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The truth about venture capitalists, Part 1

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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 *negative* experience -- 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 *their* investors 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.