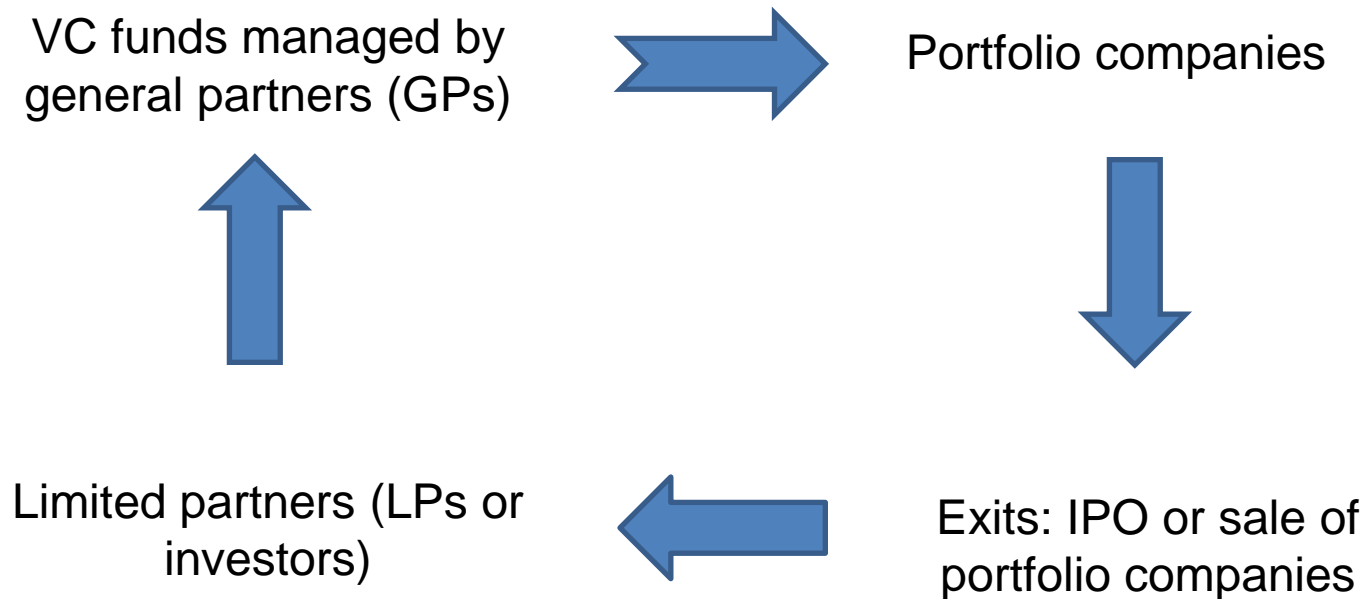


Venture Capital (VC) Firms

What is venture capital?

1. A VC is a **financial intermediary**, meaning that it takes the investors' capital and invests it directly in **portfolio companies**.
Question: What's the difference between VCs and angel investors?
2. A VC invests only in private companies ("private equity"). This means once the investments are made, the companies cannot be immediately publicly traded.
3. A VC takes an active role in monitoring and helping companies in its portfolio (e.g., board representation, recruiting talented managers).
4. A VC's primary goal is to maximize its financial return by exiting investments through a sale or an initial public offering (IPO).
5. A VC invests to fund the "internal growth" of companies. In other words, investments are made to build new businesses rather than acquiring existing ones.

The flow of funds in the VC cycle



Well-known VC firms

- **Sequoia Capital** – invested in Apple, Cisco, Google, Symantec, and Yahoo before they became publicly listed.
- **Kleiner Perkins Caufield & Byers (KPCB)** – invested in AOL, Amazon.com, Compaq, Google, Netscape, Sun, and Symantec...

What do venture capitalists do?

1. Investing

- **Screen** hundreds of potential projects to identify projects worthy of attention.
- **Preliminary offer** with a term sheet, which outlines:
 - the proposed valuation,
 - type of security,
 - proposed control rights for the investors
- If the term sheet is accepted, VC performs extensive **due diligence**
- **Closing**: Formal set of contracts are signed

2. Monitoring

- Board meetings, recruiting, regular advice

3. Exiting

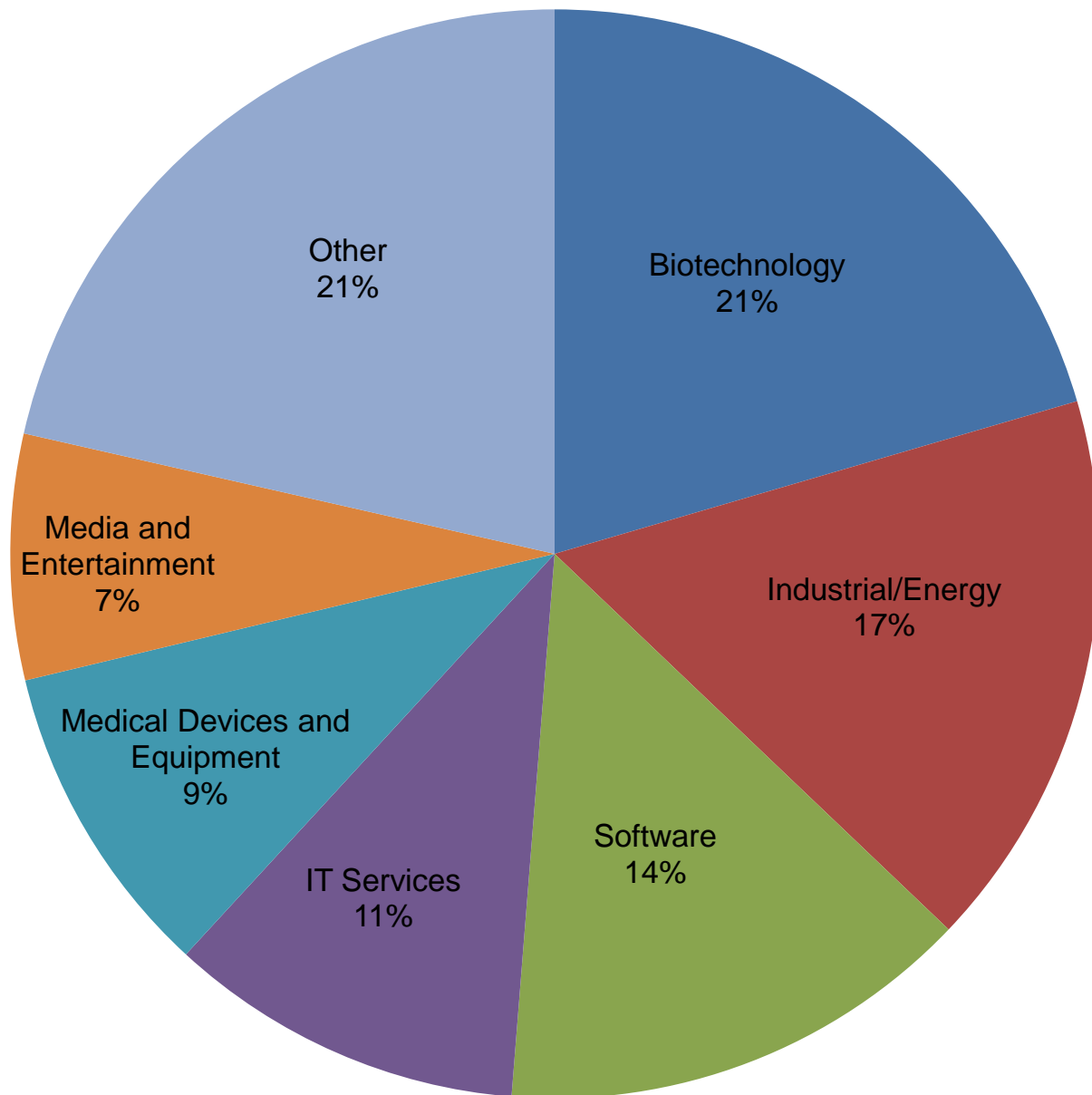
- IPO (most lucrative), strategic sale to a corporation

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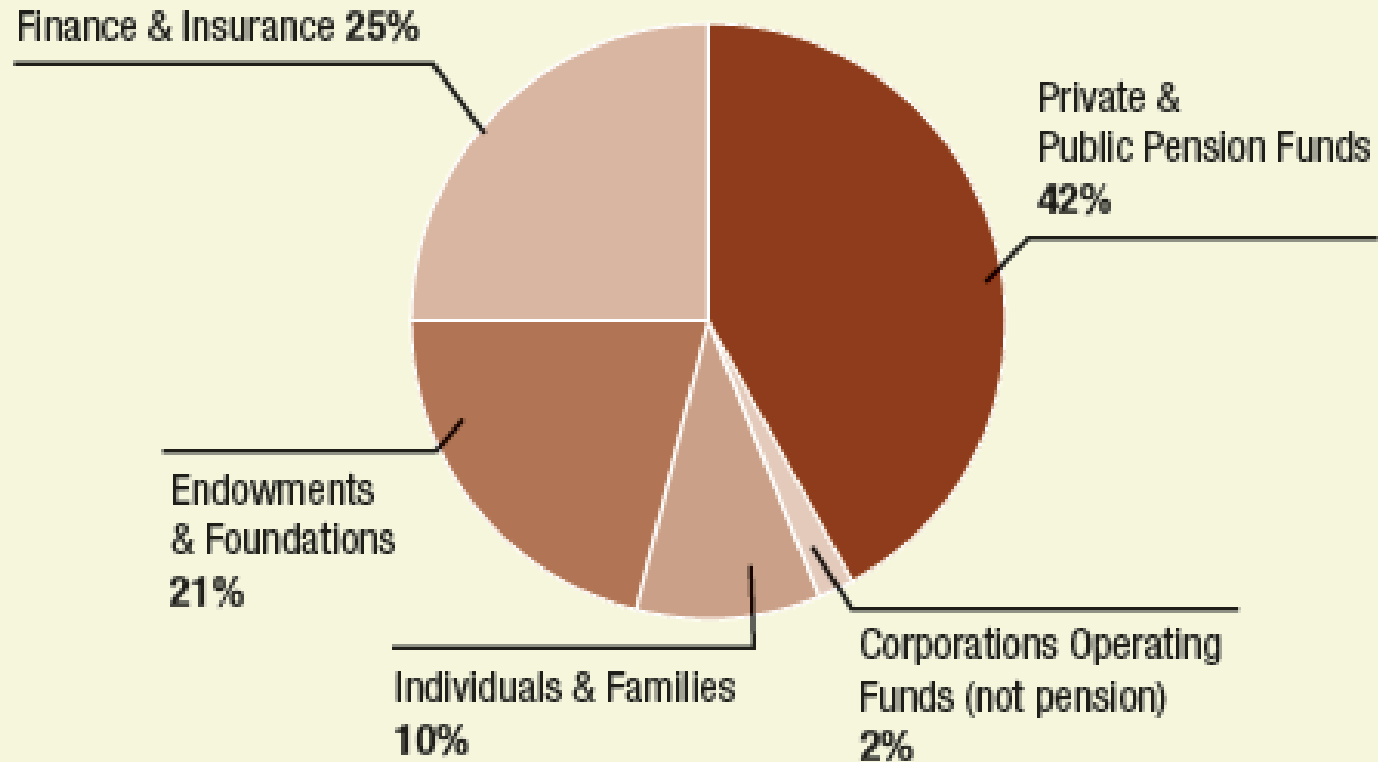
Venture Capital Investment in the United States 1970-2008



Source: The MoneyTree Report by PricewaterhouseCoopers and the National Venture Capital Association, based on data from Thomson Reuters.

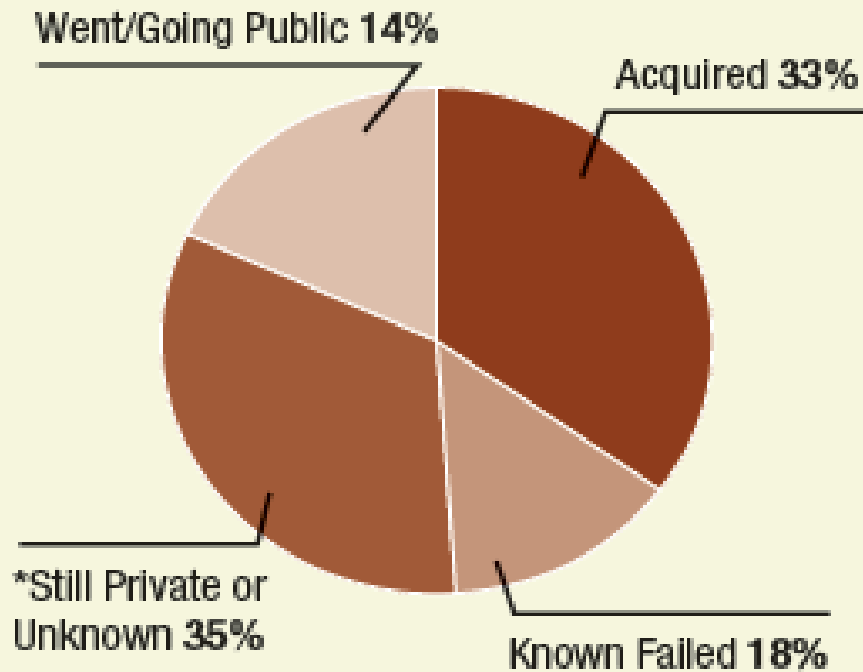


Investors In Venture Capital Funds



Source: 2004 NVCA Yearbook prepared by Thomson Financial using 2003 data

The Exit Funnel — Outcomes of the 11,686 Companies First Funded 1991 to 2000



** Of these, most have quietly failed*

GP compensation

- **Management fees**

- 2.5% of the committed capital per year (sometimes drops after the first 5 years)
- Example: If the management fees average 2% over the 10 year life of a \$100 million fund, management fees in dollars equal \$20 million and only \$80 million **investment capital** remains.
- Main use of management fees: Salaries to VC staff and GPs, working capital and operating expenses.

- **Carried interest**

- The GPs typically receive 20% of the fund's total profit (=exit proceeds – committed capital), called carried interest.
- This provides the GPs incentives to maximize the fund's total profit.
- Some GP-friendly funds use invested rather than committed capital to calculate total profit.
- The timing of carried interest payments to GPs makes a big difference.

VC contracts: Covenants

Description	% of contracts
Covenants relating to the management of the fund:	
Restrictions on size of investments on any one firms	77.8
Restrictions on use of debt by partnership	95.6
Restrictions on co-investment by organization's earlier or later funds	62.2
Restrictions on reinvestment of partnership's capital gains	35.6
Covenants relating to the activities of the GPs:	
Restrictions on co-investment with general partners	77.8
Restrictions on sale of partnership interests by general partners	51.1
Restrictions on fund raising by general partners	84.4
Restrictions on addition of general partners	26.7

VC contracts: Covenants (cont'd)

Description	% of contracts
Covenants relating to the types of investment:	
Restrictions on investments in other venture funds	62.2
Restrictions on investment in public securities	66.7
Restrictions on investment in leveraged buyouts	60.0
Restrictions on investments in foreign securities	44.4
Restrictions on investments in other asset classes	31.1

Why do VCs exist?

- To provide funding to high growth firms that seek external financing to undertake positive NPV projects at their disposal
- VCs mostly fund firms that are unable to borrow from banks (firms that do not have enough collateral and cannot not make timely interest principal payments)

Why do some countries have a well-developed VC sector while others don't?

- Property rights
- Enforceability of contracts
- Private savings
- Ability to exit (well-developed capital markets)