# The Paradox Of VC Seed Investing

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This is the first in a series of articles I am writing to bring more transparency and honesty to the field of venture capital. While many of the themes may be contrarian or controversial, I have two primary goals: First, I want to help entrepreneurs and startup enthusiasts understand what motivates investors. Second, I hope to draw attention to some of the fallacies venture capitalists use in their negotiations with entrepreneurs. Aligning the incentives of entrepreneurs and VCs will lead to much stronger relationships and innovation.

Entrepreneurs regularly come to Founders Fund asking us to lead or participate in their seed/angel round. They are often confused or shocked when I try to convince them that with very few exceptions, it is not in entrepreneurs' best interest to raise seed capital from large venture firms and neither is it beneficial for large firms to invest in seed stage companies. Among the reasons: the structure of VC economics and unavoidable perception issues. Since this conversation happens frequently, I'd like to share my honest thoughts on why large funds should avoid angel investing -– and also why Founders Fund nevertheless does so through its wholly owned FF Angel funds.

The economics of VC explain a lot about why large funds should not do seed investing, so let's start with a quick review of those dynamics. VCs raise money from a pool of capital known as limited partners (the fund is the general partner), which include accredited individuals and large financial institutions . The VCs usually charge 2% of this capital annually for operating expenses (the management fee) and 20% of the profits (the carry). This is known in the industry as a 2-–and-–20 structure but varies from fund to fund. While the management fees from a large fund can be an important source of revenue, the real incentive is (or anyway, should be) the carry. For of every dollar committed to a fund, the firm will take home approximately $.15-20 of management fees (which ratchet down over the life of a fund), but $.40 in carry if the fund triples. And good VC managers aim to get a return of at least 3-5x committed capital. Established firms have been raising more capital lately and this has important consequences for the kinds of investments they make. For the remainder of this article, when I refer to "VCs," I am referring top tier funds in the range of $400 million to $1 billion+. As I am a partner at Founders Fund, I will use our latest $625 million fund as the example.

There are many reasons to work in venture capital. Founders Fund, for instance, has remained steadfast in its mission to transform our world for the better, as presented in our manifesto. At the same time, venture capitalists are capitalists, with a duty to provide returns. With a 2-–and-–20 structure, we and every other VC in the world are incentivized to make money for LPs and ourselves. In order to achieve meaningful carry, we need to return several multiples of the fund, or multiples of $625 million in our case. Consider the basic implications here: we make a traditional seed investment in a company of $250k, and that investment returns. 20x, which by anyone's standards is a home run. The problem is that it only returns $5 million and we need to make another 124 "home-–run" seed investments to return our fund. In a more extreme example, take Andreessen Horowitz's $250K seed investment in Instagram. This was one of the most successful seed investments of all time and netted its fund $78 million. In our case, we would need eight Instagrams to get to $625 million—a feat that no single fund has ever achieved in the history of venture capital. The case would be very different if we were a smaller early-–stage firm where the Instagram investment may have returned its fund multiple times over.

This begs the question: why do VCs do seed investing at all? The standard reason is "option value", or the ability to put in more money later as the company scales and gains traction. That's a terrible answer.. Example: You are the founder of Acme Computing Technologies (ACT), and raise $250K in your seed round from a moderately successful venture firm. That firm has not been bad to you in any way, and may have even been helpful. Six months later, ACT is doing well so you are thinking about a $5 million Series A to scale the business. Your original VC would love to do this deal, but you get a call one day from a legendary Silicon

Valley firm. Are you really not going to take that call? Of course you will! And if she offers you competitive terms, are you not going to strongly consider taking the money? Of course you will! Top tier firms almost ALWAYS have an option on a company, even if they did not participate in the seed round. Firms with great reputations bring many benefits, from branding and signaling to good advice and great connections. For good companies, this scenario happens frequently.

On the flip side, entrepreneurs should be cautious of taking seed money from top tier VCs because of this "option value." Let's change the story and say that a top tier made a seed investment in ACT from the start. We will ignore the subset of companies that die or "crush it" and focus on the large majority of companies in the grey area. If the top tier fund skips the next round for whatever reason, ACT would have a serious problem on its hand. The most common question other firms will ask is "Why didn't the fund take this round"? Passing sends a negative signal to the market, and in some cases, may actually kill the company. The perceived option value comes at a potential huge cost to company, and is the main reason entrepreneurs need to strongly consider this downside.

Those are the structural problems with VCs doing seed investing – it's challenging for a seed investment to have an impact on the fund's total returns and there can be all sorts of signaling problems. So why would an entrepreneur take money from a top VC, and why would the VC itself ever make seed investments?

A potential reason to take money from large VCs is because of their size and ability to move quickly on a small seed investment. In general, if any $400mm+ fund VC takes more than 24 hours to decide on a $250k seed investment, the entrepreneur should run away, fast. Rapid access to capital allows entrepreneurs to waste less time fundraising and spend more time on product or business development. Furthermore, since the fund is so large, and the investment a small fraction of committed capital, the VC will likely leave the entrepreneur alone to run her company with no interference. VC meddling is potentially very detrimental to a company's early success. Convenience and autonomy seem like great reasons to take money from a large fund, but the negative signaling potential to kill the company in the future outweighs these.

Despite these reasons, there are some cases where it does make sense for us (and indeed, any VC firm) to invest in seed stage companies. First, we invest in very high risk tech companies that otherwise would have a difficult time raising funds. We do this because we believe that IF these companies achieve their technical milestones, they open up huge new markets. This is usually a big IF, and also mitigates any signaling risk since other firms might not be willing to invest in the first place. Second, we invest in our network, who are typically amazing entrepreneurs or visionaries (e.g., the PayPal mafia, Facebook mafia, etc.). Investing in our network means we do not need to exert much incremental effort sourcing and helping out on deals because we already know the entrepreneurs and what they are working on.

That kind of investing is a process that is almost infinitely scalable and thus incredibly efficient. These companies often do not fall under our manifesto criteria which we apply to our large main fund investments, so there is very little signaling risk if we do not participate in the Series A round. At Founders Fund, we do these seed investments through FF Angel to signal one of these cases, both to other VC firms as well as our own investors.

At the end of the day, we are venture capitalists. We strongly believe in stimulating innovation through capitalism. We are in this profession not simply to make money, but to help fund some of the most important technology the world has ever seen.

Making our industry more transparent is an important part of what we do, as it can help cut through all the myths of venture capital, and empower founders to focus on the most important thing: progress.