(3) My approach to venture investing

Status is offline

9-12 minutes

Ever since my partner Brad wrote a great piece about how he invests, I've wanted to create a similar manifesto. I've seen the value that founders get from reading Brad's post before connecting with him, as it provides a valuable window into his culture, mind-set, priorities and passions. I will endeavor to achieve a similar objective.

Passion for the mission

I personally see somewhere between 1–2k potential investments per year. If someone sends a note and an investment deck that is personally addressed to me, I will respond every time. My belief is that it is both hard and admirable to start a company, and that if someone thinks enough of me to share their business or idea, then the least I can do is read the materials and reply. However, I have a pretty rigid rule: if I'm not specifically passionate about the problem being addressed, then I won't engage. The last thing I want to do is waste a founder's time if there is no chance I'll dig into, much less invest in, their business. And it isn't fair to me, my existing portfolio founders or our investors if I'm spending time on stuff that doesn't fit with my personal mission. Finally, founders deserve investors who are closely aligned with them, and are as excited about the business as they are. And if I'm not that investor, then I always counsel founders to find a better fit. So what am I passionate about? Well, I'm a sucker for all things in the realm of alternative finance. My investments in Simple, Transferwise, and more recently Octane Lending, are examples of this. I also like information businesses which exhibit data network effects. The Trade Desk and Cognitive Logic fit this mold. And complex, real-time analytics at scale are also interesting to me, as MemSQL, Recorded Future and Sight Machine demonstrate. This is by no means a comprehensive list, but it is indicative of where my head is at today.

Pursuit of big ideas

I have a rule: if I don't think a company has the potential to grow into a billion-dollar+ value business, then I don't engage. This might seem like a strict hurdle for a firm that initiates almost all of its investments pre-Series A, but given that we need two 40x-type outcomes per fund to achieve our 3–5x net return objective, we pretty much need to swing for the fences every time. Clearly it is hard to know this given the sparse data available at the time we make our initial investment, but it is possible to hypothesize about a product roadmap, a scale of market opportunity and a founder's ability to execute. If each of Brad, Jesse and I make 2–3 investments per year for ~4 years per fund, and maintain this level of investment discipline, our first 7 years in business seems to indicate that this approach can achieve our desired outcomes. So no point solutions. No neat features. No "we're likely to be bought by Salesforce for $100M." This is not why we're in the venture investing business. Big ideas. Very early. Product/market fit risk. Large potential rewards.

DNA that embraces experimentation

Our fundamental view at IA is that our pre-product/market fit, pre-Series A investments look a lot like experiments, and we bond well with founders who embrace this mind-set. When I find a team working on an idea I'm passionate about that I believe can achieve large scale, the first thing I do is to align on what we're collectively trying to prove over the next 18–24 months. This involves asking the question: "What does the future state of this company look like in order to raise a great Series A round from the just-right investor?" We then work to unpack this into a set of hypotheses that must be tested over this time period, and to agree on the measures and metrics that would serve to validate (or invalidate) these hypotheses. Another key output is the size of an institutional seed round sufficient to fund the company to these essential milestones. It takes a certain kind of team to get charged up and inspired by this exercise, because let me tell you, it's no joke. It's really hard to get very specific this early in the game, but we've found it to be an invaluable exercise for the founders, and a good barometer of the chemistry between the founders and IA.

A bias towards action

I've had the good fortune of working with many brilliant people in my career. However, I've noticed that a common failure mode of brilliant people is being paralyzed by not having "the answer" to a problem. Much of early success in start-ups is based upon fuzzy logic, developing hypotheses, rapidly testing them, iterating on the fly and working towards product/market fit through a series of jiggles before locking in on a particular path and "burning the boats." This approach goes against the grain of many a Mensa member, because there is only clarity around process, not around outcomes. This can lead to moving slowly, as certain founder personas are deathly afraid of making mistakes that can: (a) make them look stupid; or (b) seemingly waste time and resources. But, of course, time and resources are really being wasted through inaction, because the less founders are colliding with the market and learning, the fewer opportunities there are to iterate, refine the product and achieve product/market fit. So I have a strong bias towards founders who aren't afraid of imperfect information, and focus their efforts on constructing smart experiments which generate useful data for analysis, iteration and further action. Fear is adaptive, but only if it doesn't paralyze.

A founder-friendly seed round with deep alignment

While we do some incubation and have entered some investments at the Series A, IA's normal mode is a $1.5-$2.5M investment as part of a $2-$3M institutional seed round where IA owns 15–18% of the company. We always issue our term sheets on a post-money basis, so founders understand exactly how much dilution they're taking by selling equity to investors and setting aside shares for future option grants. No pre/post money funny business. I am confident in saying that IA's seed term sheet, which is barely a page long and represents a small set of adjustments to the NVCA seed template, is perhaps the most founder-friendly institutional document in the venture world. Part of the reason for this is our view of the seed round as an experiment, where the energy should be focused on proving the hypotheses and achieving product/market fit, not on unnecessary governance and control provisions. No board seat. IA pays the legal costs (because there isn't much, if anything, to negotiate because of its founder-friendly tilt). We can go from signed term sheet to close in less than two weeks. If the experiment is successful and the company is able to raise a great Series A round, a traditional board structure with standard governance provisions can be implemented at this point, when the dollars are larger and the business is more complicated. We've actively sought to strip away all unnecessary complexity to increase the chances of getting to a great outcome.

A transparent approach to reserve management

When IA makes a seed investment, we allocate ~$3M per company at inception. For instance, if IA invests $2M in the seed round, we have allocated an additional $1M to invest in either a round extension (if additional runway is needed to raise a great Series A round) or in the Series A. However, if a company has proven its hypotheses and gotten traction to the point where we believe it can be one of the best companies in the fund, we can allocate up to $6M to invest in the company across principally the Series A and Series B rounds. And if the company shows evidence of being a true breakout, one that has the opportunity to be one of the top 1–2 investments in a fund and one of the best across the firm, we can allocate $10-$12M across multiple rounds. In general, we aim to own between 12–15% of a company at exit, with the ballast of our ownership being created in the seed round and the remainder coming largely through the Series A round. And if I do my job and become a trusted advisor to the founders, they'll almost always support IA's ownership objectives by advocating for us at each stage of the fund-raising process.

Providing critical founder support during the challenging early days

IA has experimented with several portfolio company support models over time. We ultimately arrived at the conclusion that at the stage at which we're investing (read: very early), only a few things really matter: (1) raising the right amount of money to provide the runway necessary for achieving product/market fit; (2) getting the basic operational setup right from the get-go; (3) supporting key recruiting efforts; and (4) offering a safe place for founders to share concerns, fears and insecurities. While IA has several listservs for portfolio companies to interact with each other, we've focused our efforts on the four points above. Getting the hypotheses and metrics right leads to the right answer for (1). IA provides an experienced, vetted, outsourced CFO to help getting operations set up correctly to help address (2). IA has preferred relationships with a curated set of recruitment firms to augment our partner networks to assist with (3). And IA pays for a year of management coaching for our founders to help with (4). Taken together, we've seen that getting these four things right increases the chances of founder (and company) success.

In conclusion

My life as a venture investor is a work-in-progress, and will be until the end of my days. It is the most interesting, exciting, frustrating and humbling work I've ever done. But at the end of the day, it is my interactions with my partners, Brad, Jesse and my founder partners, which makes this life so satisfying. Thanks in advance!