CAPITAL ADVICE FOR ENTREPRENEURS

"Down to earth, readable and often humorous...well worth a read"
RICHARD BRANSON

Angels

Dragons

& Vultures

HOW TO TAME YOUR INVESTORS . . . AND *NOT* LOSE YOUR COMPANY

SIMON ACLAND

Praise for

Angels, Dragons & Vultures

"Raising investment for your business can be a tricky task. Simon's book Angels, Dragons and Vultures *charts the challenges in a down-to-earth, readable and often humorous way. If you are looking to expand your business or planning to set one up, this is well worth a read."*

Richard Branson

"A helpful, expert and practical guide for those risking the world of venture capital funding. Full of excellent advice."

Tim Waterstone

"Simon Acland has written an insider's guide to the opaque and much sought-after world of venture capital. Angels, Dragons and Vultures *decodes the industry and offers sound advice for those who will engage with it."*

Julie Meyer, founder of Entrepreneur Country, CEO of Ariadne Capital, and a Dragon on the BBC's Dragon's Den Online

Angels, Dragons & Vultures

For all the entrepreneurs with whom I have had
the privilege to work

Angels, Dragons & Vultures

How to tame your investors...

and *not* lose your company

Simon Acland

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INTRODUCTION

The Venture Capital Bestiary

Angels, Dragons, Vultures: what are these beasts? Angels sound nice; Dragons and Vultures rather less so. But then Angels can be satanic. Dragons are sometimes friendly. And Vultures come in handy for disposing of corpses and clearing up rubbish.

In the context of this book, Angels invest their own money as venture capital in a business.

Vultures also make venture capital investments, but with other people's money. That way Vultures hope to earn enough to become as rich as an Angel.

And Dragons? Well, they're Angels with such a thirst for publicity that they can't resist breathing fire on television.

Angels can be Dragons, but Dragons are always Angels. Angels are sometimes Vultures, or have been in the past. Vultures can be Angels or even Dragons, or they want to be, and get called all sorts of other, even less flattering names as well. And just to complicate matters further, in the US Dragons are not Dragons at all, nor do they have a den. Instead, they are Sharks and they live in a tank.

Is that as clear as mud?

WHAT SORT OF BEAST SHOULD YOU BE TO READ THIS BOOK?

I hope that the book may be of some interest to Angels, Dragons, and Vultures, but it is written for the beasts without whom Angels, Dragons, and Vultures would be unable to exist – entrepreneurs.

My talk of Dragons and Vultures runs the risk of characterizing the entrepreneur as their helpless prey, some poor species

of defenseless ungulate with little chance of escape. But the entrepreneur is really the king of this particular jungle, the Lion. Without the entrepreneur, Angels, Dragons, and Vultures would have no purpose. On their own they cannot exist.

So first and foremost this is a book for entrepreneurs, and it is dedicated to the entrepreneurs with whom I have been privileged to work during the course of my career. They are Lions because of the bravery and energy it takes to set up a business or to step into a risky venture, because of their hunger, and because of their style.

A WORD OF WARNING

There is one sobering fact I must lay out for the Lions before I go any further.

During my venture capital career I sat on the board of 23 companies. In only 7 cases – less than one third – was the chief executive I originally backed still in that position at the end.

An even more surprising statistic is that in 4 out of 7 of these cases, the company concerned had gone bust. Over half of the instances where the chief executive remained unchanged resulted in failure. Yet in total, only 5 out of the 23 companies I backed went bust – including those where the chief executive remained unchanged. In one instance the CEO was changed and the company still went bust. In only 3 out of 18 successful cases was the original CEO still in place.

Is it fair to draw the conclusion that to achieve a venture capital success, especially from early-stage investment, it is nearly always necessary for the chief executive to change as the company grows and develops? My personal portfolio is a small sample, I know, but that is the conclusion toward which I would be forced based on my direct experience.

The table opposite shows the picture starkly. Overall my failure rate was 22%; not too bad for an early-stage investor. But

Company outcome	CEO changed	%	CEO unchanged	%	Total	%
Survivors	15	94	2	43	18	78
Failures	1	6	4	57	5	22
Total	16	100	7	100	23	100

when the founding CEO remained in place to the bitter end, there was a bitter end in 57% of cases. When a change took place, the failure rate fell to a remarkable 6%.

If until a moment ago you were an entrepreneur who was considering raising venture capital – a Lion who was summoning the courage to expose him- or herself to the spells, claws, and talons of Angels, Dragons, or Vultures – you may now be closing this book and putting it back on the shelf, deciding not to buy it or go further with your plan. If you are a founding chief executive who already has outside investors, you may be cursing under your breath and doing just the same. But please wait a moment. Keep reading for another line or two.

Written from the perspective of a venture capitalist, this book draws on a career's worth of experience of mistakes made by entrepreneurs – some of their own making, and some into which they were cajoled by their investors. By sharing the lessons of these mistakes, I hope that I will help you toward an outcome for yourself that is both lucrative and emotionally satisfactory. I hope that this book will help put *you* into the top box of the middle column in the table above.

ANOTHER DEFINITION

This is not a book about private equity. "Venture capital" and "private equity" are terms that are far too often interchanged and confused. They are as different as pride and prejudice, or sense and sensibility.

Venture capital means investment in a business which needs equity funding to grow, normally because it cannot generate enough cash itself from its existing trading activities to fulfill its plans. Perhaps the investment is to be used pre-revenue – so before the company is generating any cash at all – to research or develop a product or a technology. One way or another, venture capital is often used to allow a company the dangerous luxury of making losses. By definition, therefore, venture capital carries a high element of inherent risk and needs to offer to its provider the potential of a reward high enough to balance that risk.

Before its first venture capital investment – from Angel, Dragon, or Vulture – a company will typically be wholly owned by its founders and management team. Generally businesses that raise venture capital are quite young, at an early stage in their development. If a company raises venture capital after being around for a while, it may be about to make a step change, perhaps moving from providing a service to selling a product, or grafting a new activity onto an existing, related rootstock. Usually all, and certainly most, of the new capital will be invested in the business, not paid out to existing or former owners.

Private equity is quite different. It typically involves buying an established business from its owners. This can be a management buy-out – an MBO – by the existing team, often from a corporate owner. Or it can be a management buy-in – an MBI – with a new team acquiring an existing business. A BIMBO sounds much more fun but, disappointingly, as a buy-in management buy-out, it is simply a hybrid of the two. In any event, with these structures all or most of the money goes outside the business to pay off previous shareholders. Most businesses backed by private equity are profitable and cash generative. They are often geared up with significant levels of borrowing to provide better returns on the equity investment, and the cash flow from the business is used to service and repay

the debt. It follows, therefore, that they are usually well established, and inherently lower risk than businesses backed by venture capital. Often a large element of the risk associated with private equity investment is caused by the financing structure. Private equity failures mainly result when the debt element of a deal is too large and servicing it places an unbearable burden on the business. The debris left in the private equity world by the 2008 credit crunch and subsequent recession shows this very clearly.

A few of the points made in this book may be relevant to these private equity deals – especially around how to build, maintain, and manage your relationship with your backers – but in most cases they are too large and late stage to have much in common with real venture capital. They have a very different dynamic. Just as importantly, a different type of person is normally involved, both on the side of the investor and on the side of the management team.

There, I have used that phrase already. I have implied that there are two sides, two opposing teams, in a venture capital deal. That, of course, is one of the main problems. It is perhaps the main reason why in my career I have seen as many companies destroyed by venture capital as made by it. This book is about how to keep the Lions, Angels, Dragons, and Vultures all on the same side.

Some of my comments may appear uncomplimentary, even hostile, to venture capital practitioners. This is not my intention. In fact I am being thoroughly unfair in using the term Vulture generically for a professional venture capitalist. Really Vulture should only be used for a particular type of aggressive, opportunistic investor. So please forgive me my sense of humor. I do not want to be lynched the next time I go to Menlo Park or Mayfair.

I have many good friends in the venture capital industry, and bear for them both respect and affection. I had a lot of fun during my career, and managed to make a bit of money. It is

an exciting, varied, and challenging job. The industry performs a valuable economic function. I hope that by advising entrepreneurs on how to take well-informed decisions, this book will help, not hinder, my former colleagues.

A NOTE ABOUT GENDER

Politically incorrect it may be, but in this book I am old-fashioned and stick to "he" and "him" rather than "he or she," "him or her," and so on. This is not because I think women cannot or should not run businesses – in fact my wife is a chief executive and does it far better than I ever could – but just because it makes for an easier prose style.

Having said that, I will share one more statistic about my time as a Vulture which I always regretted and have never been able to explain: not one of the businesses that I personally backed was run by a woman, and in the whole history of my firm we backed female chief executives just twice. One was very successful and one was not.

The only possible explanation I have been able to think of is that women are too sensible, too creative, too intelligent, and too inventive to need to raise venture capital for their businesses. They develop them in different ways. That brings me neatly on to my first chapter.

CHAPTER ONE

Venture Capital: Do You Really Want It?

Can you trust doctors who don't take their own medicine?

You may well think that is a strange question to ask at the beginning of a book about venture capital. You may be so sure that venture capital will be your ticket to fortune and fame that you can afford to skip this chapter. I certainly don't want to put you off. But I do want to make sure that you go into this with your eyes wide open – not with your eyes wide shut.

Very few venture capital firms have outside shareholders. Most are fiercely jealous of their own independence. Those that start with outside investors often buy out those shareholders to regain total control just as soon as they can – and celebrate wildly when they have done so. And many venture firms suffer from succession problems precisely because their founders or senior partners are so jealous of their equity that young up-and-coming members of their team are not cut into the action soon enough – or at all. Nobody understands the value of hanging onto their own equity like a venture capitalist. They extol to entrepreneurs all the benefits an equity investment can bring, but they are not so good at swallowing their own medicine.

"It is far better to have a small slice of a big cake," they say, "than to have a large slice of a small one." But most of them are extremely reluctant to sell any portion of their own cake. No group – except perhaps the television evangelists of the Deep Southern states – is so good at not practicing what it fervently preaches.

Consider the fact that venture firms which are owned by other financial institutions are known in their industry as

"captives." That word encapsulates venture capitalists' attitude to having outside shareholders in their own business. Pause. Think. Do you really want to become a "captive" of your venture capital investor?

One of the main motivations for many entrepreneurs is independence. Remember why you set your business up in the first place. Your desire to have control over your own destiny must have been an important reason. A considerable part of the reason you stepped out of the relative security of a salaried job in someone else's company may have been in order to be your own master.

So before you sell equity in your business to any outside investor, whether Angel, Dragon, or Vulture, search your heart. Be sure that you really are willing to relinquish some control. Selling even a minority stake means that you will lose your independence. You may still technically exercise control through a majority shareholding, but you will have to take into account the views of others in the way you run your business. Their economic interests will have to be considered. As a director of your company you will have an obligation – both moral and legal – to consider your outside shareholders' needs and interests.

It will no longer be totally your business. You will find yourself operating under a new set of rules, and those rules will not be entirely of your own making. Your company's constitution will be governed by a new Certificate of Incorporation, an Investor Rights Agreement, and a string of other documents in North America, or by a complex Shareholders' Agreement and weighty new Articles of Association in the UK, and similar contracts in other jurisdictions. (See Chapter 5 for chapter and verse on those special instruments of torture.) Those documents will give your minority shareholders entrenched rights which to an extent negate your ability to exercise control of your company through your shareholding.

And if the expansionary plan on which you have been encouraged to embark does not bear fruit, or if the fruit takes

too long to ripen and the money in the bank runs down, you may find yourself completely at the mercy of the only person sitting at your boardroom table with cash to invest – your venture capital beast. (See Chapter 6 for more on this.)

Once you have brought an outside shareholder into your business, you cannot step backward in time and undo what you have done. Very occasionally an entrepreneur manages to pull off the trick of buying back his own business at a lower value than the price he sold it for. In my personal sample of 23 deals, it happened just once. On the few occasions when it does occur, it normally means that the business has not succeeded anyway. It is much more common that the first round of investment leads to a second round, and then maybe a third. (Chapter 11 covers the perils of these "follow-on" rounds of funding.) That first 30% stake you sold becomes 55% and then you are no longer even the majority shareholder. Then something goes wrong, and your investors lose confidence in you and tighten the thumbscrews. And then you find you are no longer a shareholder at all. Or a director. Or an employee. You have lost your company, your job, and your chance of wealth and fame.

If things go well, those disappointments may not happen. But in any event, by taking outside investment you have made a commitment to your venture capital beast. It will probably be specifically stated in that Stock Purchase or Shareholders' Agreement of yours, but even if it is not, the practical and moral commitment is there. You will have to provide your Vulture, your Angel, or your Dragon with an exit. (I cover the intricacies of exits in Chapter 12.) Suffice it to say at this point that you are committing yourself to a path which should lead to the sale of your business, or to the achievement of a public market in its shares. Your outside shareholders are investing on the basis that you will provide them with the opportunity to sell their shares via one of these routes within a timescale that makes sense for themselves and their own investors. That

is part of the bargain you are striking with them and they will have every right to be aggrieved if you renege on it. You will no longer be able to run your company as a "lifestyle business," living off what you can make and adjusting your input to it according to the way you wish to run your life.

ALTERNATIVES

So before you take the plunge, examine carefully whether this is really what you want. Also examine whether you really *have* to raise equity capital. Is there absolutely no other way of achieving your objectives? Whether or not there is an alternative may depend on the nature of your business and your personal position. It will also depend on your own appetite for risk.

Typical studies (for example one conducted by Cambridge Business Research in 2009, "The role of micro funds in the financing of new technology-based firms") show that around 50% of businesses resort to credit card funding. A similar number use bank overdrafts, almost inevitably guaranteed by the business's proprietor or secured on their property. Perhaps a quarter use other commercial loans and hire purchase or leasing; 5% secure grant funding; and somewhere between 1% and 3% raise external equity capital. So only a very small minority of businesses resort to Angels, Dragons, or Vultures.

Now, of course, many of the businesses covered in these studies raise small sums of money. Most of them are not suitable for venture capital treatment in any case. Many have no possibility or ambition to be anything other than a lifestyle business. But even for those that are suitable subjects for a Vulture, Angel, or Dragon, it may be a wise move to use small amounts of funding from these alternative sources to get as far down the track as possible before raising outside capital.

A phrase I particularly dislike, which is often used in early-stage equity investing circles, is the 3Fs. This stands for

"Friends, Family, and Fools." It may be foolish to invest in an early-stage business if you do not understand what you are getting yourself into. It is certainly foolish to invest money that you cannot afford to lose. But to describe in this way individuals who might provide early-stage funding partly out of generosity and optimism is churlish in the extreme. It also reflects badly on the entrepreneur who takes money for his business on this basis. If foolish friends or family invest in your business to get it started, you should treat them in the same way as any other outside shareholder or lender, and do your utmost to make sure that they get a fair return on their investment. Otherwise you may find yourself alone in the corner, and rightly so, at the next family wedding. Or simply not invited. It may be easier and less formal to raise money from them than from a professional Angel, Dragon, or Vulture, but the rules and obligations that you should impose on yourself should be no different.

THE 3CS

Let me coin a new phrase that I prefer: the 3Cs. This stands for "Colleagues, Customers, and Collaborators."

"Colleagues" is clear enough. Getting a friend, or a family member, to put money into your company so that you have to draw your own belt less tight is one thing. Having a colleague, who shares your ambitions and objectives, tighten his or her belt to the same notch as yours is quite another. Starting a business can be a lonely activity. That, of course, is the very reason some people do it; others find it easier to spread the load. Later on, perhaps, you may find that the load is not as evenly distributed as it once was (I cover that eventuality in Chapter 10), but at least it can be a fair way to start out.

"Customers" is pretty clear, too, although you don't have any and your product is little more than an idea. But can't you

pre-sell your idea to a customer? You may have to offer advantageous terms, and perhaps compromise on some intellectual property rights for a specific sector or for a certain period. Nevertheless, at least work through whether offering an early customer a sweet deal is a better option for you than selling part of your equity to an investor irrevocably, for once and for all. Your customer will certainly demand less control than your investor.

Perhaps you are worried that development for a specific customer will lead to product compromises. Maybe you think that a customer-specific design will have no application in the wider market. More often than not, in fact, it is the other way round. The venture capital-funded generic product is often developed in too much of a vacuum, so that it meets theoretical customers' needs but does not give them what they actually want. Working with an early customer on a co-development can be the best way of making sure that the product is something that the market wants to buy. So starting a business off in this way may not only obviate the need to sell too much equity too early, it can actually help you to build a better business.

Microsoft, the most successful software company of all time, did not raise a cent in venture capital until 1981, when it was six years old. Bootstrap Bill is not only a character from *Pirates of the Caribbean*. At the very beginning, in 1975, Bill Gates wrote to MITS – which had just launched the Altair 8800, perhaps the first true personal computer – and offered to write a BASIC language for it. Gates and Paul Allen continued to build products for people who paid them to do so; in other words, they carried out development projects. They did not formulate a vision of the product the world needed and lose money developing it. They found a customer who needed a product, who often had an idea of the product they needed because they already had customers of their own, and developed their product for them. Even MS-DOS, the operating system that took Microsoft into the big time, was developed under contract to

IBM for the IBM PC. Part of Gates's genius lay in striking the commercial terms around these development contracts, which in the case of MS-DOS enabled him to keep the intellectual property rights so that he could sell the same operating system to other PC manufacturers.

Apple is another famous name that started with customer funding. In 1976, Steve Wozniak, the brilliant engineer who founded Apple with Steve Jobs, designed and built the Apple I before raising any outside capital. He was still working at Hewlett-Packard. Jobs took an order for 100 units worth $50,000 from the Byte Shop. They funded this order by buying the parts for the computers on credit, and getting the Byte Shop to pay in cash. It was not until the iconic Apple II was designed that the first outside angel funding was invested to manufacture the product in early 1977, and not until 1978 that the first institutional venture capital round took place. When Apple floated in 1981, it was the largest initial public offering since the Ford Motor Company in 1956.

If winning a development contract is not an option for you, can you fund your product development through consultancy? Can you eke out your cash by drawing a smaller salary – or no salary at all – or by cutting other corners? And of course, the further you can take your business under its own steam, the more certain you will be of the market opportunity. Yahoo!, which in the mid to late 1990s reigned supreme as the dominant internet portal, started in 1994 as a collection of links to research papers created for their personal use by two graduate students at Stanford, Jerry Yang and David Filo. Other students heard about it and began sending in links themselves, asking for them to be added. It was only once the momentum had led to a proven demand that Yahoo! was set up as a business.

As certainty and market validation increase, the better the terms become when you do raise that first tranche of outside capital, and the easier that is to achieve. The risks will have reduced, and the potential rewards will have increased, making

the equation much more attractive for the investor. This is especially difficult in the case of deep science-based businesses, where a large amount of capital will be required. These businesses should choose very carefully the moment they emerge into the commercial world, breaking out of an academic cocoon, for example, or spinning out of a larger business. Venture capital equity funding is often best used for commercializing a technology and turning it into a real product, not for developing the technology itself. If investors are called on to take the strain too early, too much money will be consumed; even with a positive outcome, the amount invested may exceed the business's eventual value. If it is tough for investors to make money, it will be just as tough, or tougher, for the inventor or entrepreneur.

THE THREE LAWS OF ROBOTICS

This is the first of several anecdotes based on events from my career that I use in various places to illustrate my points. For reasons of confidentiality I use a fictional style and omit names; I assure you that the stories are genuine. Here are two which illustrate alternative ways of getting your business off the ground.

Both men looked as if they should be smoking pipes. One sat at the laboratory desk; the other paced up and down, gesticulating anxiously.

"Yes, we could develop the control system you want. But it would divert us from the direction I want to go. The market we want to focus on is machine tool controllers, not industrial robots. I've got the core technology, and know what needs to be done, but it is just not our real priority. We'd need to build a new team and write a lot of special code, even a new programming language."

The man at the desk shifted uncomfortably from side to side as if his rough tweed jacket was too thick for the pleas-

ant autumn day. "What if we were to place a development contract with you? On a 'cost plus' basis, of course. We'd have paid for the work, so we would have to own the IP, naturally…"

The pacing professor stopped in his tracks, a disconcerted expression spreading across his round face.

"…exclusively in its application to industrial robots. You could reuse the technology for other applications – your precious machine tools, for example. You could even have a go at an automated guided vehicle. Then you'd have all the components of an FMS. Sorry, flexible manufacturing system – I know you hate acronyms."

The professor started walking again, but rather slowly, as if deep in thought. "Mmm. It is a big commitment. It would probably take three years. So we'd have to have some decent royalties on the robots you sold at the end of the program. 2%? Running for 10 years? Then there's the value of what we've already built. You would have to make an up-front payment for the license."

The up-front payment, and the profits on the development contract, eliminated the need to raise venture capital in the first year. Far from selling the company's technology birthright, the development contract formed a cornerstone of the business plan when it was later decided to raise venture capital to accelerate growth in sectors outside robotics. The development contract also provided potential investors with a valuable endorsement of the company's technology.

THE RIGHT CALL?

"I just don't see how we can make ends meet if we leave."

The older man's eyes were worried behind his glasses as he ruffled his thinning hair. His youngest colleague, full of cocky energy, bounced on the balls of his feet. The other two watched pensively.

"We know they'll pay £850 per day for skilled network planners. The four of us'd get more, £1,000 or even £1,250. We already know most of the people we'd hire, and all in we wouldn't even have to pay them half that. We might have to drop our salaries a bit from what we are used to, but that should give us enough to bring in a couple of guys just to work on product development. Then, as the tool's functionality grows, we'll be able to charge more and do the network planning quicker."

"And I could get to work on the service node platform concept. If we get the architecture right, we won't have to think too much about the detailed application before we find our first customer. We could probably get them to pay us to write the first application – and that might be the best one to sell to the rest of the industry."

By the time they decided to raise venture capital, they had built a revenue stream from consultancy and product development of over £4 million. This attracted the interest of investors, reduced the amount of capital required, and increased the valuation at which capital was raised.

The service node platform was used to build a pre-paid cellphone billing system for one particular customer. The intellectual property was retained. The demand for the product, indicated by the first customer, was soon confirmed by interest from other phone operators. It rapidly became the company's main product line.

Although the strategic focus was on driving the software products into international markets, and particularly on exploiting the prepaid billing platform, the consultancy business was maintained and generated valuable cash flow. The business grew fast, and a second round of venture capital took place at a much higher valuation.

When, two and a half years after the first venture capital round, the company was sold to a major international software group for £50 million, the management team and senior staff still held a significant majority of the equity.

WINDOWS OF OPPORTUNITY

Sometimes the decision to raise venture capital is driven by the concern that a window of opportunity is about to close. If you do not raise enough capital to exploit it, somebody else will establish an unassailable position in the market you wanted for yourself. Occasionally this may be correct, but in my experience, more often windows of opportunity tend both to open and to close more slowly than you might expect. More of the businesses with which I have been involved have made the mistake of developing their product too early than too late. Consumers tend to take longer than entrepreneurs expect to change the way they lead their lives. Enterprises take even longer to change the way they do business. It is understandable – the entrepreneur's light bulb switches on, he has a great idea, he comes up with a new way of doing something that's miles better, cheaper, quicker, more elegant, and more fun and he thinks everyone will want it yesterday – but it doesn't happen like that.

Google wasn't the first web search company. Apple didn't invent the digital download of music. Microsoft wasn't the first company to develop a windows-based operating system. They all carefully watched others spending money to develop a market. They saw the mistakes these pioneers made, either technological, or marketing, or both, and developed better ways of doing the same. Then they came into the market and plucked the fruit when it was plump and ripe.

If your business depends only on being somewhere first for its competitive advantage, if market occupancy is your sole rampart against incoming competition, then frankly you are not likely to have much of a business. Cynical Vultures, their feathers ruffled by the bursting of the technology bubble in 2000, quickly renamed first-mover advantage "first-mover disadvantage."

IT ISN'T JUST ABOUT THE MONEY…

Ah. I knew you were a modest, self-perceptive individual. You understand your strengths and weaknesses. You know that your experience is not all-encompassing. There are aspects of running a business that you still have to learn. You don't just want money; you also want *help* from your investor.

Vultures are good at telling the world what they can do to help the businesses they back. Angels are more modest, quietly confident in their abilities and experience. Dragons – well, Dragons are perhaps even louder than Vultures in talking up their abilities, but then they are more likely to have built businesses themselves. In Chapter 6 I talk about what added value you can realistically expect from your venture capital beast.

There is nothing wrong with seeking added value from your investment partner. Recognizing your own limitations is as important in business as it is in life. But remember what it says about you to your beast. You are effectively saying that you might not have all the skills as CEO to take your company through to exit.

That is fine, of course, so long as you recognize at the beginning that in order to achieve your share of success you might have to be one of the 16 in the table I showed you in the Introduction. If the prospect of handing over the reins of your company is too horrible to contemplate, then start off self-funding on a less ambitious trajectory. Fill in the gaps in your skills with practical experience, and only raise outside capital when you are confident that you know it all. And good luck to you.

…BUT MONEY IS STILL IMPORTANT

Although business isn't just about money, money is a very important part of it. And one of the most basic business prin-

ciples is that over a period of time you need to bring in more money than you lay out. In many businesses that is measured from day to day or week to week; some may have more leeway and be able to sustain a loss-making, or cash-negative, month, quarter, or even year.

Raising dollops of equity investment creates the opportunity to make losses, or to be cash negative, for as long as the investment lasts. Sometimes this makes good business sense. Two, three, even five or more years of loss-making product investment can lead to a gloriously profitable, cash-generative future, where profits far exceed the previous losses, or at least where the value of the business or the technology that has been created outweighs the sums invested.

However, it can also mean that you lose good business disciplines. You become addicted to the venture capital drug. Another fix becomes the easy option. (In Chapter 8 I talk about the need at some point to wean yourself off the venture capital addiction.)

So before you stick the needle in for the first time, make sure this really is what you want to do.

CHAPTER TWO

Understanding Venture Capital Beasts

***Don't** use a long spoon to sup with the devil.*
***Do** get close to him and watch how he eats.*

So you have looked at your business from every angle. You can see the opportunity to build it into something substantial. The market is there. Your product is almost ready and it will definitely meet the market need. You have thought hard about the ominous warnings of Chapter 1, but you cannot see any means to seize the opportunity without investment way beyond your own financial resources. No alternative remains: you will have to play Faust.

You understand intimately the inner workings of your own company. You have carefully modeled the business that you hope it will become. But have you looked equally carefully at the business models of the investors from whom you hope to raise money – the Mephistopheles to whom you will have to sell your soul?

I make no apology for going on at some length in this chapter about the venture capital model. After all, before you approach investors for funding you need to understand what they are looking for; and after you have taken their money you need to understand the pressures on them and the behavior that those pressures may drive.

THE VULTURES

Most venture capital firms are small businesses; far smaller, in fact, than the ambitions of the companies they back. They can seem powerful organizations because they appear to have

access to money, and because they often occupy flashy offices in expensive locations. But appearances can be deceptive. Before you start approaching investors, pause to consider the economics that drive venture capital firms.

Fees

The main source of income for a venture capital firm is the management fee it receives from the institutions or individuals who invest in its funds. Although there has been some downward pressure toward 2%, the industry standard is still generally 2.5% per annum, normally paid quarterly. A simple rule of thumb, therefore, is that a firm with $20 million under management will have revenue of $500,000; a firm with $50 million under management, revenue of $1.25 million; one with $100 million, revenue of $2.5 million; and so on. Before you approach a venture firm for funding, find out how much capital they have under management and how many staff they employ, and you will be able to gain a quick idea of how comfortable they are – whether they have achieved "critical mass," or whether they are still having to scrabble around and earn money in other ways in order to make ends meet.

A few firms have delighted their investors by adopting "budget-based" fees, where they agree to draw a management fee which covers an agreed level of overhead, rather than a fee directly related to funds under management. These are very much the exception, however. And call me cynical, but budget-based fees are generally adopted only by firms which have done so well that they hardly need to earn money any more, or where their success justifies a very generous level of budgeted salary.

Of course, there are subtle variations on the fee model according to how a fund is structured. A venture capital fund raised from institutional investors – pension funds, endowments, insurance companies, banks, and the like – will

normally be structured as a limited partnership. This is the industry standard in the US, Europe, and Asia.

This type of fund is drawn down from investors – the limited partners, or LPs for short – in tranches as each underlying investment is made. The objective of this "just-in-time" drawdown structure is to maximize the internal rate of return on the fund. This IRR, essentially a compound annual return, is the most important yardstick by which the manager – the general partner (yes, you've guessed it, GP for short) – will be measured when the time comes for them to raise the next fund. Even though not all the money is invested in the fund up front, the management fee is calculated with reference to the total amount of money committed by the investors.

Limited partnership venture capital funds typically have a fixed-term life of ten years, with an option to extend for two further years and perhaps beyond in case some of the investments remain unrealized by then. For the primary investment period of the fund, the management fee is usually fixed, whether the value of the fund goes up or down. Normally, as it happens, the value of the fund goes down in the early years, because failures appear first and it takes longer to build a business to success than for it to go bust. In the industry jargon, "lemons ripen earlier than plums." One might conclude from this statement that few Vultures have ever grown citrus fruit; in fact, as you and I know, lemon trees flower and fruit simultaneously all year round.

The graphical effect to which this mantra gives rise is known as the "J curve." In the early years of a fund, valuations usually fall below cost, before beginning to rise again (one hopes) as successes emerge. GPs and LPs hope that about halfway through the fund's life, perhaps sooner, the valuation curve will cross the *X* axis again, and rise steeply in the later years as a result of the big winners. So in model funds, the graph you get if you plot the value of a fund against time is shaped like a *J*.

The point of the commitment-linked fee structure for fund investors (the limited partners) is that they want to be sure that the venture firm to which they have entrusted their money is stable and will have enough revenue to cover the costs of effectively managing the fund and its underlying investments ("portfolio companies," in the jargon). In fact, if a fund starts badly, it often requires more intensive management resources as each portfolio company takes more and more attention to turn it around. In those unhappy circumstances it could be against the fund investors' interests to pay lower fees, because without careful management the value can spiral down and the *J* curve can end up without a tail.

Of course, for the venture firm (the general partner) it is very nice to know that you can count on at least a fixed level of income for the first five years after raising one of these limited partnership funds. Once you have raised a fund of reasonable size you have an exceptionally steady business for the next five years. So if your Vulture turns to you in a board meeting and says "Well, we are always on budget; why aren't you?", you would be justified in pointing out to him that he has an unusually predictable business model.

A crunch normally comes after five or six years, at the end of the primary investment period, when the mechanism for calculating the fee may change. The 2.5% level may remain in place, but it will now often be calculated by reference to the original cost or the latest valuation of the investments remaining in the fund. In other words, any investments that have been successfully realized and any that have failed are subtracted. Unless the firm has delivered a strong enough performance to attract investors into its next fund and boost its fees by raising more money, this is a moment when it can feel a squeeze, when salaries and bonuses get reduced and staff are cut or leave.

Other types of fund pay fees in slightly different ways. Some venture capital funds are listed on a public stock exchange. These may be vehicles such as investment trusts, including

venture capital trusts in the UK. They will normally levy their fees by reference to net asset value. So if a fund performs badly, valuations reduce and the manager's income will go down relative to that decline in value. You sometimes find that venture capital firms which manage listed funds are more resistant to marking down the value of their investments than those which have limited partnerships. Call me a cynic again, but this is for the simple reason that the former are hit where it hurts most by a valuation reduction – in their pockets – whereas the latter feel no immediate economic effect.

Other ways in which venture capital firms can earn income are by charging fees for fund raising; deal fees or corporate finance fees for making, organizing, and sometimes selling an investment; and directors' fees for joining portfolio company boards. In institutionally backed limited partnership funds these fees are generally offset in whole or in part against the management fee. The logic here is that the limited partnership investors do not want the Vulture to become rich from management fees, but from the profit share earned if he makes money for them. Nor do they want the managers' efforts to be diverted toward fee earning in order to make ends meet. So institutional investors may be more sympathetic toward a young firm which has not yet achieved critical mass from fund management fees alone; established firms are more likely to have to return all these miscellaneous fees to the fund.

Venture capitalists which manage other types of fund – once again including investment trusts and venture capital trusts, for example – are more likely to be able to keep all these miscellaneous fees. Fund-raising fees can be particularly important. Normally, for example, investors in a venture capital trust pay a 5% up-front fee for the privilege of investing in the fund. Some of this goes to pay brokers, accountants, lawyers, and other advisers, but for a firm which manages its affairs well, a good proportion can be kept out of the clutches of these professionals. This can be an important source of revenue.

So some of the behavior shown by venture capitalists can be explained by the type of funds they manage. A general partner may not bother to charge directors' fees or deal fees. When they are pitching for your business they may make great play of this, but they are not being generous. They are merely not too bothered because such fees have to be rebated to limited partners. A venture capital trust manager is likely to be rather keen on these fees; they may have a direct impact on his annual bonus. A long-established firm with plenty of fee income from funds under management may display an Olympian lack if interest in miscellaneous fees. A newer, smaller firm which has not yet ascended to these dizzy heights and tasted ambrosia may seem greedy for deal fees and directors' fees by comparison.

As a general rule, however, everything else pales into insignificance beside the fees on funds under management. Thus to prosper and grow, a venture capital firm, like any investment management business, has to increase its funds under management. This is a very challenging and highly competitive process. Only firms which deliver strong performance to their investors will be able to raise their next fund. This is why the medium-term focus of most venture capitalists is on making their funds perform well enough that they can raise the next one – or at least, on making it seem as if their funds are performing well enough to raise the next one.

There are some venture firms which have to give up all thought of raising another fund. When it becomes clear to the general partners that their fund will never make a positive return, and that their limited partners will not invest in their next vehicle (or "re-up," in the jargon), the current management fee may become their sole *raison d'être*. They become like an exploding supernova. If the younger members of the team, faced with no future, do not leave of their own volition, they may be blown out into the cold, as the senior partners seek to maximize the cash going into their own pockets while there is

still time to milk the fees. These firms gradually disappear into their own black hole along with their investors' money.

Distributing proceeds

I described above how the limited partnership structure is designed to maximize internal rates of return by drawing down money from investors just before it is needed. Of course, the other side of this coin is that the realized coin needs to be distributed to limited partners as soon as possible. So when an investment is turned into cash as a result of a trade sale, or of the sale of shares listed on a stock exchange, the proceeds are normally paid back to the fund investors without much delay. Occasionally, realized profits are retained in the fund to cover management fees or follow-on investments, but this is a sign that the fund has become severely stretched and will do no favors to returns. Sometimes, when a company has achieved an IPO or stock exchange flotation, listed shares in the company are distributed to limited partners. (I talk in more detail about different types of exit in Chapter 12.)

These so-called distributions *in specie* are usually only made when an investment has been highly successful and become a large enough public company for there to be an active and liquid market for its shares. The limited partners will not mind receiving liquid stock which they can easily sell; they may well be large investors in listed equities themselves or have colleagues who are, and they may choose to hold the listed shares for more upside. But they are unlikely to be pleased about receiving a distribution of illiquid shares in a poxy little quoted company which may be impossible to sell all at once, or for some time; then the general partners will be seen as having ducked their responsibility and to have passed the problems associated with selling the shares back to their fund investors. In a couple of paragraphs' time I describe the profit share for which Vultures neurotically hope; this is calculated at the point

at which the distribution is made to limited partners. So if a distribution *in specie* is made and then the share price of the company concerned collapses before the fund investors have been able to sell all their shares, they may feel somewhat aggrieved.

Other types of fund have different distribution policies. Some stock exchange-listed venture capital funds have a policy of paying out the majority of realized profits in lumpy dividends. Others might aim for a progressive dividend policy, with steadily rising distributions to shareholders, implying that they retain the bulk of each realization in the fund. These funds will reinvest some of the proceeds from realizations and have the aim of building up their net asset value (which, as noted above, increases their management fees), which should in turn push up the share price. However, the shares of most funds of this type trade at a discount to their net asset value, so if a shareholder wants to cash in by selling their shares, they are likely to have to do so at a price which is lower than the underlying assets are really worth.

Who is in charge?

Limited partnerships are carefully constructed so that there can be no comeback on limited partners beyond their investment in the fund. All the responsibility for managing the fund, for taking investment decisions, and any resultant liabilities, lies with the general partner. However, the limited partners will have considerable influence with the managers of the funds in which they invest, because those managers are likely to want them to invest in their next fund. Most GPs will avoid crossing their LPs, or taking unpopular decisions.

One area to which LPs are especially sensitive is a conflict of interest. These arise where a decision for one fund might clash with another area of the same venture capitalist's business. For example, if VC Fund I has invested in Xcorp, and Xcorp subsequently wants another round of funding, by which

time the same venture capitalist has raised VC Fund II, whether VC Fund II should make an investment, and at what price, will give rise to a conflict of interest. Some of the investors in Fund I may not have invested in Fund II; some of them may have invested more or less as a proportion of the two funds; other investors may be new to Fund II. In each case, the LPs may have different relative economic interests. In these circumstances the view of an advisory committee is normally sought by the GP – and normally observed. The advisory committee is drawn from the largest and most prominent LPs in the relevant fund, sometimes supplemented by outsiders. They would also be consulted on other potentially controversial issues, such as valuations of investments for the annual accounts, and distributions *in specie*.

In most stock exchange-listed funds the roles are reversed. These funds are structured with a board which has similar legal obligations to any other group of directors and takes ultimate responsibility for the fund. Sometimes investment decision-making powers are delegated to the managers; sometimes they are formally taken by the board on the managers' advice.

Profit shares

Venture capitalists can make a pretty satisfactory living from their management fees. Unlike the entrepreneurs they back, they do not generally have to worry about closing that new sale next month to keep cash flow going to pay their salaries. The venture capital fund management business model has the attraction of being unusually stable and predictable. But how do Vultures hope to get rich? The answer is through their profit share on successful funds. In the jargon this is called the "carried interest," or "carry" for short. The normal way that carried interest works is that once a fund has returned its original cost to investors, typically plus a fixed annual return (a "hurdle rate"), the GPs receive 20% of the profits.

Supposedly this carried interest percentage and jargon originate from medieval Genoese, Pisan, Florentine, and Venetian merchants, who carried cargoes belonging to others on their ships in return for 20% of the ultimate profits. A few superstar firms, modern Medicis, have been able to better even their hard-nosed medieval antecedents, and increase their carried interest percentage to 25% or 30%.

In a sense, even the more modest venture capital firms have improved the model. For most firms, the percentage carry may not have changed from the 500-year-old model. However, the level of risk most certainly has. Those merchants often risked life and limb in order to get a ride on the back of others' capital. They owned the ships, and could suffer considerable loss if an unexpected storm blew up, or if a skull and crossbones appeared over the horizon. Today's venture capitalists only risk a modest career setback if one of their funds goes underwater. There is not yet much chance of being clapped in irons as a galley slave by pirates marauding around Menlo Park.

The carry, the profit share that they leverage from their investors' capital, is allocated between the members of the venture capital team on a pre-agreed basis. Note that usually the carried interest depends on the performance of the whole fund, not the performance of individual investments in that fund. You only reach the end of this rainbow when all the failed investments and all the management fees are netted off against the successes. Thus in a venture capital team, the return of the Vulture who backs more than his share of winners can be damaged by another member of the team who hoses away a fortune. The underperformer may not keep his place in the team. Certainly, the star investor may push for – and win – a larger share of the carry in the next fund.

In modern times, though, this consideration is often an academic one. I would wager a good portion of the carried interest that I have earned in the past that a majority of current venture capital practitioners, certainly those who were first cut into the

carry after the millennium, have never found that pot of gold. Most have never enjoyed the sweet pleasure of cashing a carried interest check.

This is because making money from venture capital investment is a truly challenging process. Remember here the distinction I made between venture capital and private equity. Remember too that the first decade of the current century has been especially difficult for early-stage and technology investing. No sooner had the fall-out from the bursting of the internet bubble in 2000/01 largely decayed than another nuclear explosion occurred in the shape of the 2008 global economic crisis.

Venture capital funds are usually measured according to vintage. Those hostile to the industry might say that this is just to give successful general partners the excuse to hold forth about their extensive collections of Premiers Crus Clarets and the vast, temperature-controlled cellars they have had to construct beneath their ranches or country houses to accommodate them. I have suffered quite a few conversations along those lines, but actually measuring funds by vintage year is fair enough. Like most asset classes, the performance of venture capital funds is inextricably linked to the era in which they are invested. So performance in the run-up to the bubble of 1999 and 2000 tended to be strong; funds raised in 1995–97 were also frequently fine performers. Funds invested at the top of the cycle, even by famous investors, have not necessarily reached the end of their lives, but when they have, most partners – both limited and general – will want to forget about them. Remember that vintages are named by the year in which they are raised and start investing; the investment process will mostly take between two and three years to complete, perhaps up to five. A 1995 vintage fund, therefore, would be invested largely in 1995–97.

Unfortunately, it seems to be one of the immutable laws of venture capital that the largest volume of money is raised and

invested at precisely the wrong place in the cycle. So the volume of capital available rose sharply around 1987, just in time to be damaged by the economic difficulties at the start of the 1990s. In the first half of the 1990s, because of weak performance, less money was raised, and then stellar performance from the 1995 and 1996 vintages attracted absurd volumes of capital in 1999 and 2000, which was invested wildly at the top of the market. So perhaps it really is rather like wine: the best vintages tend to be small and very few really special vineyards produce good wine every year.

The British Private Equity and Venture Capital Association, or BVCA for short, publishes an annual review of the performance of its members' funds based on work done by Fund of Funds manager Capital Dynamics and accountants PricewaterhouseCoopers. The performance of early-stage funds of different vintage bands is shown in the table below in terms of the performance measurement normally used in the industry, the internal rate of return, or compound annual return to investors.

Vintage	Median IRR p.a.	25th percentile IRR p.a.
1997	7.1%	18.6%
1998	N/A	N/A
1999	−7.6%	3.6%
2000	−8.1%	0.1%
2001	−8.3%	−3.3%
2002	−11.6%	2.0%
2003	−0.7%	2.5%
2004	N/A	N/A
2005	−11.9%	0.0%

Source: BVCA Private Equity and Venture Capital Performance Measurement Survey 2009.

With a negative median return for every vintage year except 1997, these statistics show that most funds in the sample actually lost money. The top 25% (the 25th percentile shows the bottom of this range) from the 1997 vintage performed pretty well. Clearly, the performance of the best funds would have outperformed even this number. However, from the 1998 vintage onward, the lowest of the best 25% has done little more than give investors their money back. Of course, once again the best funds from these vintages will have done better. I should also point out that many of the funds from later vintages will not yet have reached the end of their lives. Some of this performance data is therefore based on valuations, not realizations, and may get better as these funds finally mature.

I hear North American readers thinking: "Ah, but in the US venture capital makes more money." It hurts me as a European to have to admit the truth of that statement, but the difference is not as great as some might think. Or at least, the overall performance pattern of the industry in the US is similar. The statistics below are compiled by investment adviser Cambridge Associates

Vintage	Median IRR p.a.	25th percentile IRR p.a.
1995	42.9%	81.4%
1996	33.2%	92.1%
1997	8.6%	56.1%
1998	−1.2%	18.5%
1999	−5.4%	2.5%
2000	−3.5%	2.9%
2001	−0.4%	6.0%
2002	−1.7%	4.8%
2003	1.8%	4.2%
2004	−1.6%	2.5%
2005	−2.2%	4.2%

Source: Cambridge Associates LLC, U.S. Venture Capital Index and Selected Benchmark Statistics, Non-Marketable Alternative Assets, December 31, 2009.

and published by the National Venture Capital Association or NVCA for short. They may be compiled in a slightly different way to the BVCA statistics but are broadly comparable.

Essentially these show that in the US, median returns have usually been a bit worse and the 25th percentile a bit better than the 25th percentile returns in the UK, and have been negative every year since 1997 except for 2003.

As previously noted, these statistics demonstrate a very wide range between the firms that perform well and those that do not. Firms that have a poor track record are understandably coy about revealing how much money they have lost. But one of the peculiarities of the industry is that the superstar firms like Kleiner Perkins and Sequoia Capital are even more coy about admitting how good their performance really is. A storm erupted in the industry in 2003 when freedom of information legislation obliged some limited partners with a public-sector connection to publish the performance of the funds in which they had invested. Some of these unfortunate LPs were excluded from future funds, but not before they were forced to reveal data which makes one's mouth water. For example, the next table, showing the multiples achieved by Kleiner Perkins on its funds, was published by the University of California in 2005.

Fund	Vintage year	Multiple on cost	Estimated IRR
KP II	1980	4.30x	51%
KP III	1982	1.74x	10%
KP IV	1986	1.83x	11%
KP V	1989	4.01x	36%
KP VI	1992	3.33x	39%
KP VII	1994	32.51x	122%
KP VIII	1996	17.00x	287%
KP IX	1999	0.40x	–23%
KP X	2000	0.59x	–18%

The last two funds in the table were only partway through their life in 2005, and, if only because of its investment in Google, the 1999 vintage fund must by now have defied the cycle. But the most striking numbers in this table are the performances of Funds VII and VIII. You could perhaps criticize Kleiner Perkins's brand management skills in allowing itself to sound like a well-known marque of peanuts, but you cannot criticize this spectacular performance. For most Vultures, 17× cost on one investment is a major achievement, and 32.5× is a dream (my personal best is 50×). To achieve that result on a fund overall is just extraordinary.

Benchmark Capital, one of the younger members of the "top tier," is the firm which is reputed to have delivered the best performance on a fund. Its first fund, of the 1995 vintage, supposedly achieved a $2.5 billion return, or a modest 500 times cost, on its $5 million investment in eBay. The 2006 Private Equity Performance Monitor reports a multiple for the fund of 42× – or almost $4.25 billion on its $101 million cost. So while eBay accounts for a bit more than half of that, there must have been a few other good investments too.

Thus it is possible for venture capitalists to make a great deal of money from the carried interest. If the firm starts with a $100 million fund and trebles it after deducting fees – a strong but not staggering performance – there will be 20% of $200 million – $40 million – to share out between the general partners. A fund of $100 million might sustain a firm of four partners, so that is $10 million each, or $1 million for each year of a 10-year fund. These may not be modern investment banking-type bonuses, but they are more than enough to be getting along with.

The really successful venture capital investors, the ones who deliver extraordinary results, like Kleiner Perkins, Benchmark, and Sequoia, make extraordinary sums of money – and rightly so, for they are genuinely contributing to the wealth-creation process. Kleiner Perkins's Funds VII and VIII were $225 mil-

lion and $315 million in size respectively, and their carried interest percentage was 30%. So the multiples of 17 and 32 times, as attributed by the University of California data, could have generated a carried interest pool on these two funds of $1.1 billion and $2.9 billion respectively. The LPs must have thought that their KP GP had earned every cent of it.

Raising the next fund

Sequoia, Kleiner Perkins, Benchmark, and the handful of other superstar firms in their peer group – the famous "top tier" – have no difficulty raising their next fund. In fact, quite the reverse: it is almost impossible for new investors to gain access to them. As the general partners accumulate wealth, they are likely to want to invest more of their own money in their funds, squeezing down outside investors. They made their bubble-era funds too big, and in some cases they reduced their LPs' commitments to those funds. They are too smart to make the same mistake again. Increasing the size of a fund too far damages performance because it increases the supply of capital beyond the supply of good deals, and forces GPs to expand their investment team excessively and dilute their talent. So in these top-tier funds, a minor transgression by an investor, one small complaint, one due diligence question too many, or one small delay in responding to a drawdown request may lead to his being unceremoniously ejected from the investor group. However, there are precious few superstar firms that can behave like this. Very few hold the whip hand over their investors. Most firms handle their actual and potential fund investors with kid-gloved respect.

So just how competitive is it for a venture capital firm to raise its next fund? It always used to be said that with a net compound annual return of above 20% the next fund should not be a problem, and that with a return in the high teens you would probably be all right. The NVCA and BVCA data above

suggest that not too many firms can demonstrate that sort of performance. Even being in the top quartile – among the best 25% of their peer group – may not be good enough. Limited partners often joke that they have never met a venture capital investor who claims to be anything other than top quartile and question whether such creatures exist, but by definition three-quarters of investors are not top quartile, and at least three-quarters will therefore struggle to raise their next fund. As well as comparing one GP with another, potential LPs look at absolute returns and will expect a premium return over comparable asset classes because of the higher risk, higher volatility, and lower liquidity inherent in a venture capital fund.

After 2007–08, with returns on almost every asset class devastated, investors should perhaps be a little more forgiving – but they themselves have less money to invest. They have probably become more risk averse. The fact therefore remains that for most venture capital firms, delivering a strong enough performance to raise the next fund is very challenging. The successful investments in a fund have to overcome the drag of the failures, and of the management fees. Those fees may be important for putting regular food on the Vulture's table, but over a fund's 10-year life they will themselves gobble up nearly 25% of the capital.

Portfolio construction

All of this has major implications for how venture capital investors view your business. Different venture firms have different approaches to risk and reward and to how they construct a portfolio to deliver an acceptable return to their investors. Some, probably including the best firms of all, may rely on a small number of very big winners, investments which return not just tens of times cost, but hundreds of times cost. In the past they have made investments that have achieved very high multiples; they have confidence that they can do so again. But

they also know that such things cannot realistically be modeled. Their approach is likely to be more instinctive, more focused on sniffing out and executing large opportunities than on measuring and defining them at the beginning.

For those firms that do attempt to model their portfolio in a systematic way, a not uncommon theoretical approach is to divide it into three categories: the losers, the living dead, and the winners. Say each category forms 25% of the fund, with the remaining 25% reserved to pay management fees. Say investments are made evenly over four years, and realized evenly five years after investment. Say losers return nothing, and the living dead return cost.

The table overleaf assumes a $100 million fund on this basis and shows the cash flow to and from the fund investors. Negative numbers are cash that they pay out; positive numbers show money paid back to them from the fund. The table shows that in order for fund investors to achieve a 20% compound annual return net of fees and carried interest, the average multiple on cost of the winners must be nine times cost. Note, by the way, that, taking into consideration the management fee and the carry, the general partner ends up with almost half of the original amount committed to the fund – $49 million out of $100 million – for a performance that is good but not stellar.

Many venture capital investors have never achieved a 9× return on any single investment, let alone achieved that average across their winners. Over five years, that multiple of nine times the cost of an investment equates to an internal rate of return on that investment of 55%.

This model is, of course, simplistic. Different firms have their own, more sophisticated approaches, but broadly the same principle applies. An investor using a similar model will need to back businesses which have the potential to deliver nine or ten times the cost of the investment in five years, or an IRR of 55–60%. While that is quite a tall order, that is the sort of yardstick against which the potential of your business will be measured.

Cash flow ($m)	**Y1**	**Y2**	**Y3**	**Y4**	**Y5**	**Y6**	**Y7**	**Y8**	**Y9**	**Total**
Fees	–2.50	–2.50	–2.50	–2.50	–2.50	–2.50	–2.50	–2.50	–2.50	–22.50
Investment in losers	–6.25	–6.25	–6.25	–6.25						–25.00
Return on losers						0.00	0.00	0.00	0.00	0.00
Investment in living dead	–6.25	–6.25	–6.25	–6.25						–25.00
Return on living dead						6.25	6.25	6.25	6.25	25.00
Investment in winners	–6.25	–6.25	–6.25	–6.25						–25.00
Return on winners						56.25	56.25	56.25	56.25	225.00
Carried interest							–4	–11.25	–11.25	–26.50
Cash flow to LPs	–21.25	–21.25	–21.25	–21.25	–2.50	60.00	56.00	48.75	48.75	126.00
IRR to LPs										20.22%
Multiple on winners										9.00x
Multiple on fund										2.63x
Total multiple to LPs										2.50x
Cash return to GP										49.00

Your own Mephistopheles

Anxious Faustian entrepreneurs need to be aware of all these generic pressures on their investors. They also need to be aware of the individual pressures on their personal Mephistopheles, because the generic pressures on the GP will be compounded by the pressures placed by the GP firm on the individual who did their deal.

In particular, the younger members of the team in a venture firm may have never tasted success. They may have never made an investment which has moved through to a trade sale exit, let alone to an initial public offering (IPO) or stock market flotation. They are likely to be under considerable pressure to achieve these successes. Pressure may be manifested in very tangible ways. Many venture firms will have a good reserve of profits from their management fees at the end of the year after paying their fixed overheads. While the senior partners, the founders of the firm, will probably snaffle a large proportion of any excess, some at least will go into a bonus pool for the rest of the team. One of the factors in determining how this is allocated may be the performance of the investments for which each individual is responsible. Certainly performance will affect each individual's position in the firm. In the nearer term this may be limited to status, but over time it will also have an impact on promotion, on admission to the partnership or to the board, and on the allocation of profit share or carried interest. Normally carried interest in a fund is allocated across the investment team according to position and seniority. Occasionally it is linked to the specific deals done by each individual. But usually if someone has done well and shown himself to be a proven money-maker, he will achieve his ambition of being cut into the carry, or his share of the carry in the next fund will go up.

So if things are going badly in your company and your personal Vulture seems devilishly bad-tempered, remember that

he may feel in a very personal way that you are costing him money, wrecking his ability to educate his children, or blighting his career.

The customer and the product

I hope it is clear by now who is the Vulture's customer. Some Vultures talk about the companies in which they invest as their customer, but this is at best careless and at worst disingenuous. The companies in which Vultures invest are the products they offer to their real customers, their fund investors. And of course, the "customer is king." (I did once work for a business whose main customer really was called King, which caused much hilarity all round and led to posters bearing that slogan being pinned up all around the workplace.)

So do not make the mistake of thinking that *you* are the customer, the most important person in the Vulture's network of relationships. You are the Vulture's product. And remember that you, as an individual, are not even the whole product, but only part of it. The Vulture's whole product range is made up of all the companies in which he has invested or will invest, and each of those products has a number of components: the management team, the technology, the market opportunity, its own product or service, and so on.

Of course the Vulture's product is important to him, just as your product is important to you. But just as you can and will – or at least should – adapt your product to meet your customers' needs, so the Vulture will try to adapt his product, pressing to change the focus of a portfolio company, or altering the management team, making whatever changes are necessary to make it more attractive to their customer – in this case more successful and more profitable for their investor.

You may have a number of SKUs (stock-keeping units) in your product range. Some may be much more important than others, either because they are outselling the rest, or because

they generate a better margin, or perhaps because you have invested so much in developing them that you cannot afford to let them fail. On the other hand, you may have some products which generate little revenue, no profit, and, thank heavens, have not cost you very much. You probably don't pay much attention to those ones and they may get discontinued.

A Vulture's investment portfolio is little different to your product range. He hopes to have some companies which are doing well. These will represent a high proportion of the value in the portfolio. Some of these may have been small investments which have done exceptionally well; these are clearly the highest-margin products. And he may have some investments whose cost is so high that he simply cannot afford to let them fail. All of these will take most of his attention, and he will spend less time on the products – companies – in which he has not invested very much, and whose prospects are not very interesting.

THE ANGELS (AND DRAGONS)

The Vultures invest other people's money. The Angels invest their own. So it is no surprise that their attitudes are a little different.

You would have to be a very holy Angel indeed not to mind losing money. Nevertheless, it can be easier to lose your own money than somebody else's. No sensible Angel will invest more than he can afford to lose. He may have taken that risk earlier in his career in the business activity that made him enough money to act as an Angel now, but he will not invest more than he can afford to lose in somebody else's business. Most of his wealth now will probably be allocated to asset classes that are a great deal safer than venture capital.

Nor does an Angel have to worry about management fees. He does not lose sleep about achieving an IRR good enough to

enable him to raise the next fund, or about the impact of a bad investment on his career prospects. That is all behind him. The average Angel is probably more worried about his wife complaining about the amount of time he is spending on a particular investment, or his friends muttering in the clubhouse, "Mike's latest deal is turning sour. He must be losing his touch."

That is not to say that Angels behave in an uncommercial way. Their business antennae are likely to be far more sensitive than a young Vulture's. (You would be correct to point out that young Vultures do not have antennae at all, but nor, as far as I know, do Angels, so my metaphor has completely broken down.) Your Angel will want to cut a good deal. He may want to charge you a director's fee, but not so much because he needs the money as from the fairly reasonable point of view that it is poor discipline to do something for nothing, and that if he does not charge you a fee his contribution may not be properly valued.

If an Angel's investment does go wrong, the tax system can often apply salve to his wounds. If he makes a capital loss he may well have gains elsewhere against which it can be offset. In some tax regimes, such as the UK, even if he has no balancing capital gains, he may be able to offset a loss against income tax at his highest marginal rate. If he has invested with the benefit of the Enterprise Incentive Scheme, or EIS, the British tax man's generosity currently means that he cannot lose more than 30% of his total investment. You look surprised? That is because under the EIS you get 20% income tax relief and 18% capital gains tax roll-over relief up front, so your investment costs only 62% of face value. If you lose everything, you can offset the 80% on which you did not get income tax relief against your highest rate of 40%, effectively getting back another 32% (80% × 40%). So provided that you can roll over your capital gains tax liability again, only 30% of the original investment cost remains unsheltered. The Inland Revenue has

paid for the other 70%. In some instances, if you have an earlier capital gain taxable at the old rate of 40%, the maximum loss declines to 8% of the total, with the tax authorities funding the remaining 92% (20% + (80% × 40%) + 40%). By the time you read this book the tax rates may have changed so I apologize if my figures are out of date; however, the principle that a portion of the cost of an investment in a private company can be attractively sheltered is unlikely to have changed.

Anyway, part of an Angel's motivation will most probably be for the sport. That is not to say for a moment that Angels are likely to be a soft touch; in fact, frequently quite the reverse. Often because they have worked hard for their money and therefore know its value, because they have built companies themselves, and because generally they only invest in businesses they understand, they may be more aggressive than a Vulture about getting stuck into yours (and into you) if they think you're doing a poor job. If you are doing a poor job that may not be such a bad thing.

However, they are unlikely to give you a hard time over petty matters. Many Angels (dare I say the best Angels?) have been entrepreneurs. If so, they have often had Vultures of their own to deal with. So they can be better at not loading you with the irritations sometimes caused by institutional investors who have not been on the entrepreneur's side of the fence. They may tend to take a simpler and longer-term view of capital structures and equity incentives. They may avoid getting unnecessarily bogged down in some of the awkward remuneration issues I discuss in Chapter 7. Like the more experienced chess player, they may be better at realizing that snatching that exposed pawn now and gaining a short-term advantage from going one piece up is in fact a mistake because of what is likely to happen five moves later.

You will see that implicit in this is the definition of the Angel as an experienced businessperson, actively involved in the businesses he backs. In this sense, the Angel is a Dragon. There

are Angel investment groups which operate by sourcing funding from multiple private investors, and Angel funds with limited partnership structures which source their capital from private individuals instead of institutions. There is nothing wrong with these, but it is important to understand that they may be different in some respects to having a direct investment from an Angel and a simple one-on-one relationship. In some cases Angel funds make a point of tapping into the individual expertise of their investors and thus deliver Angelic benefits by using a member of their network to manage individual investments. Nevertheless, as soon as a third party becomes involved, managing somebody else's money, the dynamics grow more complicated, and some of the features attributed to Vultures earlier in this chapter may emerge.

Otherwise, as you would expect, the disadvantages of working with an Angel – or a Dragon – rather than a Vulture are those of working with an individual rather than a firm. Everything depends on a single relationship; if it sours, or something goes wrong, there is nobody else to turn to. If you find that you can no longer stomach your personal Vulture, at least you can call up his boss. Ringing God to complain about your Angel is not possible.

And because an Angel can afford to lose the money he has invested, because he is investing in part for sport, because he no longer has career pressures to worry about, he may be able to walk away from an investment and draw a line under it more easily than a Vulture could. His personal circumstances may also change, or he may get bored and decide to extricate himself because he is no longer enjoying it.

Finally, most Angels will not be able or willing to invest as much as a Venture Capital fund. The Dragons in their den normally talk in terms of tens of thousands, sometimes hundreds of thousands, but almost never millions. If you are going to need millions to fund your business, you are unlikely to be able to get it all from an Angel. At some point you will have to go

to the Vultures. However, the amount they invest, together with the expertise and support they provide, often make Angels the most appropriate source for the first injection of outside capital in your business.

Certainly, many of the best investments I made in my career as a Vulture were when I invested in the round after an Angel investment. I enjoyed working with these experienced businesspeople and learned a great deal from them. They helped me to contain some of my youthful Vulturish tendencies and to rub some of the rough edges off my beak. If I were starting out now to set up a business for the first time, I would aim to get a wise Angel investor to spread his wings around me before I approached any Vultures.