Winter 2025

FIN 623: Venture Capital Finance

VC Firms, Funds, and LPAs

Plan for today

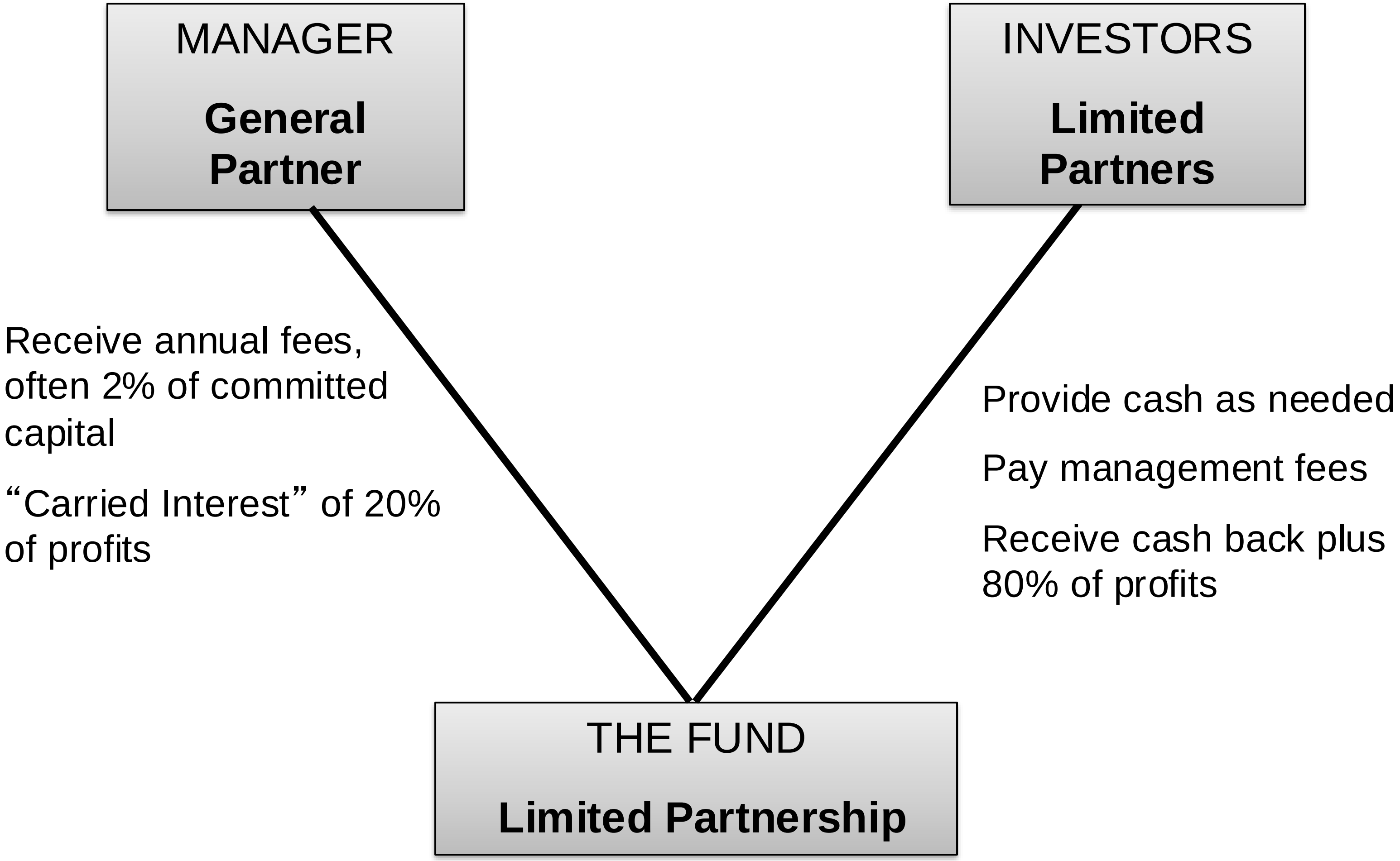
Part I: VC Firms and Funds

Part II: LPAs

Part III: Agency Conflicts

Part I: VC Firms and Funds

PE Fund Structure



Venture Capital Firms

- ❑ VC firms typically manage several funds

- ❑ They often specialize by investment stage, industry, and/or geography
  - Early-stage biotech
  - Late-stage computer hardware
  - Usually VC firm location is highly correlated with portfolio companies (monitoring!)

- ❑ Naming convention example:
  - VC firm is UM Ventures
  - VC fund names are UM Ventures Fund I, UM Ventures Fund II, UM Ventures Fund III, etc.

Venture Capital Funds

- Limited partnerships with finite lifetimes
  - Usually 10 years with possible 1-2 years extension

- Three main stages of fund activity:
  1. Fundraising
  2. Investing
  3. Exits

- Fund vintage year is the year that the fund is closed
  - Compare funds of the same vintage for a similar benchmark

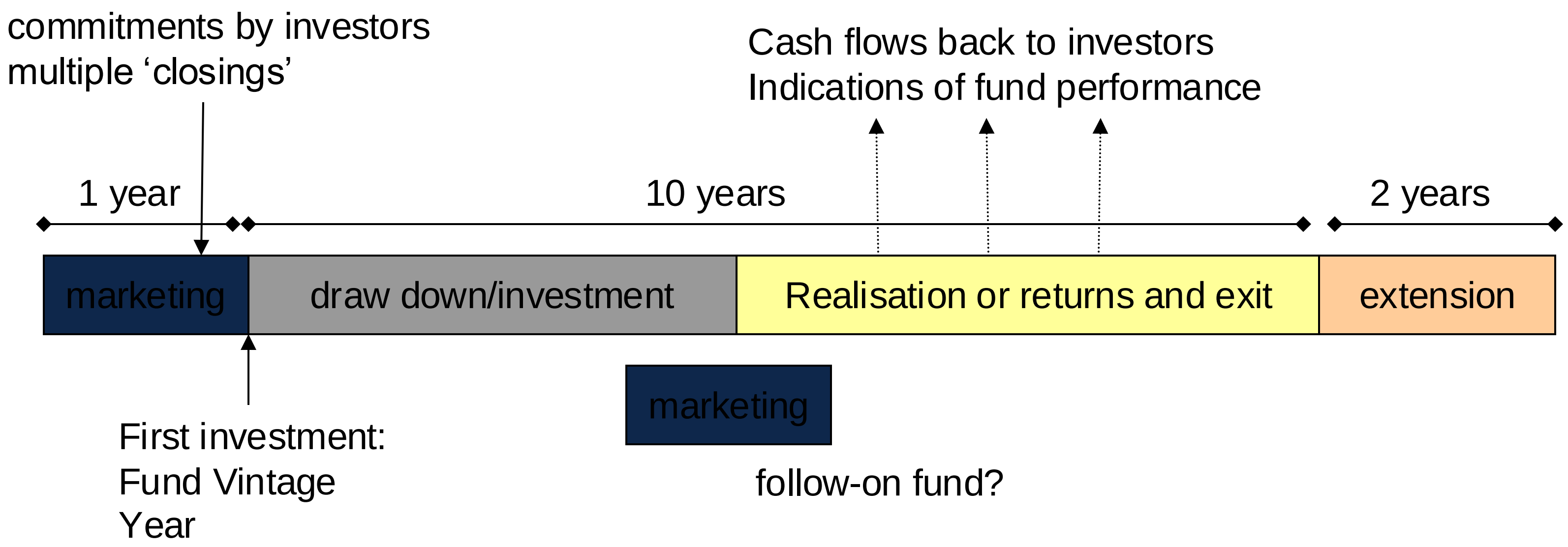
Venture Capital Fundraising

- Raise capital from limited partners (LPs)
- Call capital from LPs over lifetime of fund
  - Referred to as capital calls, drawdowns or takedowns
- Committed capital is total capital promised by LPs and set when fund is raised
- Once the capital is raised and the fund is ready to invest, the fund is closed
- Success for a VC firm
  - Raise a new fund every few years
  - At least one fund is always in the investment period

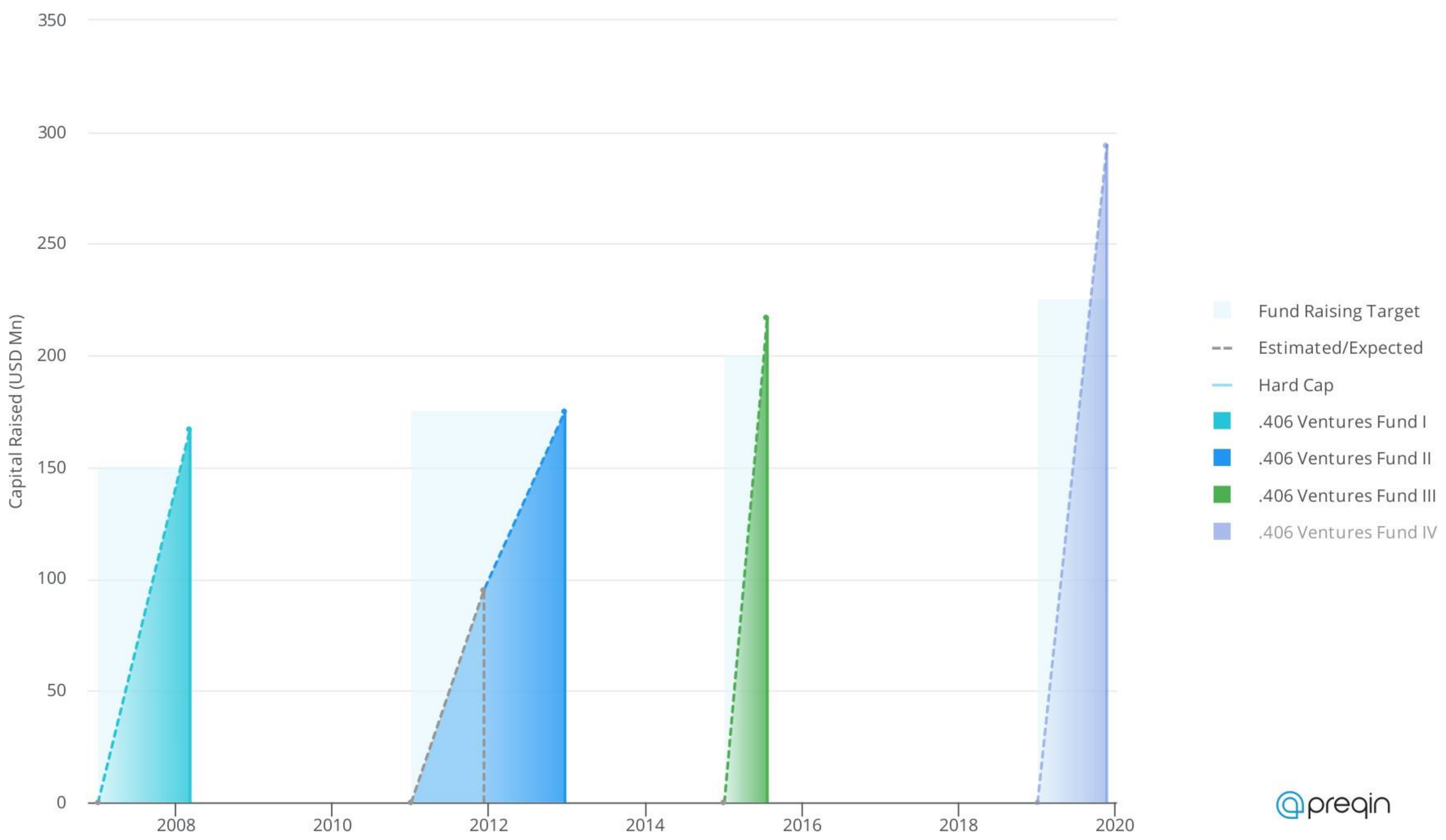
Typical Life of PE Fund LP/LLC

- Industry standard life is 10 years
- Call-downs on commitments are typically limited to 5 or 6 years
- GP may have the right to extend for three or four one-year periods
- LPs may have the right to terminate the Fund early under certain circumstances with supermajority approval

The Limited Partnership timeline



Fundraising for .406 Ventures

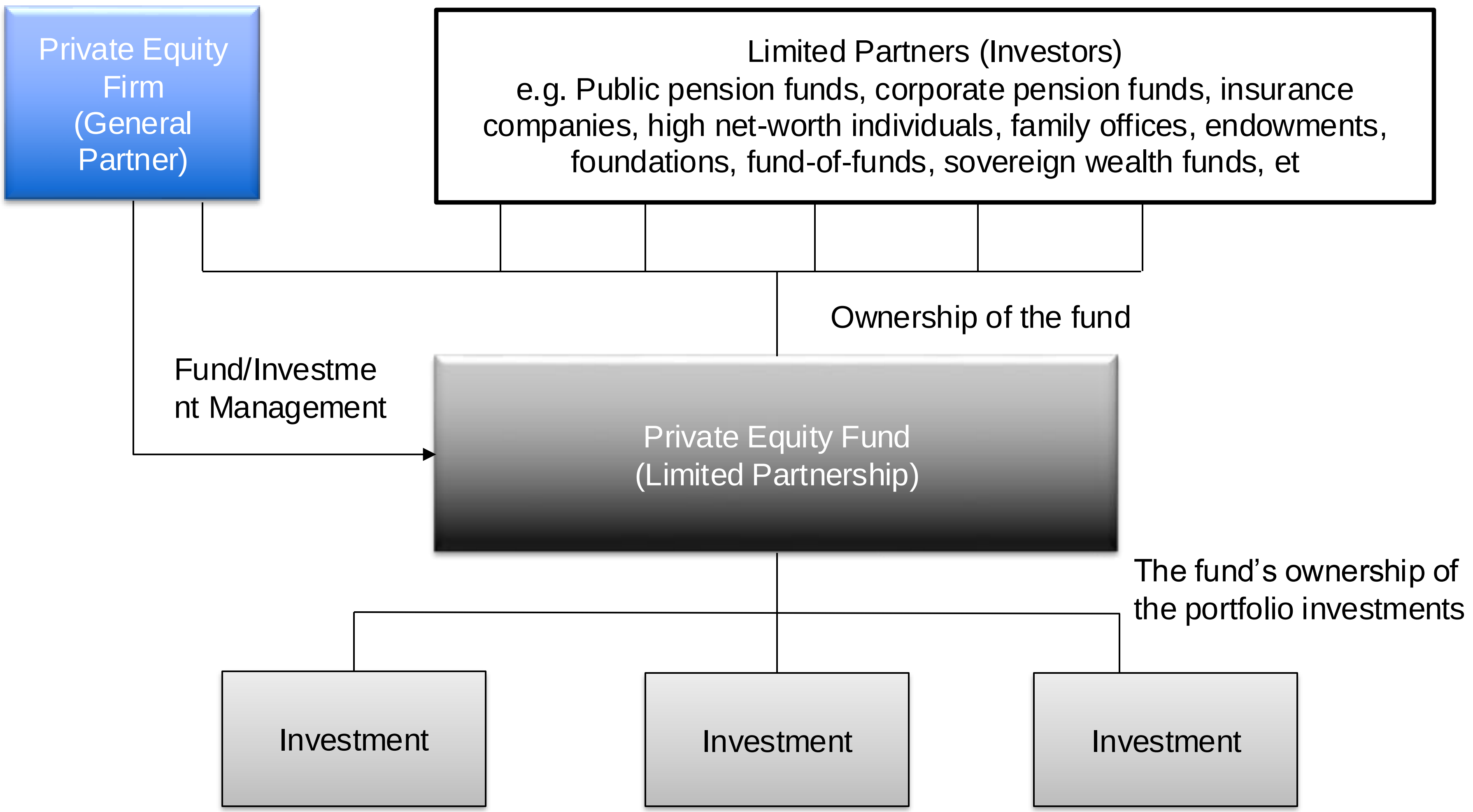


VC Fund Investing and Exits

- VC funds typically have a set investment period
  - About first 5 years of the fund
  - Invest in portfolio companies, which are high-growth entrepreneurial firms

- Following five years (plus extensions)
  - VC fund can only make follow-on investments in current portfolio companies
  - Aims to exit investments and provide returns to LPs, net of fees

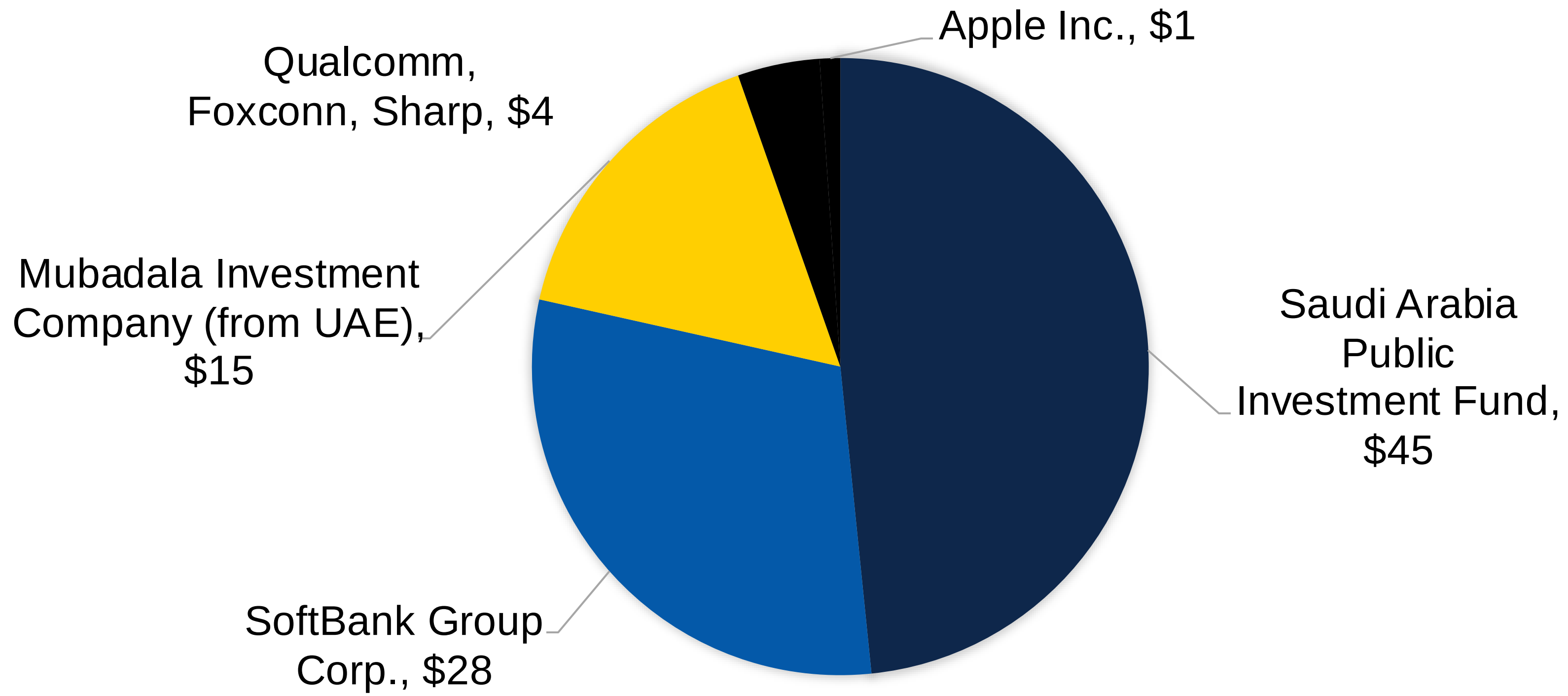
Typical Fund Structure



Softbank Vision Fund

- Launched in October 2016 with a target fund size of $100 billion.
- First round closed on May 2017, raised $93 billion.

LPS' CAPITAL COMMITTED (USD BILLION)



Part II: LPAs

Oversight and control rights

- Limited Partnership Agreement (LPA)
  - Defines the fund, its scope, any limitations on the GP, fees, and other contractual terms
  - Negotiated before the fund is raised

- Limited Partner Advisory Committee (LPAC)
  - Sometimes referred to as advisory board, though that may mean actual advisors
  - Typically has to approve any transactions with affiliated parties

- Ability to terminate partnership if sufficiently many LPs vote for it

"I thought we'd start with the agreement and finish with the disclaimers."

Source: Lyrique Cartoons

Contract: Limited Partnership Agreement

- A Limited Partnership Agreement (LPA) is an internal document that defines how the fund will be operated.

- Outlines the rights, responsibilities, and expectations of each partner.

- It is not filed with a state or government entity.

- Identify two key financial aspects:
  - How profits and losses will be shared
  - The process and expectations for when a partner wants to sell their stake in the partnership.

What's in an LPA?

- Limited partnership agreements (LPAs) define the VC fund along several important dimensions:
  1. Details about fund characteristics, such as duration
  2. Costs and incentives
  3. Restrictive covenants

- Terms in LPAs depends on demand for and supply of VC

Where can I learn about LPAs?

- Institutional Limited Partners Association (ILPA) provides example LPAs to use as a starting point in negotiations
  - Whole-fund (European) and deal-by-deal (American) carry type LPAs are uploaded on Brightspace
  - The overview and term sheet documents may be most useful

- Downloaded from https://ilpa.org/model-lpa/
  - They also maintain a compendium of standards of best practices found at https://ilpa.org/standardsandbps/
  - And a PE glossary (albeit somewhat brief) https://ilpa.org/private-equity-glossary/

Lyrique
PRIVATE EQUITY

"Are you sure we're in the same fund?"

Source: [Lyrique Cartoons]

Limited Partnership

- Limited Partnerships are “tax transparent” – they do not pay taxes at the level of the partnership
    - Income is taxed at the LP level
    - Gains or loss on the assets of the fund are not recognized as taxable income until the assets are sold.

- Limited Partnerships are private – they provide full information to their partners but have traditionally had few obligations to reveal information to others
    - This is changing, as public scrutiny, and regulation, of private equity has increased

- Investors are “Limited Partners”, i.e. with liability limited to their commitment

- The VC firm is the General Partner (GP), with unlimited liability
    - But the GP is usually a limited liability company
    - Sometimes the executives are employed by a Fund Adviser (for regulatory or fiscal or control reasons) that advises the GP

Why Limited Partnership?

- Solves many of the managerial problems inherent in new venture investing
- The GP can concentrate on opportunities in which the partner's expertise adds the most value
- Mitigates the need to continuously value each portfolio investment
- Makes efficient use of the liquidity of large institutional investors
- LP form is not universal

The Organization of PE Funds

- Advantages of the limited partnership structure
  - limited liability for investors
  - finite life
  - allocation of returns

- The general partner (GP) is the fund organizer and is responsible for raising investment capital from the limited partners (LPs)

- The GP deploys the capital by investing in portfolio companies, which the GP monitors and advises until harvest

Restrictive Covenants

1. Management of the fund
    - Investment size in one portfolio company
    - Co-investment by VC firm's other funds
2. Activities of GPs
    - Co-investment by GPs
    - Fundraising by GPs
3. Types of investments
    - Restrict to invest in high-growth entrepreneurial firms

LP-GP Relationship

- Every state of the world cannot be included in the LPA

- Reputation is critical in VC
  - LPs and GPs are connected for at least 10 years

- Unanticipated areas can include:
  - Valuation of portfolio companies
  - Investment opportunities

Side letters

- Large LPs and/or those that back the fund early often get preferential terms
- All LPs can negotiate for such terms, but bargaining power varies
- Takes the form of side letters – separate agreements not included in the main LPA
- May be considered problematic due to secrecy and lack of transparency
- SEC considered restricting side deals last year, but watered down to disclosure rather than ban (source: SEC, FT, WSJ, Aug 23, 2023' bloomberglaw.com, Dec 19, 2022; Proposed SEC rule, Mar 24, 2022)

Side letters

- Common terms
  - Preferential (= reduced) fees
  - Preferential coinvestment rights
  - (much more innocuous) tailored disclosure rights
  - May be needed for regulatory reasons (e.g. public pension funds)

- Two agency conflicts here:
  - Puts important LPs versus the rest (think majority vs. minority shareholders)
  - Limits amount of (implicit) cooperation in negotiations
  - Analogy is wage setting of unions versus individuals

Why use side letters?

- Newer funds may need to entice investors with preferential terms
  - But why not offer lower fees across the board?

- Some investors require specific (additional) information in quarterly reports to comply with regulation (for example, state pension funds)
  - Also used to force disclosure on ESG and diversity
  - But why not increase transparency to all investors?

Towards greater transparency?

- SEC approved rules requiring more disclosure (SEC press release, Aug 23, 2023)

- SEC primarily focused on increased transparency
  - But currently being challenged by industry

- Main argument against:
  - Costs
  - Sophistication of investors (SEC traditionally protects retail investor)

Key person clause

- LPs may worry that key partners leave a fund before liquidation (or devote insufficient time)

- Mitigation techniques include compensation terms and terms such as a “key person clause”
  - A partner leaving typically forfeits any carry
  - Key person clause may include terms
    - specifying how replacements are found
    - allowing LPs to not make any further investments
    - allowing LPs to terminate the partnership (in some, typically extreme, circumstances)

Part III: VC Compensation

How are VCs Paid?

- VC compensation has two components:

1. Management fees
   - Do not depend on fund performance
2. Carried interest
   - Funds receive part of the upside from investments

Management Fees

- Often many years before returns are realized
- Covers expenses of fund, including salaries, travel, and office rent
- Lifetime fees are total amount of fees paid over the lifetime of a fund
- Investment capital is money available to be invested by VC fund
  - Committed capital minus lifetime fees

How to Calculate Management Fees

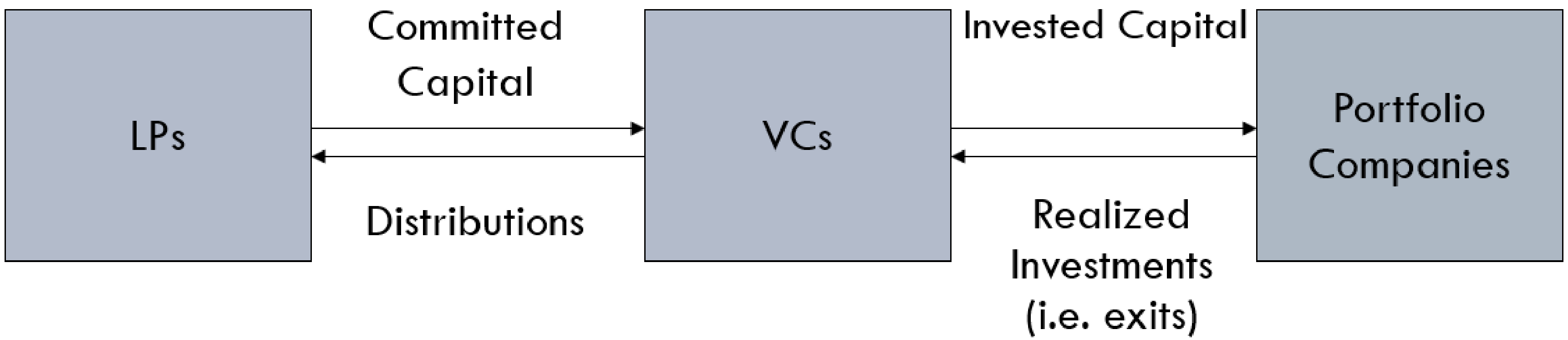
- Annual management fee = Level × Fee basis

- Level is usually 2% of basis each year
  - Sometimes above 2% in the earlier years of a fund
  - Can decrease after investment period

- Fee basis is usually:
  - Committed capital
  - Net invested capital

- Fee basis is not based on portfolio values
  - Low at beginning of fund life
  - Would create incentive to invest quickly

Net Invested Capital



- Measures “active” investments in fund’s portfolio

- Net invested capital = Invested capital – Cost basis of realized investments
  - Cost basis = Dollar amount of the original investment
  - Invested capital = Cost basis of investments made
  - Realized investments = Exited investments or companies shut down

- Minimizes incentive to overinvest because it relies on cost basis of investments

Common Industry Practices

Fees	Median
Initial fee level (%)	2.0%
Lifetime fees (% of committed capital)	15.0%
No discount	8.4%
Fee level reduced later	16.8%
Fee basis change later	42.1%
Both level and basis change	32.7%

Source: Metrick and Yasuda (2010)

- Majority of funds (91.6%) provide concessions to investors after investment period
- Lowers median lifetime fees from 20% to 15%

Management Fees Example

- UM Ventures just raised UM Ventures IV:
  - Committed capital is $250 million
  - Management fees are 2% of committed capital annually
  - Fund life is 10 years

- What are the lifetime fees and investment capital for this fund?

- What if the level started at 2% until year five and then decreased by 25 basis points per year in each of the subsequent years?

Management Fees Example

Carried Interest

- Share of investment gains for GPs
  - Often referred to as carry
  - Historically has been largest component of compensation

- Aligns interests of LPs and GPs since both receive share of gains

- Based on exited investments
  - Not based on paper gains, such as for hedge funds

How to Calculate Carried Interest

- Carry = Carry percentage × Profit

- Carry percentage is 20% for vast majority (95%) of VC firms
  - Historically goes back (at least) to Venetian merchants in the 12th century

- Profit = Exit proceeds – Carry basis
  - Carry basis is threshold that must be exceeded before GP can claim a profit
  - Carry basis is either committed capital or investment capital

Carried Interest Example

- UM Ventures IV is considering two alternative carry structures
  1. 20% carry with a carry basis of all investment capital
  2. 25% carry with a carry basis of all committed capital

- UM IV details:
  - Committed capital is $250 million
  - Management fees are 2% of committed capital annually
  - Fund life is 10 years

- Suppose that exit proceeds will be $400 million
  - How much carry would the GPs receive under each carry structure?

Carried Interest Example

Carried Interest Variations

- Hurdle rate
  - GPs promise preset rate of return to LPs before GPs collect carry
  - About 45% of VC funds provide a hurdle rate
  - Most common hurdle rate is 8% per year
  - Catch-up provision provides the GPs with a greater percentage of the carry percentage after the hurdle rate is reached

- Timing when GPs receive carry

- Clawbacks
  - GPs might have to provide carry back to LPs if subsequent proceeds perform poorly

VC Background

- Education background at VC firms:

Education	Percent
MBA	58%
Engineering degree	39%

- Work background at VC firms:

Jobs	Percent
Startup experience	15%
Finance	29%
Engineer	9%
Consultant	15%
Previous VC experience	44%

Source: Zarutskie (2010)

VC Compensation

- Salary, bonus, and carry ($ thousands):

Title	Salary	Bonus	Carry	Total
Managing GP	800	822	2,516	4,138
Senior partner	612	335	1,000	1,947
Partner	350	210	558	1,118
Principal/Director	240	100	375	715
VP/Senior Associate	150	85	195	430
Associate	125	48	197	370

Source: Holt Compensation Survey (2016)

Part IV: Agency Conflicts

'Our niche is a limited number of limited partners with unlimited money.'

Managers-Investors Relationship

- Economic perspective: Principal (LPs) hires an agent (GPs) to manage their investments.
- Business perspective: PE managers (GPs) offer a product (the Fund) to investors (LPs).

- GPs are expected to exert effort to maximize the returns for the LPs. Will they?
  - LPs: Tied-up capital with no guaranteed return and almost no control over the fund's investment activities.
  - Long-term commitment
  - GPs have too much freedom

- Limited partnerships do not have the usual corporate governance mechanisms:
  - No board of directors
  - No market for corporate control

- Chances for misalignment of incentives are high: opportunistic behavior by the GP.

Problems and Solutions

What could go wrong?

1. Shirking
2. Excessive risk-taking
3. Fee manipulation
4. Favorable treatment of already existing funds
5. Self-dealing

- Mechanisms that mitigate agency problems:
  1. Restrictive covenants*
  2. Co-investment (generally 1%, but not required since the 1986 Tax Reform Act)*
  3. Finite life*
  4. Compensation Structure*
  5. Reputation
  6. Ultimately, LPs can withdraw funds or terminate the partnership*

*Contractual provision

Managers' Contracts with Investors

- Legal contracts between the managers and investors:
  - Limited Partnership Agreement (LPA): Establishes the Limited Partnership (Fund)
  - Private Placement Memorandum (PPM): Specifies the investment conditions (offering)

Limited Partnership

Pros

- Personal liability protection for limited partners
- Pass-through entity for taxation (i.e. only taxed once unlike C-corp)
- Ease of creation and reporting (e.g. no required annual meetings)
- Less formal structure
- No self-employment taxes for limited partners

Cons

- GPs have unlimited personal liability (although they also have management control of the LP)
- Limited partners limited in management participation
- Ownership can be harder to transfer than other entities, such as an LLC
- Not as flexible for changing management roles

Contracts: Private Placement Memorandum

- A private placement memorandum (PPM) is also commonly known as an offering memorandum or offering document.

- A legal document that discloses the objectives, risks, and terms of a proposed investment in your company.

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- A PPM will be distributed to potential investors whenever a company sells stock or another type of security in a private placement.

- Conversely, a prospectus is an offering document that performs the same function for publicly traded issues, such as companies selling common stock or introducing an IPO.

Reputation in the Venture Capital Market

- Reputation plays a key role in venture capital
  - LP capital calls
  - institutional investors
  - GP’s effort and investment decisions
  - entrepreneur’s commitment

- Benefits of reputational contracting
  - easier to raise capital
  - higher fees and carried interest
  - access to better deals

Covenants and Restrictions

- Covenants and Restrictions on the Limited Partnership Agreement (LPA):
    1. Covenants relating to overall fund management
    2. Covenants relative to Activities of the General Partners
    3. Covenants restricting the types of investments

Covenants on activities of the fund

- Investment focus: LPs want GPs to focus on their area of expertise
    - Limits investment in asset classes other than private portfolio companies (e.g., public companies, other PE partnerships)
    - Limits investment in sector/stage other than the fund's defined specialization
- Investment size
    - GPs have an incentive to place big bets and increase variance in fund returns
    - Solution: to limit the size of a single investment (10-25% of fund size)
- Co-investments across funds
    - Later funds may be used to salvage investments gone awry in earlier funds
    - GPs may especially want to do this when raising another fund!
    - Solution: To require approval by LPs, co-investment by the earlier fund, or by third-party
- Reinvestments of profit: often permitted but restricted
    - Until invested capital reaches 100-125% of committed capital

Covenants on activities of the Individual GPs

- Co-investments by GPs themselves
  - LPs don’t want GPs to spend all of their time on companies they’re personally invested with
  - Solution: to require LPs’ approval, restrict investment size, timing, and terms

- In general, LPs want GPs to be devoted to their fund
  - Future fundraising activities: not allowed until sufficient amount of investment is made for the current fund
  - Sale of GP interests: not easily allowed!
  - Inclusion of new GPs: restricted

Limited Partnership Agreement (LPA)

Key covenants in a limited partnership agreement (LPA)	
Overall Fund Management	
Key Person Provision	The provision addresses what occurs if there are important changes in core investment personnel. LPs may have the right to suspend investment or terminate the fund.
Investment in a Single Firm	As a way to restrict risk-taking by the venture capitalist, the covenant limits the amount of the fund's investment in a single firm.
Use of Debt	The covenant may limits borrowing by the fund and possibly debt maturity. It also may limit borrowing by the GPs or guarantees of loans. The covenant addresses concerns with leveraging the fund and creating conflicts of interest.
Co-Investment by GP's Other Funds	To limit opportunism and avoid incentive conflicts, the covenant provides for monitoring of decisions to invest in any portfolio company that is in one of the venture capitalist's other funds. The covenant may require co-investment with other fund.
Reinvestment of Profits	The covenant restricts or prohibits reinvestment of profits from a fund and concerns possible conflict of interest regarding the GP's management fees.

Limited Partnership Agreement (LPA)

Key covenants in a limited partnership agreement (LPA)	
Activities of General Partner	
Personal Investing in Portfolio Companies	The covenant limits the ability of the partners to invest along side of, or in advance of, the fund. The provision serves several purposes, including controlling incentives of the GP to over-invest efforts in those funds in which it has a personal investment, and to avoid conflicts about when to harvest. Limits on the timing of investment may prevent front running by the GP.
Sale of Interest by General Partner	The GP may not be permitted to sell its interest in a portfolio company separately from selling the Limited Partner's interest. This provision serves to protect the Limited Partner from self-dealing.
Fundraising	The covenant may limit ability of the GP to raise new funds until existing funds are substantially committed (avoid dilution of effort and to prevent efforts to try to increase fees).
Outside Activities	The provision ensures that the GP provides sufficient effort to portfolio companies, the provision limits its outside activities or involvement with outside companies, especially during the portfolio companies' early stages.
Addition of General Partners	The covenant limits additions of partners to ensure the quality of effort to the fund remains high.

Limited Partnership Agreement (LPA)

Key covenants in a limited partnership agreement (LPA)	
Types of Investments	
Restrictions on Asset Classes	The provision limits the ability of the GP to invest in certain classes of assets, notably those that require less effort (such as public securities), or other venture funds, or in portfolio companies that compete in industries where partners lack expertise. The provision limits opportunistic behavior by the venture capitalist.

Private Placement Memorandum (PPM)

Summary of terms in a private placement memorandum (PPM)	
Purpose	The "purpose" identifies the Fund's focus and investment objective, such as, "to earn superior returns from early-stage investments in e-commerce ventures." Provisions may limit the amount invested in any one venture and/or restrict the types of investment vehicles the Fund can use.
General Partner	Normally the General Partner is a partnership of individual general partners. Investors in the Fund may seek access to the contract between the individual general partners to assess their incentives and perhaps seek revisions and limitations to the agreement.
Limited Partnership Interests	The provision specifies the total amount of the Fund that is being raised, such as $250 million, and the minimum per investor, such as $10 million.
General Partner's Investment	The usual contribution is 1%, and sometimes may be in the form of a promissory note.
Minimum for Closing	The provision specifies the dollar commitment, such as $100 million, that must be received before an initial closing. If there is a subsequent closing, it may be required to occur within a fixed period, such as 1 year after the initial closing.
Payment of Subscriptions	Investors must provide a specified amount of capital at the time of closing (such as 30% of their total commitment). Subsequent calls may be at specified times, but often are made on short notice to afford maximum flexibility for investing the funds. Penalties for late or missed calls will be enumerated.

Private Placement Memorandum (PPM)

Summary of terms in a private placement memorandum (PPM) - Continued	
Term	The term of the agreement usually is 10 years, with options to extend under certain conditions, which permit orderly liquidation of investments.
Allocation of Profit and Loss	The provision specifies the allocation and distribution of returns from investment. The most common allocation is 80% to Limited Partners and 20% to the General Partner.
Distributions	The provisions ensure prompt distribution of invested capital and gains as investments in portfolio companies are harvested. Normally, distributions can be in the form of cash and public securities. Terms may specify that the investors receive a full return of their invested capital before the General Partner receives any distributions. An alternative is to distribute 20% of the gains to the General Partner, but if there are losses on some investments then the agreement obligates the General Partner to make up for the overcompensation through a Clawback provision.
Management Fee	Normally, the management fee is 2.0% to 3% (VC), lower for buy-outs, of contributed and committed capital. The fee may be linked to expenses, may specify specific offsets to be charged, and may be set in light of other funds under management.
Organizational Expenses	The front-end cost of setting up the Fund is usually paid out of the capital contributions to the Fund. The agreement may specify a maximum amount and enumerate items covered.
Conflicts of Interest	Provisions limit co-investing with individual general partners or with earlier funds of the venture capitalist.
Other Restrictions and Limitations	Other restrictions include prohibitions on borrowing, organizing follow-on funds, etc. The intent of the provisions is to control effort devoted to the Fund and to prevent risk shifting.

Next: VC Performance