The truth about venture capitalists

- Marc Andreessen. Jun 8, 2007

A lot of people have opinions about venture capital -- the pros and cons of VC, whether or not to take VC, which venture capitalists to take money from, how to get VCs to invest in your company, whether VCs are **seasoned risk-taking professional investors** or **psychotic entrepreneur-hating sociopaths**, etc.

Often these opinions are based on one individual's specific personal experience with venture capital, and often based on someone's negativeexperience -- as is often the case, people who have negative experiences are more motivated to tell others than people who have positive experiences.

With that in mind, I will try to provide my hopefully broad perspective on the topic.

I'll just say up front that I don't think my point of view on this is any more valid than that of any of my fellow entrepreneurs -- everyone's experience is different, and this is definitely a topic where reasonable people disagree.

My experience with venture capital includes: being the cofounder of two VC-backed startups that later went public (Kleiner Perkins-backed Netscape and Benchmark-backed Opsware); cofounder of a third startup that hasn't raised professional venture capital (Ning); participant as angel investor or board member or friend to dozens of entrepreneurs who have raised venture capital; and an investor (limited partner) in a significant number of venture funds, ranging from some of the best performing funds ever (1995 vintage) to some of the worst performing funds ever (1999). And all of this over a time period ranging from the recovery of the early 90's bust to the late 90's boom to the early 00's bust to the late 00's whatever you want to call it.

I'm starting to understand why I don't have any hair left.

The most important thing to understand about venture capitalists is that they are in business to do a very specific thing.

They raise a large amount of money -- often $100 million or more -- today, in order to invest in a series of high-risk startups over the next small number of years -- usually 3 to 4 years.

The legal lifespan of the fund is usually 10 years, so that's the absolute outer limit on their investment horizon.

They generally intend, and their investors generally expect, to have the returns from those startups flow back within the next 4 to 6 years -- that's their realistic investment horizon.

Within that structure, they generally operate according to the baseball model (quoting **some guy**):

"Out of ten swings at the bat, you get maybe seven strikeouts, two base hits, and if you are lucky, one home run. The base hits and the home runs pay for all the strikeouts."

They don't get seven strikeouts because they're stupid; they get seven strikeouts because most startups fail, most startups have always failed, and most startups will always fail.

So logically their investment selection strategy has to be, and is, to require a credible potential of a 10x gain within 4 to 6 years on any individual investment -- so that the winners will pay for the losers and in the timeframe that theirinvestors expect.

From this, you can answer the question of which startups should raise venture capital and which ones shouldn't.

Startups that have a credible potential to be sold or go public for a 10x gain on invested capital within 4 to 6 years of the date of funding should consider raising venture capital.

Most other startups should not raise venture capital. This includes: startups where the founders want to stay private and independent for a long time; startups where there's no inherent leverage in the business model that could result in a 10x gain in 4 to 6 years; and startups working on projects with a longer fuse than 4 to 6 years.

Notably, there are many fine businesses in the world -- many of them highly profitable, and very satisfying to run -- that do not have leverage in their model that makes them suitable for venture capital investment.

By leverage in this context, I mean: the ability to make something once (a piece of software, a chip design, a web site) and sell it (directly or indirectly) to a lot of people (1,000 business customers or 10 million consumers) -- which leads to the classic "hockey stick" revenue projection.

Venture capitalists shouldn't, and can't, invest in companies that don't hit these criteria -- not because they're not good businesses but because their own investors wouldn't stand for it.

There are also many fine entrepreneurs in the world who want their companies to stay small, or who don't want to sell their companies or take them public. That is also well and good, and those entrepreneurs should not raise venture capital.

On the other hand, a business that is built for leverage that could be sold or go public in 4 to 6 years should strongly consider raising professional venture capital, for three reasons:

First, **you get the cash** to invest in the business and grow it at the speed required to realize its full potential.

It's satisfying to say you don't want to deal with VCs and you want to do it on your own, but if your business has the potential to get big, in my view you should take the cash to invest to make it as big as you can, and that usually requires more capital than you can raise from bootstrapping or from angels.

Second, you get that cash **from a professional investor** who invests in this kind of business as her full-time job and reason for existence in the world.

Most other possible investors in a high-growth startup will be much more difficult to deal with than a professional venture capitalist.

Third, in the best case, you will get **help** building your high-growth business from the venture capital partner you take money from (but see more on this in Part 2).

When a venture capitalist turns you down, it isn't personal and it isn't (usually) because she's stupid. Instead, it's often for one of these reasons:

One, she can't see the leverage -- she can't see you getting to a sale or IPO with a credible prospect of a 10x return within 4 to 6 years. If she can't see this, and 10 of her peers at other firms can't see it, then you may want to revisit your fundamental business model assumptions and try to understand what's missing.

Remember, it's in her best interest to see the full potential in your business -- she is looking for high-potential startups in which to invest.

Two, she thinks that what you're doing is too early or unproven.

This is the one that drives entrepreneurs nuts. Isn't the whole point of venture capital to make risky investments in unproven technologies and markets?

Unfortunately, that's life -- sometimes things are simply too early for venture capital. In that case, develop your idea further with bootstrap or angel funding and then take it back to the VCs later with more proof points.

Three, she isn't convinced that you've assembled the right team to go after the opportunity. This usually means she doesn't think your technical founder(s) are strong enough, or she doesn't think your founding CEO is strong enough. Again, it's in her best interest to see the potential in the team if it's there -- so if she and 10 of her peers pass on your startup because of concerns about the team, then you may want to rethink your team.

There are many other reasons in addition to these that a VC may pass on your investment that have nothing to do with you:

She loves it but she can't talk her partners into it -- which happens.

She's fully committed and doesn't have time to take on a new opportunity.

It would require traveling and she can't or won't do that.

You're in a market she doesn't know much about.

Or, she had a bad experience with a similar investment in the past.

The frustrating part is that she won't always tell you why she's passing -- in large part because she wants to keep the door open to investing at a later date if things change (i.e. if it becomes clearer that you have a home run on your hands).

For that reason, whenever a VC passes and explains why, no matter how mean or unfair they sound, the best response is to thank them for their honesty.

I'm trying to keep these posts from getting too long, so I'll stop here, but tantalize you with the topics to be covered in Part 2:

- Comparing venture firms, and comparing partners within firms.
- The VC's ideal investment.
- How much help, and what kinds of help, you can expect from your VC.
- How VC's spend an awful lot of their time, and why you should feel sorry for them.
- VCs: soulless and rapacious capitalists, or surprisingly generous philanthropists? Or both?

- Why we should be thankful that we live in a world in which VCs exist, even if they yell at us during board meetings, assuming they'll fund our companies at all.

- And, how to make a VC's head explode.

The truth about venture capitalists, Part 2

As promised:

Comparing venture firms, and comparing partners within firms:

When raising venture capital, remember that venture firms vary wildly in style and quality.

For example, some venture firms are very entrepreneur-friendly. Others are notoriously brutal.

Interestingly, financial success in the venture capital profession does not seem to be correlated to entrepreneur-friendliness.

Individuals (partners) within each venture firm vary wildly in style, personality, knowledge, experience, ability to be helpful, drive, and ethics.

Personally I'd recommend being more focused on picking the right partner than picking the right firm.

This is slightly counterintuitive advice -- and firm quality does matter -- but the partner is the person you're going to be working with. The other people at the firm you will see probably twice in the whole lifespan of your company.

Best of both worlds is to pick a strong partner at a strong firm, but be aware going in that even strong firms have weak partners.

Venture capital professionals arguably used to be a more homogeneous group: the founders and pioneers of the business, and their hand-picked proteges who had grown up as venture capitalists under close supervision and with rigorous training.

The explosion of venture capital in the late 90's has led to a much broader range of people becoming partners in venture capital firms.

Many partners today have little venture capital experience but come out of an operating background (an executive role at a big company, or experience as an entrepreneur with their own startup), or come out of some other background (corporate attorney or executive recruiter), or come straight out of business school with no meaningful experience whatsoever.

There are pros and cons to working with any of these kinds of partners.

For example, VCs with operating experience are great when it comes to sitting down and talking about how to run a business, but sometimes they have less perspective (because their career was probably focused on one or two companies, whereas a professional VC has probably invested in 30+ companies), and they may have trouble keeping their hands off the steering wheel.

A VC with an executive recruiting background can be incredibly helpful at recruiting -- one of the main areas in which a VC can add value (see below).

And a VC who used to be an attorney can be very helpful when you need to get a parking ticket fixed.

But there's probably still no substitute for the VC who has been a VC for 20 years and has seen more strange startup situations up close and personal than you can imagine.

A venture capitalist's ideal investment:

A venture capitalist's ideal investment is the one that would be a huge success without her.

How much help, and what kinds of help, you can expect from your VC:

Assuming your startup does not fall in the category of a VC's ideal investment, what kinds of help can you hope for from your VC?

First, it's important to really internalize that the founders of a startup are the ones who have to make a startup succeed.

Odds are, nothing your VC does, no matter how helpful or well-intentioned, is going to tip the balance between success and failure.

In addition, VCs are -- usually -- incredibly busy people. Sitting on as many as a dozen boards, sourcing new investments, tracking the fast-moving technology industry, raising money and managing their LPs, and pitching in on their partners' companies and their problems takes up a lot of time.

(Although every once in a while you will run into a VC who is lazy as sin -- but that's a topic for another post, when I've had more to drink.)

The best assumption to make is that your VC's primary value add is the cash they are investing.

Then you'll always be surprised on the upside.

Additional areas in which a VC can help include: recruiting, strategy, partner introductions, customer introductions, additional fundraising, and generally being a good sounding board and source of advice and industry knowledge.

Some firms run incredibly helpful programs such as forums in which new consumer Internet startups can interact with major advertisers, for example.

The only real way to find out how much help you can really expect from your new VC is to ask the founders of other companies funded by that same partner.

Finally, never expect the help to just happen unsolicited. If you want it, ask for it proactively.

You actually don't want a VC who provides too much help without being asked. I leave the why as an exercise for the reader.

How VCs spend an awful lot of their time, and why you should feel sorry for them:

My friends who are VCs seem to spend a surprising amount of their time working with their failing companies.

The reason goes right back to the definition of a VC's ideal investment: their winners are succeeding -- they don't need very much help.

Some of the best VCs in the industry spend most of their time on their successes, helping to boost them to higher and higher levels of success.

But generally, life in the VC trenches seems to consist of trying to jumpstart or otherwise fix fatally flawed startups.

Can you imagine how un-fun that would be?

Venture capitalists: soulless and rapacious capitalists, or surprisingly generous philanthropists? Or both?

Here's something surprising about venture capitalists: their primary job is often helping very worthwhile nonprofits build larger and larger endowments to be able to continually make the world a better place.

The largest investors in many top-tier venture capital firms are nonprofits -- particularly universities and large philanthropic foundations.

This is partially because such institutions are very patient investors and have very long time horizons. But this is also partially because many of the top venture capitalists feel a real sense of obligation and mission to help such vital organizations grow and flourish.

Traditionally this has been hard to see because venture capital firms have wrapped the identities of their investors (limited partners, in the lingo) in confidentiality agreements. But more recently, via certain SEC filings and disclosures by public universities, it has become possible to get a glimpse into the investor bases of some of the world's best venture capital firms.

For example, it has been previously well publicized that you can see who Sequoia's investors are by reading the **SEC disclosure on the Google/ Youtube acquisition**.

You can see in that filing that Sequoia's major investors include such universities as Amherst, Brown, Colby, Columbia, and Dartmouth -- and that's just into the D's. Similarly, philanthropic foundations invested in Sequoia include the Ford Foundation, the Moore Foundation, the Irvine Foundation, the Rockefeller Foundation, and the Hewlett Foundation.

This is not unusual.

The best VCs get to improve society in two ways: by helping new companies take shape and contribute new technologies and medical cures into the world, and by helping universities and foundations execute their missions to educate and improve people's lives.

Why we should be thankful that we live in a world in which VCs exist, even if they yell at us during board meetings, assuming they'll fund our companies at all:

Imagine living in a world in which professional venture capital didn't exist.

There's no question that fewer new high-potential companies would be funded, fewer new technologies would be brought to market, and fewer medical cures would be invented.

We should not only be thankful that we live in a world in which VCs exist, we should hope that VCs succeed and flourish for decades and centuries to come, because the companies they fund can do so much good in the world -- and as we have seen, a lot of the financial gains that result flow into the coffers of nonprofit institutions that themselves do huge good in the world.

Remember, professional venture capital has only existed in its modern form for about the last 40 years. In that time the world has seen its most amazing flowering of technological and medical progress, ever. That is not a coincidence.

How to make a VC's head explode, in one easy step:

Point out to her that her compensation from carried interest should be taxed as ordinary income, not capital gains, since she's receiving a fee for service and it's not her capital at risk.

The truth about venture capitalists, Part 3

Jun 10, 2007

Bonus chapter!

(This will be the last post on venture capital for a while, if I can help it.)

The current venture capital environment in the United States is characterized by a very large number of venture firms (866, according to the **National Venture Capital Association**), investing an extraordinarily large amount of capital (over $7 billion in the first quarter of 2007 alone, according to **Price Waterhouse**).

Traditionally the venture capital industry was said to experience a "seven fat years, seven lean years" model -- seven years of boom, followed by seven years of bust.

Following that pattern, the late 60's/early 70's were great (the "-tronics" boom -- this is when Intel was funded by Arthur Rock), the mid-70's were terrible, 1978-1985 was great (the PC!), '86-92 was terrible, '93-99 was fantastic, and '00-06 was not so good.

As you'd expect, inflows of capital to venture firms during the lean years typically shrank dramatically -- venture capital returns are terrible during the lean years, and who in their right mind wants to put more money into an investment vehicle with terrible returns?

This capital inflow shrinkage would then lead to a significant percentage of venture firms closing their doors (technically, not raising new funds -- the venture capital firm equivalent of going under) -- especially the newer, less proven ones.

Ultimately, capital inflows would shrink to the point where the remaining venture firms were managing a much smaller base of cash, which primed the pump for dramatic investment returns over the next seven fat years: less capital + a new wave of high-growth startups = explosive investment returns.

That is the cycle that has played out every time -- except this time.

Let's examine that $7 billion invested by venture firms in the first quarter of 2007.

Annualized, that is an annual investment rate of about $28 billion per year.

Pulling **the data** on venture capital investing by year over the last 10 years, we see that this is, as you might expect, substantially lower than 1999's $54 billion and 2000's $105 billion (what a year!)...

...but, higher than 1997's $15 billion and 1998's $21 billion.

And that rate of investment has been broadly consistent for the last several years -- in fact, it's been **trending up**.

Even when you adjust for inflation, venture capital funding is flowing intoventure firms and out to startups at a higher rate in 2007 than in 1997 and 1998.

Those of you remember 1997 and 1998 will remember that those were true boom times for venture capital. The returns on funds from '93-95 were extraordinary -- some of the best ever -- and limited partners were shoveling money into venture firms, leading VCs to fund new companies as fast as they possibly could.

Yet, despite disastrous venture returns on average from 2000-2006, the cash spigot from investors in venture capital firms continues to be wide open to a level where VCs can be more active in 2007 than they were in 1998.

While some older, stale venture firms have recently shut down -- Sevin Rosen and Yankee come to mind -- the rate of venture firm death has not been anywhere close to what you'd expect, and in fact many new funds have been formed and raised money in the last few years.

And the cash just keeps on coming.

Somehow we've ended up in a paradox: venture capital returns, on average, have been terrible, but contrary to historical precedent, the money keeps flooding in, venture firms keep going, and you have more money chasing deals than you did in the middle of the dot com boom.

How can we explain this?

In a nutshell:

Institutional investors who invest in venture funds -- large university endowments, philanthropic foundations, and pension funds -- began radically shifting their investment strategies in the early to mid 1990's, and that shift has led to private equity generally, and venture capital specifically, becoming a permanent "asset class" for those investors.

I call this the "asset-classization" of venture capital.

Here's how it works:

A large institutional investor like a university endowment runs its investment strategy with a top-down approach that says, we'll put x% in stocks, y% in bonds, and so on -- this is called asset allocation.

The actual details of which stocks, which bonds, etc. are less important -- the big decision is what percentage of the total capital to put in which asset classes, because when you run a huge pool of capital, that's what mathematically drives your returns. (You can't put enough money into any single investment to really move the needle, at least not without being irresponsible, so you have to think in broad strokes -- in terms of asset classes.)

Traditionally, such large institutional investors were quite conservative. An asset allocation that was perhaps 60% US equities, 30% US bonds, and 10% cash would not have been unreasonable.

Really daring institutional investors might have allocated some percentage to non-US equities, or (gasp) high-yield "junk" bonds.

This all started to change in the late 80's and early 90's when a group of advanced thinkers, such as David Swensen, then and now head of the Yale University endowment, crunched the numbers and realized that if they had a long-term time horizon (which they did -- Yale and its peers are expected to be around for some time), they could generate higher returns by allocating more of their capital to so-called "alternative asset classes" -- basically, anything other than public stocks, bonds, and cash.

This meant hedge funds, real estate partnerships, commodities, timber, leveraged buyout firms -- and venture capital.

To read about this new strategy -- and it is a fascinating strategy -- pick up a copy of David Swensen's excellent book **Pioneering Portfolio Management**, which describes his approach in detail. (Be sure to also pick up a copy of his book for individual investors -- **Unconventional Success** -- which explains why you can't pursue this strategy without getting your clock cleaned.)

The institutions such as Yale and its peers that adopted a Swensen-style strategy did fantastically well in the 1990's, and outperformed (technically, "kicked the ass of") any institution that had an older, more conservative investment policy.

This predictably led a significant number of institutions to shift massively into alternative investments and venture capital in the late 90's, just in time to get hammered by the crash of 2000-2002.

Here's the interesting part: that hammering -- by people who, say, only started investing in venture funds in 1999 -- has **not** resulted in a significant pullback on the part of institutional investors from venture capital.

Instead, venture capital has become an apparently permanent asset class of many large institutional investors -- and increasingly, smaller institutional investors.

Those institutional investors are managing so much money -- literally trillions of dollars -- that even a very small asset allocation to venture capital represents an enormous amount of cash -- tens of billions of dollars per year.

An organization called **NACUBO** (don't ask) tracks asset allocation behavior of university endowments, and **tells us** that the average large ($1+ billion) university endowment had a 3.5% asset allocation to venture capital in 2006.

3.5% of a ginormous amount of money is a lot of money.

But it's a small percentage of the total base, so apparently what's been happening is that although returns on venture capital have been poor (technically, "sucking") for the last several years, institutions that invest in venture capital are not taking that much actual pain on their overall asset bases, and they don't see that many better alternatives, and so they're sticking with their overall asset allocations and therefore sticking with venture capital.

You can argue that this is smart -- that such institutions are very well set up for the next venture capital boom, and that they will do very well over the next 10-20 years with this strategy -- versus the old approach of pulling out just before the sector was set to boom again.

You can also argue that this is not smart -- that this is leading to more venture dollars chasing few good deals and long-run terrible returns for everyone. Particularly since historically, most of the positive returns for venture capital have gone to the top 10% of venture firms -- or maybe even the top

10 venture firms -- and most of the money going into venture capital as an asset class by definition is going into the other 90% of venture firms.

But regardless, it does seem to be the case.

And that's why, from where I sit in Silicon Valley, there are probably 200 venture capital firms within 20 miles with likely over $20 billion of capital at their disposal chasing a very small number of good potential investments, despite terrible average returns for the asset class over the last seven years.

I love this country.