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Thinking About Venture Capital? Think Harder

The emergence of the modern VC industry in the second half of the last century set off the greatest innovation explosion in the history of the world. The attractions of venture capital for entrepreneurs are obvious: VCs tread investment frontiers otherwise trod only by fools and angels, and often bring significant value to startups beyond capital. If changing the world (and likely generating enormous wealth) is the stuff entrepreneurial dreams are made of, venture capital usually provides the financial fuel for realizing those dreams.

All of that said, venture capital is not for everyone. And not just because most entrepreneurial business ideas don't fit the scalable, high risk/reward venture investment model. Even entrepreneurs with ideas that fit the venture capital model should think long and hard about the implications of accepting venture investment before starting a venture capital campaign.

Venture capital is a hard business, for VCs and for the entrepreneurs they invest in. Problematic VC/Entrepreneur relationships are common, and downright ugly VC/Entrepreneur relationships are not uncommon. VC/Entrepreneur relationships are complex, and the ground upon which they are built is unstable and shifting. It's not surprising so many of them go bad, and little wonder that some of them get ugly.

With that in mind, entrepreneurs thinking about seeking venture capital should focus on three aspects of working with VCs that are common sources of VC/Entrepreneur angst. The expense of venture capital (financial and otherwise); the duality of the VC/Entrepreneur relationship (investor and partner); and divergent VC/Entrepreneur interests (that change over time). Let's explore each of those in turn.

Venture Capital is Expensive.

In terms of legal sources of capital, venture capital investors are easily the most demanding. Most early stage VCs think in terms of making at least 10x on each investment. That's because VCs are lucky if two of each ten investments actually

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deliver the goods. It's probably the only business where offering an investor a surefire 4x return is a good way to get turned down.

Aggressive VC return metrics can become problematic as your own balancing of risk/reward tradeoffs changes as your startup evolves. You may find yourself at a point where a nice double or triple looks readily achievable and very attractive, but find your investor nixing the idea in favor of continuing to swing for the home run. Or, alternatively, if your startup hits a rough spot, you might find your venture investor pushing for a "fail fast" shut-down rather than a double-down investment.

As a general matter, while you and your VC might start out with a common "go for the Gold" approach to building out your startup, as time goes on your respective thinking about risk/reward tradeoffs can change; given that your VC is a partner at least as much as an investor, that can get, well, complicated.

<u>Venture Capitalists are Business Partners</u>.

The good news is that VCs don't (usually) want to run your business. The decidedly mixed news is that they are very interested in how you run it, and (even when their equity position is well below 50 percent) typically endowed with *de jure* and *de facto* tools for translating interest into influence.

As for *de jure* influence, the "standard" terms employed in the vast majority of venture capital investments include a plethora of "protective" provisions that let VCs punch well above their weight in terms of management control. Standard protective provisions give venture investors the power to block all kinds of business and investment actions, including future financings (debt as well as equity); increases in equity incentive pools/grants; strategic business transactions; and a host of more esoteric matters that don't seem important – until they are. These provisions are above and beyond the Board representation that comes with most VC deals.

As for *de facto* venture capital rights consider the plight of everyone's (current) favorite poster child for startup excess, Adam Neuman, late of We Work. Neuman had complete control of the Board and voting control from a shareholder perspective. Right up to the day he "chose" to resign he had the legal right to replace the Board with folks who would back him. Despite his seemingly unassailable position in law, the *de facto* realities of WeWork's business/financial position overwhelmed him, and he "voluntarily" left the scene.

Neuman's experience may have been unusual in its public airing, and its influence on the broader market, but in substance it happens more often than most entrepreneurs think. (And, for that matter, more than most VCs would like.) Fine print and tough times are usually not top-of-mind at closing parties, but as an entrepreneur your chances of getting your startup all the way home without confronting the same are pretty low.

<u>Divergent VC/Entrepreneur Perspectives</u>.

When a venture round closes, it's likely (well, it should be) that the entrepreneur and the VC are more or less aligned in their thinking about the future of the business. Be that as it may, as time goes on their thinking will almost certainly diverge. Couple that with the aforesaid discussion of VCs as business partners, with hard and soft tools for shaping important business strategic and operating decisions, and you've got a recipe for a wide range of good, bad and ugly outcomes.

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In my experience, there are three common sources of divergent VC/entrepreneur thinking about how any given startup should be managed. First, entrepreneurs tend to think of their deal as “the” deal, while VCs think of the same deal as “a” deal. Second, as the “facts on the ground” evolve over time, smart folks following the deal closely will almost certainly develop alternative takes on the business/investment implications of those changes. Finally, VCs aren’t personally interested in deals so much as they are institutionally interested, and their institution’s interests also evolve as the facts in their business evolve.

Managing portfolios vs. managing businesses. Entrepreneurs think about deals the way pigs think about breakfast: they are 100 percent in on the meal. VCs, on the other hand, think of any given deal the way chickens think about breakfast: they are interested in the festivities, but only to a point.

The contrasting “committed” vs. “interested” perspectives of the entrepreneur and his/her VC are not problematic by nature but can become problematic in the particulars as a startup and its venture backers move past the post-closing honeymoon. You can be pretty confident; for example, that if (when) times get tough, your VC will be quicker to consider a “why throw good capital after bad” approach than you will. When a business is based, as a VC’s is, on how a portfolio of investments perform rather than how an individual business performs you don’t worry so much about breaking a few eggs in the pursuit of a winning omelet.

More generally, as coaches of stables of athletes rather than athletes themselves, VC interest in any particular portfolio entrepreneur waxes and wanes over time. Bored VCs can become micromanagers, and overly-taxed VCs can be hard to engage. The former state is seldom productive, and never pleasant, while the later can make for entrepreneurial bliss or extreme frustration. (Perhaps the only thing as frustrating as a VC who won’t stop meddling is a VC who won’t return your call when a crisis is knocking at your door.)

The VC “Value Add”. Good VCs (and even some of the bad ones) bring more value to the table than just capital. But whether your VCs add value or not, you can be sure they think they do. And given that the typical VC has a big ego, more brains than the average bear, and a Type A personality, for good or ill you can be sure they will make themselves heard in the discussion of every important (and likely more than a few unimportant) issue that face your startup. If as an entrepreneur you are not prepared for skeptical, empowered, backseat drivers on your cap table and Board, then stay away from venture capital.

Internal Fund Considerations. The common venture capital fund is a strange animal. Unlike the startups it invests in, it has a fixed life, usually ten years, over the course of which its business changes directions several times. Those changes often have a big impact on the various startups in its portfolio, and the nature of the VC/entrepreneur relationship.

From the entrepreneurial perspective, a venture fund’s lifecycle starts when it first begins making investments. Depending on various factors, including how hot or cold the venture business is at the time, the first two to three years of the fund’s life will be all about finding, evaluating and making *de novo* investments to build its portfolio. After that, the fund will spend another two or three years focused on managing its investments and making follow-on investments in its portfolio companies. Thereafter, the fund’s managers will shift their focus to assisting its portfolio companies to achieve liquidity. With a bit of luck, it will have exited – for good or ill – all of its investments before it winds down as its ten-year lifetime runs its course.

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Somewhere in this cycle, usually say three or four years out, the VCs managing the fund will determine that the fund is fully invested. Not in terms of having no more capital to invest, but rather that it has allocated, in its planning, its remaining investable capital for its existing portfolio companies. That's critical, because that is the point where the VCs managing the fund (assuming they have a decent track record) will start turning significant attention to raising the next fund.

What all of this means is that both the quantity and quality of a VCs interest in its portfolio companies will change as the VC's fund works through its lifecycle. More specifically, as the fund ages you can generally expect your VC's thinking to be more about exiting and less about growing, all the more so if your VC doesn't already have a string of successful exits to their credit from prior funds. Again, as a general matter, when your VCs start raising their next fund, you should expect that they'll have less time and energy for your problems – particularly those that are not exit-related.

One more thing about VCs and their funds. While it is not uncommon for a VC team to stick together throughout a fund's lifecycle, neither is it uncommon for fund teams – and now and again even investment thesis – to shift within a fund's lifecycle. Finding out that "your VC" has left a fund for greener pastures can put a real dent in your relationship with a fund; and there is nothing you can do about that beyond hoping it doesn't happen. (In some cases, though, you may in fact hope that it does happen.)

Final Thoughts

High risk/reward entrepreneurship drives the innovation economy, and venture capital provides most of the fuel for that engine. World-changing tech startups that don't rely on venture capital for their financial fuel in the early stages are rare: more exceptions to the rule rather than examples of an alternative path. At the same time, there are reasons – good and bad, but reasons – that many entrepreneurs talk about vulture capital as much as venture capital. Any entrepreneur thinking about seeking venture capital should think long and hard about what could go wrong as well as what could go right. Because, once you've got a VC on board, when the going gets tough you'll just have to remind yourself "this is the business you chose."

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