FOCUS VENTURES

Private Equity... or Personal Equity?

Why Who You Know Still Drives Venture Capital Returns

By Steve Bird

Introduction

Over the past decade, the venture capital industry has come under increasingly rigorous scrutiny. Sophisticated, data-driven analysis now provides a much clearer picture of the factors that drive profits in venture capital. This analysis has confirmed some pieces of conventional wisdom, debunked others, and forced caveats on others.

In this paper we combine our own empirical data (analysis of returns from more than 8,000 venture financings from 1980-2003) with that of other industry watchers to re-examine some of the prevailing myths of venture capital. In doing so, we find that despite the proliferation of venture capital business models in the industry and the emergence of hundreds of new firms, a few core principles continue to define the industry:

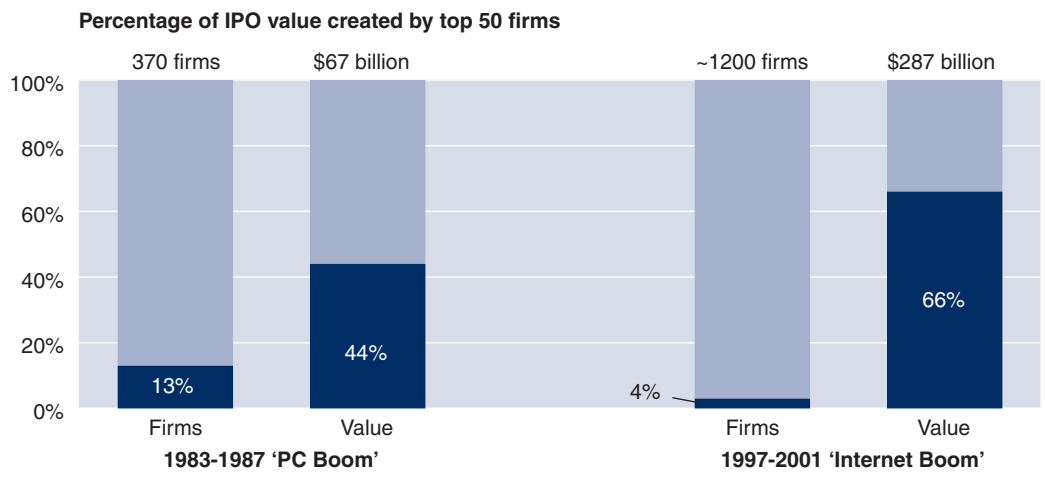
1. 40-50 VC firms create the bulk of industry value. The same small group of firms has consistently created the majority of value in the VC industry over the last 20 years, and their share of total industry profits has *increased*, not decreased, over time.

2. Stage doesn't matter... much. With one big exception, late stage VC investments have performed as well as early stage VC investments over the last twenty years.

3. Management is everything. When you strip out the various factors that are thought to influence VC fund returns – sector, stage, geography – you find that above all else it is quality of management that drives returns. (Though "management" may not mean what you think.)

Together, these findings reinforce a notion that is intuitive but bears repeating: that it is the quality of the startup that drives VC returns. And since only a handful of firms and general partners (GPs) get to invest in the best startups, success in venture capital still boils down to one thing: relationships.

Figure 1
A Tale of Two Booms – VC Value Concentration



Source: Focus Ventures analysis of Venture One data

The same 40-50 VC firms have dominated the market since the early 1980s, and their grip on the industry appears to be tightening.

Pinpointing the Drivers of Value

1) The Rich Get Richer: The Increasing Dominance of the "Top 50" VC Firms

There is a perceived leader class in the VC industry, typified by a handful of big, early-stage firms with brand-name appeal. Conventional wisdom holds that these firms set the course for the industry and consistently earn higher returns than their peers. To test this notion, we analyzed more than 8,000 financings by hundreds of VC firms over a 24-year period. What we found both reinforces common wisdom, and suggests a modification.

In the early 1980s, the venture capital industry experienced its first real boom, centered around the PC industry. As firms began realizing profits from their investments, a pattern of value concentration emerged that persists to this day. We ranked each VC firm in the industry based on the total pre-money valuations of their portfolio companies that IPOd between 1983 and 1987. By this measure, VC industry profits were quite concentrated: 50 VC firms (the "Top 50" or 13% of all VCs in that period) shared in 44% of total venture-backed IPO value created. ***(Figure 1)***

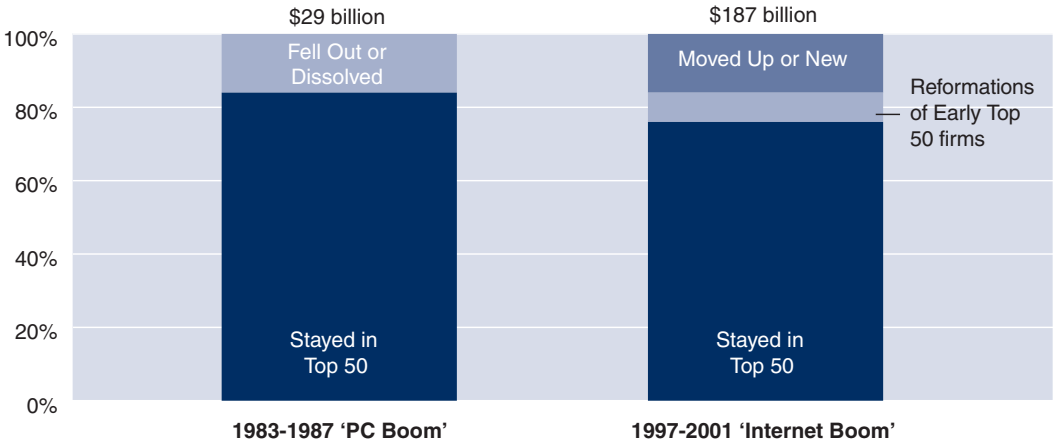
By the time the next major VC boom peaked in 2000, there were more than 1200 VC firms in the U.S. Yet despite the new entrants, concentration of value among the Top 50 (measured by the same proxy) actually *increased*. In the period 1997-2001, the Top 50 VC firms – 4% of all firms - shared in 66% of total venture-backed IPO value created.

Clearly, despite the hyperactivity of the Internet/high-tech boom, a process of maturation and consolidation was underway in the venture capital industry. Fewer firms were generating and capturing more of the industry's profits.

Now here's the twist: it was the *same VC firms* that led the pack in both booms.

Consider: of the Top 50 firms in 1983-1987, 38 were also in the Top 50 of 1997-2001. Of the twelve "newcomers" that made their way into the Top 50 of the second boom, four were actually reformations of Top 50 firms from the first boom. Excluding these reformations, churn of the Top 50 firms over the course of 15 years was only 16%. ***(Figure 2)*** From this we can draw two conclusions: leadership in venture capital is extremely sticky, and longevity matters. Later, we will examine why this may be true.

Figure 2
A Tale of Two Booms: Persistence of the 'Top 50' Firms



Source: Focus Ventures analysis of Venture One data

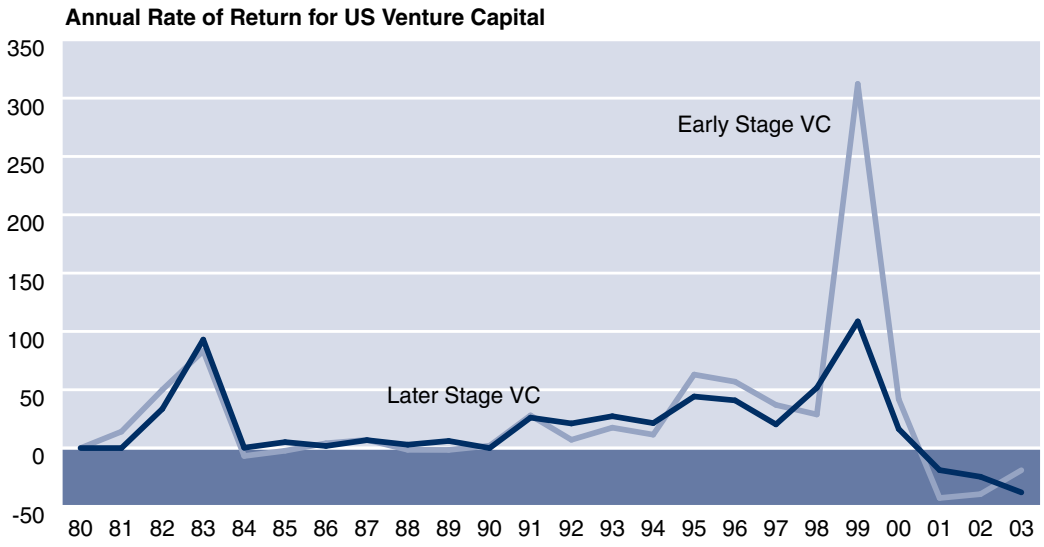
2) Why Stage Doesn't Matter… Much

Perhaps the biggest myth in venture capital is that only early stage investors earn high returns. The logic is alluring: early stage investors are the first to capitalize on emerging trends, and because they buy in at the lowest valuations, they stand to make the most when their portfolio companies go public.

But a closer look shows that it's not that simple. Using data from Venture One and Venture Economics, we peeled the onion on VC returns by stage over the last twenty years. At first blush, early stage investors appear to have a real advantage over late stage investors, earning pooled IRRs of 20% versus 14%. ***(Figure 3)***

In reality, this disparity is driven almost entirely by one aberrant year, 1999. ***(Figure 4)*** In that year, near the height of the dot-com bubble, 245 venture-backed startups IPOd. Companies were going public earlier than ever before, and receiving pre-money valuations higher than anyone thought possible.

Figure 4
Annual Venture Capital Fund Returns

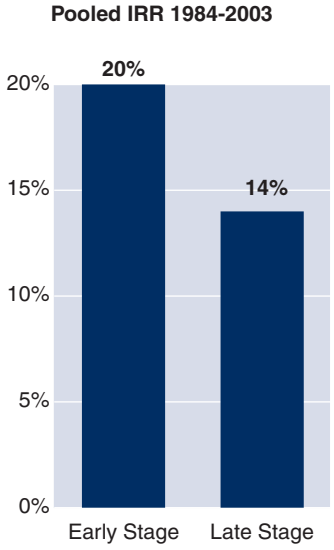


Sources: Thomson Venture Economics

1999 was an anomalous year for the venture capital industry, but particularly for early-stage firms. The dot-com era was the first VC boom where a significant number of companies founded *during* the boom itself were able to go public before the boom ended. As a result, early stage firms were able to exit their investments remarkably quickly –often in a year or two - and at high valuations. The result was a substantial one-year disparity in returns for early versus late-stage firms: roughly 300% IRR for early stage investors in 1999, and a still respectable 100% IRR for late stage investors.

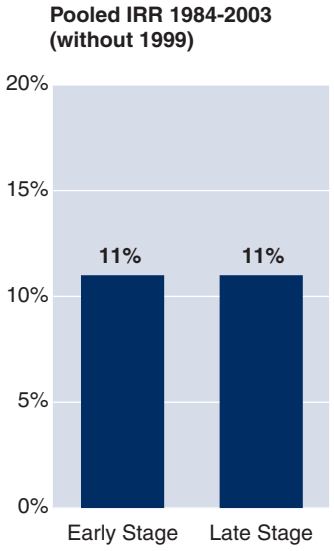
Over the history of the venture capital industry, this had never happened before. Given the current financial climate, we think it unlikely to repeat. Take 1999 out of the mix, and we find that IRRs for late stage firms matched those of early stage firms for the 1984-2003 period. ***(Figure 5)***

Figure 3
Comparison of Early and Late Stage VC Returns



Source: Thomson Venture Economics

Figure 5
Comparison of Early and Late Stage VC Returns



Source: Thomson Venture Economics

Three primary factors explain this parity:

IPO Rates

Early stage investors typically earn higher cash-on-cash returns when their companies go public. But fewer of their companies actually *do* go public. According to Venture One, seed and first round investors in the period 1992-1997 had "IPO rates" (percentage of portfolio companies that eventually went public) of 23% and 28%, respectively. Fourth and later stage investors, by contrast, enjoyed an IPO rate of 47%.

Time to IPO

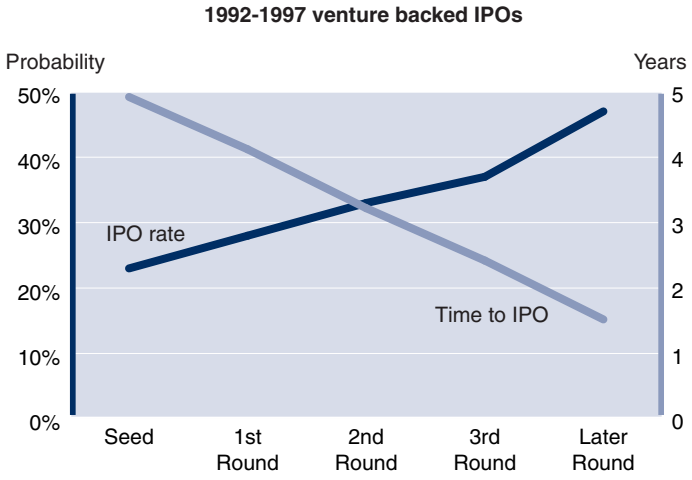
On average, early stage investors hold their equity stakes longer than late stage investors. From 1992-1997, seed and first round investors waited 4.1 and 3.2 years respectively for each IPO. Late stage investors waited just 1.5 years. ***(Figure 6)*** Since IRR is a function of cash returns and time, all else being equal, holding investments for a shorter time raises IRR.

Average Cost of Equity

On average, a venture-backed startup can expect its valuation to increase about five-fold between seed and fourth round financings. This would seem to put late stage investors at a significant disadvantage – after all, the more you pay for your equity, the less profit you make when the company goes public. In reality, though, it's not that simple. Late stage investors do pay more for equity than early stage investors – but not as much as one might think. Here's why:

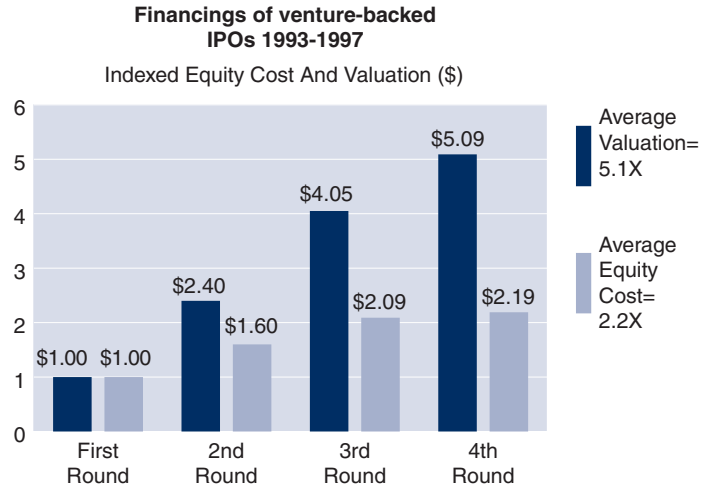
At each successive round of financing, a company must issue additional shares to new investors. The result is dilution: a larger number of shares by which to divide company value, and a smaller rise in share price than the increase in valuation would suggest. ***(Figure 7)*** First round investors bear the brunt of this dilution effect – they may see their equity stake diluted three, four, or more times before a company goes public. Late stage investors, who often constitute the last round of financing before a company goes public, suffer far less dilution. The result is that while a company's valuation may increase five-fold between seed funding and IPO, late stage investors often pay only about twice as much for an equivalent equity stake as early stage investors.

Figure 6
IPO Rate and Time to IPO, By Stage



Sources: Venture One

Figure 7
Average Equity Cost and Valuation by Round



Sources: Focus Ventures Analysis; Venture One data

Putting these three pieces together – IPO rate, time to IPO, and average equity cost – provides a new way to frame the late versus early stage debate. Simply put, as a late stage player, you pay a little more than twice as much for equity as a first round investor. But you nearly double the odds that your investment will pay out (47% IPO rate versus 28%), and you halve the time you need to wait for this pay-out (1.5 years versus 3.2 years to IPO). The net result is that over long periods, returns are essentially the same for early versus late financing rounds.

This conclusion may sound obvious, but it defies conventional wisdom in the venture capital industry. Analysis by Jesse Reyes, Vice President at Thomson Venture Economics, suggests an even more provocative finding: that on a risk/return basis, late stage funds may have the advantage. ***(Figure 8)*** Reyes calculated the Manager Risk Coefficient (MRC) for each asset class by dividing standard deviation of fund returns by average fund return. (Effectively, MRC measures the risk an investor is willing to take for each 1% increase in average returns.) MRC for early stage investors is 3.2 (that is, the standard deviation in returns is three times higher than the average return), while MRC for late stage investors is 1.8. In other words, even when early stage funds earn higher IRRs than late stage funds, the far higher variation in fund returns makes early stage investing a riskier bet.

Late stage investors pay about twice as much for their equity. But they also nearly double the odds of a pay-out, hold their investments half as long as early stage investors, and enjoy more predictable returns.

Figure 8
Risk-Return of U.S. Private Equity Funds by Investment Stage (as of 12/31/02)

Stage Focus	Pooled IRR	Standard Deviation Of IRR	MRC (Std. Dev./IRR)
Seed	12.2%	38.3%	3.1
Early Stage	21.4%	68.4%	3.2
Balanced	14.5%	29.3%	2.0
Later Stage	16.5%	30.4%	1.8

Source: Jesse Reyes, Thomson Venture Economics. "All Funds Aren't Created Equal." Venture Capital Journal, July 2003.

3) The Importance of Relationships and Management

If the stage you invest in doesn't explain returns, then what does? Peeking ahead, we can tell you that it's not investment focus, and it's not the state or region in which you invest. The real answer is both simpler and more complicated.

Venture capital is an inherently risky business. Fewer than one in four venture-backed startups go public, and even then most of the profits are created by just a handful of IPOs. Our analysis found that in most years, fewer than 30 IPOs account for 70% of total venture-backed IPO value created. This explains why the bulk of the VC industry's profits are concentrated in just a handful of firms. Even with multiple VCs backing each IPO, with (at last count) more than 1,000 VC firms in the industry, there simply aren't enough high-value IPOs to go around.

So how is it that a corps of successful firms – our Top 50 - consistently get more of the best deals? How do they repeatedly find the needle in the haystack? A number of studies have examined this topic recently, and all have reached the same conclusion: it is the quality of the VC manager that drives venture capital returns.

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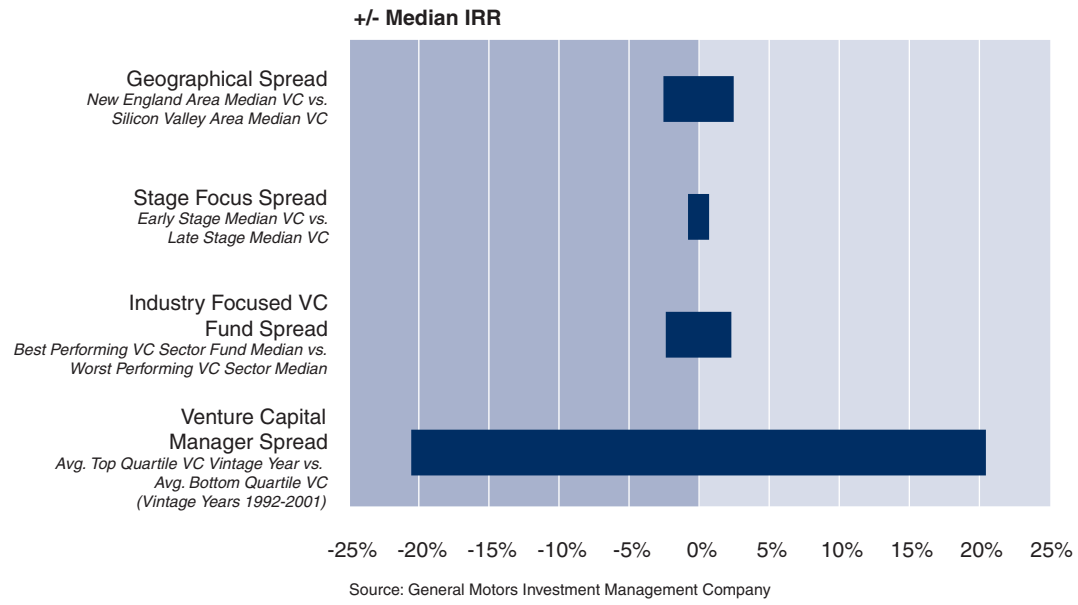
Consider analysis by General Motors, one of the largest and most experienced LPs in the world. GM regressed the returns of individual VC funds against a number of factors. After ruling out industry focus, stage, and geography, they concluded that quality of management is the main driver of returns. ***(Figure 9)***

Figure 9
Factors of Return Variance (General Motors analysis)



Source: General Motors Investment Management Company

Jesse Reyes has reached similar conclusions in his writings on venture capital, finding that manager selection is the single most important part of the asset allocation process for LPs.

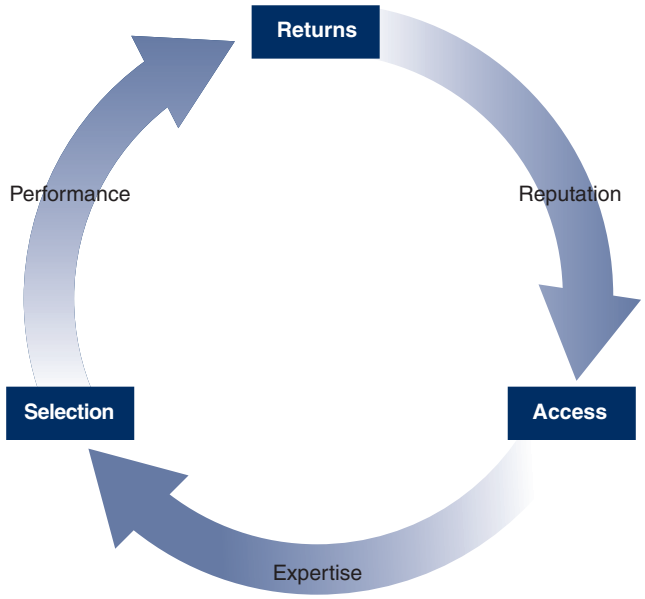
But what does this mean - "management?" Does it mean the top VCs are more adept at sleuthing out the handful of stars from thousands of cashed-strapped startups? Does it mean the best managers are operational wizards, and can help their portfolio companies better reduce their burn rates or leverage their assets?

In part, yes. But we believe "quality of management" really means the quality of the relationships that GPs build over years in the business. Management means forging relationships with other top VCs that allow both parties to repeatedly form syndicates on the best deals. It means building a network among the entrepreneurial community so that the GP hears about a revolutionary technology when it's still in the lab, not after the company has landed its first round of financing. It means knowing important customers, suppliers, and scientists that can help a fledgling company reach its first quarter of profitability. And it means building trust with the broader financial community so that when the time comes for a portfolio company to get a loan, raise more capital, or go public, company management doesn't have to recreate the wheel.

Given the sophisticated nature of the financial world, this notion of "relationships" may seem too quaint and abstract to be the primary factor determining how billions of dollars in profits are split up every year. But private equity is called private for a reason. Despite the fierce competition that pervades the industry, venture capital is not a perfect market.

Fortunes in venture capital are made or lost not just on how smart you are or whether you pick the right sector. Fortunes are built on bonds of trust and transactions of insight; once forged, these bonds are reinforced by repeated success. High returns and long-standing relationships earn a firm access to the best deals, and ultimately to better performance. It is this cycle, and no other, that explains the striking persistence of a small group of winners that dominate the industry year after year, decade after decade, and whose grip on industry profits is growing stronger, not weaker, over time.

Figure 10
The Virtuous Circle of Management



Conclusion

These findings both simplify and complicate the life of LPs. As we've seen, a handful of IPOs, usually fewer than thirty, account for the bulk of industry profits in most years. A small corps of firms, fifty or so, are privileged enough to invest in these companies (whether at early or late stages) and earn extraordinary returns when they go public. The grip these firms hold on the industry is tightening, not loosening. And if anything, it is becoming harder for LPs to gain a foothold with the top VCs.

The choices for LPs, then, are clear. If LPs can't directly access the best deals through the top tier early stage funds, they should consider other avenues to do so. The most common options are seed and angel investments (highly risky), late stage funds (the best of which invest later in the life of the highest quality startups), or funds of funds, some of which provide access to the top tier early stage players.

But if none of these options are possible or palatable, LPs should avoid compromise: history has shown that unless you can capture a piece of the very best deals in venture capital, your money may be better off in the public markets.

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This paper may be found in electronic form at www.focusventures.com

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Focus Ventures amplifies the success of our partners by addressing the unique needs of a company on the verge of exponential growth. Our concentration on leading expansion stage technology companies has allowed us to develop capabilities that are complementary to those of prominent early stage venture capital firms. By building upon a company's solid foundation, we augment its value by leveraging our extensive network of industry professionals in the United States and Asia to create strategic and prosperous business opportunities.

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