active investment and was widely adopted across the VC industry.¹⁰

This approach demonstrated that there is more to venture capital than just capital. By some estimates, the guidance VCs provide is an important part of why venture capital dollars can be three to four times as powerful as corporate R&D in sparking innovation.¹¹ VCs also play a significant role in the professionalization of young companies, helping them adopt stock option plans, hire a VP of sales and marketing, and bring in a professional executive team, including the CEO.

The VC pioneers took their post-financing roles very seriously. After New Court Securities funded FedEx in 1973, Charles Lea joined the start-up’s board of directors and stayed on it for five years. “There was no CEO; I ran that company,” Lea said. “Fred [the founder] was on the phone every day. There was the oil embargo, and we couldn’t get any fuel for the airplanes. But every problem that came up, we’d somehow solve it.”

However, the value-adding function VCs used to perform routinely has deteriorated in recent years. Faced with too much capital to invest, many VCs spread their investments across too many companies thereby diminishing their effectiveness. As a result, many VCs simply do not have enough time to work with the entrepreneurs they back, spending as little as one day a month on each portfolio company.¹²

¹⁰ Hsu, D. and M. Kenney. 2005. Organizing Venture Capital. *Industrial & Corporate Change*. 14 (4): 589-613.

¹¹ Kortum, S. and J. Lerner. 2000. Assessing the Contribution of Venture Capital to Innovation. *The Rand Journal of Economics*. 31 (4): 674-692.

¹² Pontin, J. 2010. Sick Capital: Why It Matters that VCs Won’t Do Their Jobs. *MIT Technology Review*. 113 (2): 6.

Final Thoughts

Many of the early venture capitalists were driven by the satisfaction of working with new ideas and breakthrough technologies and creating new companies and new industries. They saw business-building as part of their noble mission. “If you did a good job you could create companies whose products would be beneficial to mankind,” said Paul Wythes, a founder of Sutter Hill Ventures, the oldest VC firm on the West Coast.

For Wythes and many of his generation, financial rewards resulted from identifying promising start-ups and working hard to nurture them to profitability. “It isn’t instant gratification,” said Wythes. “This business on average, from startup until you achieve liquidity, either through an IPO or merging, takes probably seven or eight years, maybe even a little longer.”

When Wythes started out, most VC firms were straightforward groups of investors raising pools of capital to back high-growth companies. “What we’re trying to do is build companies, not do financial transactions. There’s a difference,” said Wythes. Things changed dramatically when institutional investors entered the picture. The money flooding the venture capital industry has taken it from a long-term view of building companies, to producing returns to please institutional limited partners.

The archetype of VC investing has always been placing bets on young, innovative companies. However, the pressure from institutional investors for venture funds to realize returns earlier, combined with the financial crisis has caused a shift in VC financing. In the past decade, some of the biggest VC firms with billion-dollar funds have lost their appetite for risk. They have been investing in more established companies that may have demonstrated revenue streams and are less likely to go under.

The problem here, some say, is that it’s the scrappy start-ups, not established companies that are typically the source of breakthrough innovations. Consequently, with less money flowing into the developmental stages of new ventures, many are worried about the implications for the U.S. economy and for innovation.¹³

“WHAT WE’RE TRYING TO DO IS BUILD COMPANIES, NOT DO FINANCIAL TRANSACTIONS.”

Paul Wythes, founder of Sutter Hill Ventures, the oldest VC firm on the West Coast

ACKNOWLEDGEMENTS

The Batten Institute is especially grateful to **Chuck Newhall**, cofounder of New Enterprise Associates, who provided the inspiration and encouragement to develop this special series of Batten Briefings about the venture capital industry. Without his persistence and willingness to provide access to people and other critical resources, this project would not have been possible.

We are also indebted to many other industry experts who generously contributed their time and insight, including: **Susan Chaplinsky**, Darden School of Business; **Robert C. Faulkner**, Redmile Group LLC; John W. Glynn, Glynn Capital Management; **John May**, New Vantage Group; and **Francine Sommer**, Village Ventures. Of course, any opinions otherwise unattributed belong to the authors, as do errors of any magnitude.

¹³ Pontin, J. 2010. Sick Capital: Why It Matters that VCs Won't Do Their Jobs. *MIT Technology Review*. 113 (2): 6.

Next in the Series

An anemic market for initial public offerings and a financial system still recovering from near collapse have created severe problems for venture capital. Today, the VC industry is structured for very large exit deals, and in order to generate high returns, a successful VC model needs high-priced IPOs of portfolio companies. In the past few years, however, there have been only a few VC-backed companies that have gone public or were sold for more than \$1 billion. This has led some to suggest that the VC model is broken and has to change.

Obviously, not everyone agrees that the current dearth of IPOs constitutes a crisis for venture capital. One view is that the VC industry has always been subject to boom-and-bust cycles over time. Another view is that VCs can still generate outstanding returns by focusing on building companies that will be acquired by other established companies. Even so, there's a growing chorus of voices calling for the VC industry to shrink or at least restructure itself. The next issue of this Batten Briefing series on venture capital will present both sides of this debate—broken or battered?—and will suggest what it may mean for the high-risk, high-growth ventures of tomorrow.

FEBRUARY
2011

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BATTEN BRIEFINGS, February 2011, Volume 1, Number 1, published by the Batten Institute at the Darden Graduate School of Business Administration, 100 Darden Boulevard, Charlottesville, VA 22903.
POSTMASTER: Send address changes to Batten Briefings, P.O. Box 6550, Charlottesville, VA 22906-6550.
www.darden.virginia.edu/batten

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