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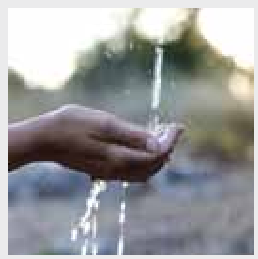


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Phil Wickham

Managing Editor
Anna (Fitzpatrick) Doherty

Associate Editor
Leslie F. Peters

Production and Design
Anna (Fitzpatrick) Doherty
Leslie F. Peters

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About the Editor

Anna (Fitzpatrick) Doherty is an experienced editor and writing instructor with a unique collaborative focus in her work. With the Kauffman Fellows Program, she launched the *Kauffman Fellows Report* in 2010 and the Kauffman Fellows Press in 2012. Recent edited books include Eric Ball and Joseph LiPuma's *Unlocking the Ivory Tower: How Management Research Can Transform Your Business* (Kauffman Fellows Press, 2012), Frank Slootman's *TAPE SUCKS: Inside Data Domain, A Silicon Valley Growth Story* (CreateSpace, 2011), and Yene Assegid's *Forget Not the Sparrows: Conversations with My Grandmother* (Shola Stories, 2011). Anna has 19 years of editing experience on three continents in a variety of business industries, and is the principal of Together Editing & Design, working with lead designer Leslie F. Peters. Anna graduated *summa cum laude* from Georgetown University. www.togetherediting.com

KAUFFMAN FELLOWS
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Town & Country Village • 855 El Camino Real, Suite 12 • Palo Alto, CA 94301
Phone: 650-561-7450 • Fax: 650-561-7451

The Rise of the Innovation Strategist

José Romano
Class 15

In 1993, the Ewing Marion Kauffman Foundation rocked the basic pillars of entrepreneurship by deciding to support a program for venture capitalists. At the time, the undertaking inspired frowning and raised eyebrows by some board members of the entrepreneur-centric organization—one "characterized it as 'investing in the enemy.'"[1] Still, their bold move resulted in today's Kauffman Fellows Program (KFP). Few today would challenge the usefulness of KFP and the resulting numerous marriages of equals between entrepreneurs and venture capitalists.

In this article, I argue that a similar crossroads and decision point has been reached regarding the relationship between Limited Partners (LPs, i.e., institutional investors) and General Partners (GPs, i.e., venture capital fund managers) and that history is being re-visited (see figure 1). Again, a bold and brave decision is needed to build a bridge and heal what is today an inefficient, unequal, and largely dysfunctional relationship.

I begin by outlining the current relationship between LPs and GPs and its problematics. I then present some data on what GPs think about LPs, and introduce the concept of the "Innovation Strategist"[2] as a way for LPs to come closer to GPs in venture.

1993: GPs-Entrepreneurs	2012: GPs-LPs
GPs are all about the money	LPs are all about the money
As an entrepreneur, best to cover up those things that are going sour	As a GP, best to cover up those things that are going sour
Low levels of mutual trust	Low levels of mutual trust
VCs have all the power	LPs have all the power
Relationship defined by largely unequal term sheets	Relationship defined by stringent Limited Partnership Agreements
VCs struggling because they cannot tap into entrepreneurial talent	LPs struggling because they cannot access the top quartile VC funds
Board meeting dynamics (inside and outside the Board to obtain buy-in)	Advisory Board (LP meeting) dynamics (inside and outside the Advisory Board to obtain buy-in)
Releasing too much information is thought to be adverse	Releasing too much information is thought to be adverse

Figure 1. Comparison of the Challenges Between General Partners (GPs) and Entrepreneurs in 1993 and that of GPs and Limited Partners (LPs) in 2012. Author's table.

Cash is King, and Innovation Suffers

In the relationship between LPs and GPs, cash is king—and LPs have the keys to the vault. As

[1] Phil Wickham, "Retrospective on the Mission of the Kauffman Fellows Program," *Kauffman Fellows Report 2*(2011): 1, http://www.kauffmanfellows.org/images/documents/Journal_Vol2/PhilWickham_Vol2.pdf.

[2] Term coined by Dr. Thomas Meyer (LDS Partners), personal communication, 17 November 2011.

institutional investors[3] in a venture capital fund, LPs comprise a range of institutions including pension funds, insurance companies, endowments, foundations, sovereign wealth funds, and funds of funds. When applying a broad (European) definition of *venture capital* (including growth, mezzanine, and leveraged buyout funds), LPs contribute to a $2.9 trillion global industry[4]—a figure equivalent to the GDP of France. Using a narrower definition of *venture capital* (VC) as funds investing in young, fast-growing companies, the market size in terms of assets under management can be estimated at around $300 billion.[5] This is an expectedly small percentage of the whole alternative assets class, given the large sizes of leveraged buyout and mezzanine funds.

Two observations emerge from this data and from conversations with industry practitioners (see "What GPs Say About LPs" below). First, many of the big LP players do not invest in venture. Second, there is a definite LP migration away from venture and toward private equity.

Two reasons for these trends usually appear at the top of the list:

- The ticket sizes needed in VC (i.e., the amount to be committed by LPs) are too small for LPs. It is not atypical for large pension funds to have a minimum ticket size of $100 million. On several occasions, this has led pure VC players to be pushed up the investment-stage ladder into bigger, later-stage funds, with the consequent misalignment of interests created by larger fees.
- Historical returns on the venture asset class are not seen as compensating for the illiquidity and risk exposure.[6] In its 2010 VC report, Ernst & Young reported that as many as 60% of LPs consulted indicated they would not "re-up" with more than half of the firms in their existing portfolios.[7]

This trend of LPs moving away from venture poses a worrying picture when considering the basic VC value chain (figure 2). Less LP money translates into less funds to be managed by GPs, which in turn means less money reaching entrepreneurs and consequently less innovation in the hands of customers.

Figure 2. VC Value Chain. Author's figure; data from Mohan Nair, "The Venture Capital Value Chain," *Cost Management* 18, no. 2 (2004), pp. 13-20.

By default and as the "suppliers" of funds in the VC industry, LPs are the most important and currently the weakest link in the value chain.

Is the VC Model Really Broken?

Based on history and on the opportunity that lies ahead, the VC model is not really broken.[8] In a recent thought-provoking article by the Ewing Marion Kauffman Foundation, Diane Mulcahy, Bill Weeks, and Harold Bradley signal several reasons why things are not working optimally (i.e., large fund sizes, misalignment of interests, incorrect performance analytics, "Fordist"[9] approaches

[3] For the purpose of this article, LPs are limited to institutional investors.

[4] Haley Wong, "Private Equity Performance," *Private Equity Spotlight* 8, no. 1 (2012): 10, http://www.preqin.com/docs/newsletters/PE/Preqin_Private_Equity_Spotlight_January_2012.pdf.

[5] Prequin Ltd., *Preqin Special Report: Venture Capital*, May 2012, 17 (fig. 22), http://www.preqin.com/docs/reports/Preqin_Special_Report_Venture_Capital_May12.pdf.

[6] This point is outside the scope of this article; for a full discussion of the priority placed on accessing top quartile funds, see Tamara N. Elias, "LPs and the Venture Capital Asset Class: A Candid Conversation," *Kauffman Fellows Report 2*(2011), http://www.kauffmanfellows.org/images/documents/Journal_Vol2/TamaraElias_Vol2.pdf.

[7] Ernst & Young, *Back to Basics: Global Venture Capital Insights and Trends Report 2010*, 6, http://www.ey.com/Publication/vwLUAssets/VC_insights-and-trends-report_2010/$FILE/VC_insights-and-trends-report_2010.pdf.

[8] See Dan Geller and Dana Goldfire, dirs., *Something Ventured: Risk, Reward, and the Original Venture Capitalists* (Zeitgeist Films, 2011), www.somethingventuredthemovie.com.

[9] i.e., Henry Ford's mass production system.

toward investing rather than selectiveness and discipline, etc.).[10]

While several of the insights provide valid arguments, care must be taken with some of the conclusions (particularly that LPs should limit their exposure to VC): experiences elsewhere (e.g., the Canadian VC industry[11]) and methodological issues[12] challenge some of the conclusions derived from the study. Personally, I do not think LPs—or any other actor along the VC value chain for that matter—are the enemy. I do think that one major challenge lies not only in the (decreasing) amount of money going into VC and at what terms, but also in how some LP professionals approach their job. The challenge is indeed LP-centric, but I suggest the trouble lies more at the cultural- and leadership-levels within LPs themselves.[13]

What GPs Say About LPs When They Leave the Room

To test this hypothesis that the existing GP–LP relationship is suboptimal and that a new breed of LPs is needed, I surveyed 30 GPs on an anonymous basis. I presented eight statements to which they could reply on a five-point scale of agreement regarding what (on average) they thought about LPs.[14] Two additional open-ended questions concerned what the GPs thought of LPs when LPs left the room, and specific examples were added at the end of the survey. Responses to the survey questions are summarized in this section.[15]

The survey asked whether "the relationship with LPs is characterised by strong mutual trust, transparency, and communication flowing both ways." While most GPs agreed this was the case, only 33 percent strongly agreed and 7 percent showed doubt.

Regarding the LPs "being all about supporting them and helping them create value in their portfolio," more than 50 percent of GPs disagreed or doubted that this was the case. The good news is that most GPs do think that LPs know what they are in for—for the statement that "LPs do not really understand how a GP works," most disagreed. Still, 13 percent of those GPs consulted agreed with this statement.

For the statement that the "Limited Partnership Agreement defines an equal relationship between LPs and GPs," 67 percent showed doubts or completely disagreed, with 7 percent strongly disagreeing. Sixty percent of respondents showed doubt about (i.e., partially agreed or partially disagreed) or agreed that "LPs care too much about ticking boxes," showing that this stereotype seems to hold true for many GPs.

Three questions generated particularly strong responses. Sixty percent of respondents disagreed or doubted that "LPs are very sophisticated and they understand each other (i.e., GPs) very well." Over 78 percent of respondents showed doubt or disagreed with the statement, "LP has been represented by the same person throughout the fund lifetime." Finally, over 85 percent of respondents showed doubt or disagreed with the statement that their "LP is characterised by having staff with strong personal brands and a willingness to differentiate themselves from the crowd."

The percentages of the last three statements are cause for some concern. In an industry based on human relations and the understanding and quality of the actors involved—entrepreneurs, fund managers, and investors—having a herd mentality, switching jobs continuously, or not

[10] Diane Mulcahy, Bill Weeks, and Harold S. Bradley, *We Have Met The Enemy… And He Is Us: Lessons from Twenty Years of the Kauffman Foundation's Investments in Venture Capital Funds and the Triumph of Hope over Experience* (Ewing Marion Kauffman Foundation: May 2012), http://www.kauffman.org/uploadedFiles/vc-enemy-is-us-report.pdf.

[11] Canada's Venture Capital & Private Equity Association (CVCA), "Comments on the Kauffman Foundation Study" (i.e., Mulcahy et al., *We Have Met the Enemy*), forthcoming article, http://www.cvca.ca/.

[12] Dan Primack, "Breaking Down 'Broken' Venture Capital," *Fortune*, 11 May 2012, http://finance.fortune.cnn.com/2012/05/11/breaking-down-broken-venture-capital/.

[13] The "kind" of money reaching VC funds is also an issue worth exploring, but is beyond the scope of this article. For a good review of why the LP base should broaden to include charities, see Kiki Tidwell, "Venture Investment's Potential to Further Mission Impact for Charitable Foundations," *Kauffman Fellows Report* 3 (2012): 24–34, http://www.kauffmanfellows.org/images/documents/Journal_Vol3/KikiTidwell_Vol3.pdf.

[14] The 30 fund managers were from the United States, Europe, Latin America, Asia, and Africa. Most strictly focused on VC, except 8 who had a growth focus and 2 with a growth/buyout remit. All were experienced fund managers, except for one first-time team. A 50 percent response rate was achieved.

[15] This survey aimed to take the pulse of things; while it is statistically significant for the participant population, I do not claim to provide an analytical representation of the VC industry.

being on the same wavelength is problematic. Still, the most acute reflection of the suboptimal situation is shown in figure 3, which presents some of the respondents' own words, where the power imbalance in the LP-GP relation can be inferred.

Hence, those who have access do not need to care. Those who do not have access—the pension fund that would be disregarded once things returned to normal, the fund of funds that does not have access to top-quartile GPs—are the ones who should be worried. Without access, these

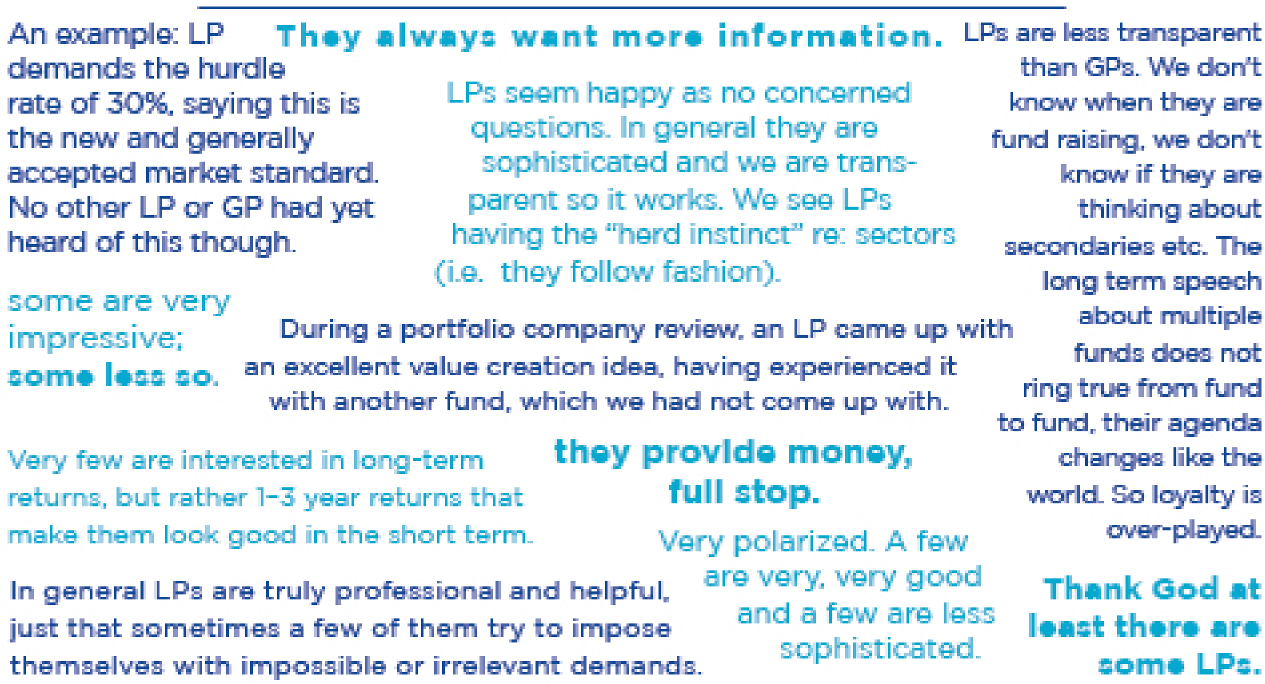

Figure 3. Selected General Partner (GPs) Statements about Limited Partners (LPs). Author's image.

Why Some LPs May Not Care about the GP Perspective, and Why the Rest Should

Those LPs who have access to top-quartile VC funds do not necessarily care what GPs say about them behind closed doors. Actually, I would argue that those LPs who have access to top-quartile funds do not need to care, most likely because they already maintain quite an equal relation with those GP fund managers.

As anecdotal proof of this power imbalance, during the prior downturn in the industry and with some university endowments having to cut back on their commitments to VC funds in Silicon Valley, a major North American pension fund had the opportunity to take secondary stakes in those funds. Did they? No—they argued that once the economy was back, the university endowments would be back, and GPs would again ignore them in preference for the long-term and established relationship with the endowments.

LPs are forgoing an asset class that may entail relatively smaller commitments with a higher upside in top-quartile funds, that is, more "bang for their buck."

Rising above Mediocrity: LPs as a Value Add for GPs

While LPs are motivated to maximize returns over a long period of time within a well-balanced portfolio, one may argue that their role as providers of cash is not enough. Being a "supplier" of money is a commodity for which there is only value when money is scarce, and savvy GPs know this.

This section describes several of the ways an LP can add value to its GP. LPs who want to have a position in a top-quartile fund manager (i.e., the supply of cash from LPs is not scarce) had better have been in that GP's first fund from day one, have a heavy brand name (e.g., Yale Endowment will do just fine, thank you), or else start thinking about how to differentiate from the pack and add value.[16] These are just some of the things that can be explored.

Bringing Data to the Table

Venture is an information-scarce industry. While respecting the principles of confidentiality, an LP with multiple positions can provide enough data points for GPs to benchmark themselves appropriately. Although there are several public databases available for this, it is widely known that the databases have limitations and thus a sufficiently large LP can provide a better indication of performance for the GP fund manager.[17]

Being Transparent

The need to level the powerbase is unmistakable. Trust is impossible along the value chain when LPs insist on having "LP-only events" at major VC conferences. Meeting behind closed doors as if there is certain information that GPs should not hear—this is the opposite of building trust. Incidentally, little is discussed in such meetings that the industry does not already know about—so drop the barriers!

Sharing a Web of Relations

While safeguarding confidentiality for each fund position, an LP may nonetheless have a network of well-established contacts that can help a GP reach a specialist in a particular field or open a new sales channel in a new market. Similarly, an LP can open the door to co-investors when VCs are looking at an investment or seeking other LPs when fundraising.

Sharing Knowledge

The most experienced LPs bring a deep level of knowledge, particularly when it comes to geographic and industry know-how (which an LP needs for its own portfolio diversification). An LP that covers multiple geographies is able to share knowledge of other places, may have seen similar technologies in other funds, and can recall what worked and what did not work in the past. Even pricing and valuation on historical transactions elsewhere can be useful in a different part of the world.

The astute GP immediately understands how valuable such an LP is—not only for its dollars, but also for its experience. It is not atypical for top quartile funds to have specific LPs in their LP Committee, even though these may not be their most sizeable investors. Furthermore, knowledge sharing should lead to co-investment opportunities, a must for any LP worth its salt.[18]

Being Trustworthy

Of course, to provide the value described above an LP must not break the boundaries of confidentiality or of its scope of work, not only for liability reasons but also (and most importantly) so it does not meddle in the GP's daily operations. For an LP to add value successfully, a degree of mutual trust is required between the LP and the GP: the GP must know that she is driving and that the LP is one of several passengers on the bus. The LP is the "passenger" to whom the GP can confidently turn for directions—either because the LP is shrewd or because he has the network, the experience, or the knowledge.

The Rise of the "Innovation Strategist"

I propose the Innovation Strategist as an LP that will break from the pack and take a new, creative approach toward building value. Innovation Strategists are definitely not mediocre. They include LP leaders who have strong personal brands and a willingness to differentiate themselves from the crowd.

The best complement you can get as an LP is when a successful GP wants to have a key man clause on you as an LP. Unlike LPs, GPs have to

[16] Bill Gurley, cited by Kik Tidwell, "Venture Investment's Potential to Further Mission Impact," 26.

[17] Steven Kaplan, Per Strömberg, and Berk A. Sensoy, "How Well Do Venture Capital Databases Reflect Actual Investments?" (working paper, University of Chicago Booth School of Business and Ohio State University Fisher College of Business, September 2002), http://ssrn.com/abstract=939073; Steven Kaplan, presentation to Kauffman Fellows Program, 15 March 2012, Palo Alto, CA.

[18] Mulcahy et al., *We Have Met The Enemy*.

commit to stability in their teams, vesting periods for their carry (i.e., the upside) and key-person trigger events. When working as an investment professional at the European Investment Fund (Europe's most diversified fund of funds), the biggest complaint I repeatedly got from GP fund managers was the amount of rotation in LP teams. One GP even counted five people in three years, and I am sure there are worse cases.

When a successful GP[19] approaches you as an LP and half-jokingly mentions that they should have a key man clause on you—then you know you have crossed the great divide between LPs and GPs and are building something together. Your GP now values your personal brand above any institutional logo on your business card.

From then on, you will know promptly when a deal is turning sour, when there is an important decision to be taken in the LP Committee, or when there is a personal matter that could be affecting the GP's performance. Most importantly, you will start feeling the trust and may find yourself discussing more positive and strategic issues. The relationship shown in figure 2 is now in balance.

Should the LP organization be worried about its investment professionals becoming more entrepreneurial? On the contrary, since this is a long-term business, leadership within its ranks to "build something together" with GPs leads to stronger alignment of interests. Unfortunately, the current practice within LP organizations encompasses career-track thinking, and one seldom finds LP investment professionals willing to put their careers at risk. As one stated, "I won't risk my job to invest more in VC."[20]

The Future: KFP's Role in Healing the LP–GP Relationship

We seem to be re-experiencing history (as shown in figure 1). In 1993, the existence of venture was questioned, returns were poor, and there was no successor planning and absolutely no trust between VCs and entrepreneurs. All this led to an innovation bottleneck, and the Kauffman Foundation was compelled to act.

Today, we are in need of Innovation Strategists in the LP world. For KFP to remain the engine of capital formation across the VC value chain, it must take that leap of faith and build a cadre of Innovation Strategists in the LP community—members or allies of the Society of Kauffman Fellows who can interact with GPs in the same way that Kauffman Fellows interact with entrepreneurs.

There may be no "secret sauce" for Silicon Valley success, but there surely are KFP ingredients. VC is about access—to the best entrepreneurs, the best deal, the best market, the best GPs, and increasingly going forward, the best LPs. VCs have a vested interest in this nurturing of Innovation Strategists, as this new cadre of LP leaders will bring a better and more informed LP base for the industry. Although large pension funds may not initially pour millions into VC, Innovation Strategists will likely entice traditional LPs to start reconsidering their to venture.

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[19] Emphasis is put on *successful* GP, as an unsuccessful one may just be currying favor in the hope of getting the money!

[20] Tamara N. Elias, "LPs and the Venture Capital Asset Class, 34.

José Romano

José heads the Istanbul Venture Capital Initiative (a €160 million fund of funds program) and the European Investment Fund's Turkish operations. Previously, José was at Deloitte (where he comanaged a €25 million challenge fund), Actis, and PricewaterhouseCoopers. He started his career as an Overseas Development Institute Fellow working as a senior economist in Namibia's Ministry of Trade and Industry. With extensive experience operating in Europe and emerging markets, José has particular interest in public–private partnerships for private sector development, especially early-stage financing. He holds a First Class Honors degree in Economics from Queen Mary College, University of London, an MPhil in Economics from Cambridge University, and an MBA ("la Caixa" Scholar) from London Business School.

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