

A new Venture Capital model, much like the old

The VC model does not scale... early stage finance is not an unlimited universe of opportunity.

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There has been a great deal of banter lately about the deteriorating state of Venture Capital, with a chorus of voices that ranges from economists to entrepreneurs to venture capitalists themselves. An interesting summary of the state of affairs was posted last week on the popular blog of Union Square Ventures partner, Fred Wilson <http://tinyurl.com/cu95ob>. In short, the venture capital segment has been the recipient of too much liquidity, which, given the nature of the venture investment model, has made the deployment of funds at an adequate risk/return balance more and more challenging. The VC model “does not scale”, is the conclusion, which stands to reason and we probably should not have required almost two decades of sub-standard segment returns to realize that early stage finance is not an unlimited universe of opportunity. And there is still another interesting aspect to the venture capital conundrum, which is that by stripping away, say, the top 10% of the venture deals executed, or even the top 10% echelon of venture firms, or, for that matter, just taking Google out of the equation, overall industry returns crater. Below are a few thoughts about the state of affairs, leading to one path in particular that Venture Capital and the entrepreneurs seeking it could be forced to follow.

The concept of one successful deal covering up four failures and five mediocrities is an extreme of portfolio theory that probably points to option value more than to equity investing. Indeed, when talking about venture capital deployed into early stage projects, the value probably is exactly that – option value – especially in an environment as fragmented and rapidly evolving as technology and its related venture capital targets. In Venture Capital, it is commonly understood that the first institutional round comes with at least two or three follow-on opportunities, which is itself suggestive of that initial round representing something like an option. And yet, the valuations associated with such investments, even if sometimes painful to entrepreneurs, have really been at equity value, reflecting the full value of the enterprise at the stage that the investment is made, based on a competitive market dynamic.

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of angels, and typically comprise tens, sometimes hundreds, of thousands of dollars – amounts that are too small to pursue for a VC with \$100-\$3,000 million under management. But recently, Sequoia Capital raised some eyebrows with a roughly \$2 million infusion into west coast seed investor/incubator Y-Combinator; Boston VC Spark Capital announced its own seed-stage initiative called Start@Spark; and other prominent firms have been seen dabbling in the seed-stage even if with less fanfare.

From an optionality perspective, this is indeed more like it. Granted, the stage of investment is even earlier than would be a Series A, but it should be well worth the higher risk to spend \$100,000 in order to determine if the subsequent \$3 million round makes sense (or doesn't). In isolation, that same \$3 million investment reduces the fund's “research” opportunity by the equivalent of 30 option purchases (in our example). If the same 10% success ratio applies, (i.e. to which VCs have become accustomed), there are three “hit” opportunities embedded in that \$3 million, and 27 misses. Thus, the subsequent \$3 million, invested in the actual Series A, comes with a significantly lower risk and substantially higher return profile.

Although time will as always tell, it seems that this staged approach would materially and positively impact Venture Capital returns. The extent to which such a system is adopted, however, carries its own set of unknowns... and challenges abound. When managing a sizable fund, for example, it is not an ideal model to have to monitor several dozen small positions. From the entrepreneur's perspective, moreover, raising seed capital from a VC is almost akin to selling exclusivity. If that VC chooses not to fund the subsequent Series A, the entrepreneur's opportunity to take the deal elsewhere is seriously hurt. Even to the extent that the obvious question is addressed, (i.e., why the institution that knows the business best has decided to pass), there still remains the problem of an existing venture investor at the table, whose agenda may or may not coincide with that of any new institution joining the group. The potential conflicts that these issues trigger are not immaterial, and may be the biggest impediment to wide scale seed-stage investments by venture firms.

Still, the VC model needs fixing, and entrepreneurs need venture capital to develop their business projects. And since each side stands to benefit from the other's cooperation, perhaps the two will meet somewhere along the middle path with compromise. Which is to say, maybe after the inevitable shakeout in Venture Capital has



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occurred and dust has settled on the reduced number of participants that will survive it, the model evolves such that the typical fund size is reduced to the realm of \$100 million, tops, and the \$3 billion funds no matter how prominent are rightly categorized as something else, not Venture Capital. With a smaller capital base, both in the aggregate and individually, the appetite of venture firms to become involved with more fragmented seed-stage investing should rise, and, given the business rationale previously laid out, could even become a standard mode of operation. Entrepreneurs will then be faced with the alternative of accepting the risks behind seed capital from a VC, or seeking the seed capital elsewhere.

As always, market forces should prevail, and perhaps the answer will be seed-stage/developmental venture rounds that are more than tens of thousands, but less than millions, thus offering entrepreneurs higher value for the sale of options. And perhaps even in such circumstances, some entrepreneurs will still choose to fund their formative stages independently, or with non-VC affiliated groups. Regardless, a smaller industry with more modest targets and more focused footprint will be a constructive formula for investors, the entrepreneurs who need them, and the economy that needs both in order to grow. Not accidentally, the Venture Capital model described is something like what Venture Capital used to be, before several bubbles and a capital markets shakeup have now forced the segment to consider "reinvention." Boy, those ancients really knew a thing or two!

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