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CHAPTER 3

Fundraising

After reading this chapter, you will be able to:

- Appreciate the incentives of general partners and limited partners in the fundraising process.
- Understand the macroeconomic drivers behind fundraising.
- Anticipate the needs of limited partners.
- Strengthen your base of institutional limited partners and protect yourself against downturns.
- Understand why poor-performing venture firms are able to continue raising funds.
- Raise your first venture capital fund.
- Increase your compensation and fund size over time.
- Anticipate the future of fundraising.

Fundraising Is a Venture Capitalist's Number-One Priority

A lot of people think venture capitalists invest money as their primary job. Don't be fooled; venture capitalists get paid when they raise money, not when they invest it. The ability to raise money from large limited partners separates the professionals from the tourists. It's the single most important thing a venture capitalist can do. If you can't raise money, you can't invest money.

A venture capitalist that can raise a fund is guaranteed a paycheck. When a firm manages a fund, its general partners get a fee each year to cover expenses and pay their salaries. Each year, a typical general partnership might get between 2 and 2.5 percent of the fund they raise in consideration for their management efforts, although management fees as high as 3 percent are not unheard of. For example, a firm that raises $100 million will get $2 million each year it actively invests that fund to split among its partners and pay for office space, flight tickets, and business lunches. Such a firm might actively invest that fund for five years, after which the management fee might decrease substantially.

Raising a $100 million fund ensures that the general partners will earn $10 million over five years, regardless of any investment success. It's a good job if you can get it.

Venture capitalists raise money from large investors entrusted with hundreds of millions or even hundreds of billions of dollars. These big investors, such as university endowments and pension funds, enter into a special type of legal partnership with the venture capitalists that defines their roles. The endowments and pension

funds have little active participation in the partnership. They write checks and later reap the rewards of the venture capital firm's investing activities. Because their role is limited, they are called *limited partners* or LPs for short.

Venture capitalists are the *general partners* or GPs of the special partnership agreement and are actively involved with making investments in start-up companies.

When a venture firm raises funds, it doesn't actually get any money—at least not immediately. What it has secured is a promise from its limited partners to wire money to its accounts in small increments over several years. The venture firm "calls down" or "makes capital calls" for several million dollars at a time from its limited partners to make a specific investment.

To raise funds, general partners can introduce themselves to potential limited partners, seek introductions from other professionals, or hire a placement agent. A placement agent helps dozens of firms raise funds, typically representing a portfolio of both venture capital firms and buyout shops.

A good placement agent is constantly in touch with the managers of large institutional funds and chief investment officers, assessing their needs, and looking for ways to match their money with firms the placement agent represents. It's not unusual for a placement agent to collect a fee near 2 percent of the total amount a fund expects to raise, or much higher.

When a limited partner gets interested in a fund, he or she may request the *private placement memorandum* (PPM). The PPM is a formalized, legal version of a PowerPoint pitch that outlines exactly who the partners are, what they will invest in, how much they expect

to raise, and other details. The document contains about 5 pages of actual content and another 45 pages of boilerplate legalese.

At that point, there are essentially two types of fundraising: easy and hard. Fundraising is easy for firms that have good returns or have been through the process many times. Well-respected venture firm Kleiner Perkins Caufield & Byers, for example, is said to send out only the name of the fund it is raising and the money it expects to collect from a given investor and a deadline to fax back a signed commitment. Newer firms can take years to raise a fund, especially if they don't have a track record of success.

The goal is to sign a *limited partner agreement* (LPA), which defines a partnership between the venture firm and its sources of capital. The LPA will set out the fund's size and the terms and conditions of how the venture capitalists will be paid and will pay back the money limited partners invest. Once the ink is dry on the LPA, the fund is said to have *closed*.

A firm will set a target of how much it hopes to raise at the outset of its fundraising. It can have multiple "closes" as it corrals signatures from limited partners before reaching its target. For example, a firm with a $250 million target might have a first close on $125 million. It would be halfway through its fundraising process.

Targets are flexible. If a venture firm finds it can't raise as much money as it set out to, it can always take the money it has already closed on and begin investing it. Similarly, a firm may face more demand from limited partners than it initially expected and abandon its target to accommodate a larger fund size. Such a fund is said to be "oversubscribed" and probably has many characteristics of what limited partners want.

What Limited Partners Want

Large institutions employ investment officers to make decisions about how to grow their endowments or pension funds. The investment officers are professional finance experts who pick and choose venture capital firms based on a number of criteria.

First and foremost, investment officers want to see a track record of successful investing from the general partners. At one level, investing with a firm that has been successful in the past is a safe strategy. It's an argument similar to "I never got fired for buying IBM." At another level, a firm that has been successful in the past is actually increasingly likely to be successful in the future thanks primarily to enhanced brand recognition among entrepreneurs.

If no investing track record exists, LPs look for GPs to have experience working with each other. The thinking here is that people who have worked together in the past are less likely to come into conflict with each other. That's surprisingly important in small firms where the partners have to be able to rely on each other and function as a team.

LP investment officers also look for impressive people who have experience either as entrepreneurs or executives in the technology field. Investment officers feel that since many successful venture capitalists come from operational backgrounds, GPs with this experience on their résumés have a good chance at being successful investors. A bevy of references from prominent technologists or other executives may be a deciding point in a venture firm's favor.

LPs also look for a differentiated investing strategy. They want to see that GPs have some kind of specific competitive advantage and

will work to exploit that to make smart investments. A team of GPs with experience working in the software industry should focus on investing in software start-ups instead of trying to put money into every sector in the technology industry.

Marketing plays an important role in a limited partner's decision to invest. Not every LP investment officer will admit it, but a little flash goes a long way, especially when a team of investors has yet to establish an investing record.

Historically, limited partners have demonstrated a strong preference for funds that the GPs have personally committed their own wealth to. The idea here is that GPs that have a significant portion of their personal assets tied up in the venture fund they manage will be aligned with the institutions whose money they invest. For example, an LP considering an investment in a venture fund looking to raise $100 million might expect the GPs to commit a bare minimum of $1 million from their own wealth to the fund. Recently, limited partners have begun calling for higher levels of up to 6 or 7 percent of the fund's commitments to come from the GPs.

TIPS AND TECHNIQUES

Learn the Guidelines

Complexity is a problem when it comes to contracts. Venture capital firms and other private equity firms developed increasingly dense agreements with their limited partners, often exceeding 100 pages, during a recent boom in the leveraged buyout business. The contracts were designed to protect the general partners from any type of financial loss.

Limited partner investment officers agreed to these complex contracts either because they desperately wanted to invest in the funds or they did not fully understand the protections that had been written in. That may seem incredible, but it's important to remember that a venture firm needs to understand only one contract, but a limited partner might have to read over a hundred in a year, depending on how many commitments it plans to make.

The Institutional Limited Partners Association (ILPA) wants to see simpler contracts with fewer protections for venture firms and buyout shops. The ILPA represents over $1 trillion in investment assets and has released guidelines for writing contracts. It wants to see fewer clauses that give opportunities for GPs to enrich themselves at the expense of their LP investors.

The list of terms and conditions to avoid putting into a contract primarily apply to buyout funds, but are a good thing for venture capitalists to be aware of too, especially when the issues involve compensation and capital gains distributions.[a] An investment officer at the California Public Employee Retirement System (CalPERS) recently stated that compliance with the ILPA guidelines was driving much of the investment decision-making process at the pension fund.

[a] ILPA Private Equity Principles, http://bit.ly/doSQkl.

Working with Limited Partners

Not all limited partners are created equal. Although most venture firms aren't lucky enough to be able to pick and choose whose money they take, successful firms do have some flexibility.

Venture capital firms that can choose their LPs have a standard set of preferences:

- Avoid money that comes from sources subject to public disclosure laws.
- Diversify the base of investors so no single LP can dictate terms or jeopardize the future of the GP.
- Avoid capricious investors affected by market fluctuation, such as corporations.
- Take money from endowments and nonprofits whose causes you support.
- Seek LPs that will support other fund initiatives.
- Determine if "funds-of-funds" are friends or foes.

The Problem with Public Money

We discussed in Chapter 1 some of the reasons general partners choose not to raise money from public entities such as the endowments of large public universities or public pension funds. Venture capitalists are concerned that disclosing information about their operations may endanger their returns. They feel that the start-ups in their portfolio might get lower bids from potential strategic acquirers should too much information about their financials be made public. Venture capitalists are also concerned that if data about their start-ups' operations are readily available that competing start-ups will benefit from the intelligence.

These concerns have pushed many venture investors to seek private sources of capital, such as the endowments of large private universities, corporate pension funds, and charitable organizations, such as the Ford Foundation.

Diverse Limited Partners Provide Protection

Limited partners are usually extremely stable. There's little concern that Princeton University will shut down its multibillion-dollar endowment, or that CalPERS will abandon its $24 billion alternative asset investment program.

Still, venture capitalists are anxious to move away from relying on just one or two limited partners for their funds. A diverse base of investors protects a general partnership from investors that go out of business. It also helps them weather turnover in investment officers.

Limited partners do go out of business. The financial crisis of 2008 was a wake-up call to that reality. Big investment banks such as Bear Stearns and Lehman Brothers either helped firms raise funds by aggregating smaller investors or had had direct corporate investments in venture funds. Insurance giant AIG had interests in several firms as well.

Some LPs faced short-term liquidity problems during the downturn and specifically asked general partnerships not to call down capital. Others found they had to sell their stakes in venture funds to other LPs. Having a diversified base of investors can protect a venture firm from the ups and downs of any one specific LP.

Each commitment to provide investment capital to a venture fund is based on a personal relationship between a LP investment officer and the general partners of a firm. The venture capitalists have to persuade, convince, and cajole the investment officer to put in money. But what happens when a major investment officer gets a promotion, leaves for another pension fund, or retires?

Limited partners see a lot of turnover. One large university endowment has had four investment officers in the past decade. The level of continuity of the portfolio from one year to the next is

surprising, and suggests that investment officers seldom second-guess their predecessors. But there is always a risk that they will.

Perhaps most important, a diverse base of investors prevents any one LP from dictating the terms of a venture fund's compensation.

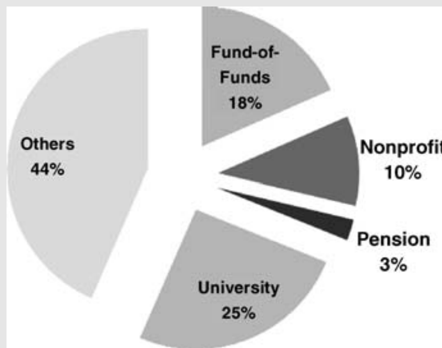
IN THE REAL WORLD

The Right Mix of Limited Partners

Sequoia Capital has a long track record of successful investments and the power to pick which limited partners it prefers to raise money from. Over the years, the firm has developed a diverse network of investors. For the firm's $400 million eleventh fund, raised in 2003, it had more than 65 investors, each contributing 1 percent or more of its funds. But 45 percent of the fund was made up of institutions or individuals who owned less than 1 percent of the $400 million, according to documents filed with the Securities and Exchange Commission.[a] (See Exhibit 3.1.)

EXHIBIT 3.1

Limited Partners of Sequoia Capital XI



Sequoia's biggest investors for its eleventh fund were the nonprofit Ford Foundation, fund-of-funds HarbourVest Partners, the Trustees of Princeton University, the University of Notre Dame du Lac, fund-of-funds Commonfund Capital, Harvard Management Private Equity Corporation, the University of Southern California, Yale University, Vanderbilt University, and the nonprofit Barr Foundation. Each had less than a 3 percent stake in the fund, records show.

[a] Securities and Exchange Commission Files: An S-3 filed in conjunction with the sale of YouTube to Google, February 7, 2007, http://bit.ly/b0TAdi.

Capricious Investors

Venture capitalists are careful to avoid entwining themselves with LPs that have only a recent involvement in venture capital. During the dot-com boom, for example, many large corporations invested their excess cash into venture capital funds. When the bubble burst, CEOs typically terminated their venture capital commitments first, either by selling them to another limited partner or by refusing to finance further funds. This is one reason why venture firms generally do not market their funds to large corporations, hedge funds, or other investors likely to be affected by market cycles.

Venture Fund Allocations as Charity

One of the surprise beneficiaries of the sale of video-sharing company YouTube to Google in 2006 was the San Francisco Opera. The Opera earned shares of Google worth $800,000 through distributions made from Sequoia Capital.

The Opera's endowment weighs in at over $100 million but is not large in terms of LPs that typically invest in venture capital funds. The Sequoia Capital partners likely enjoy the Opera and felt that allowing the Opera's endowment to invest in their fund was a little like donating the investment returns to charity.

Having nonprofits as investors can make venture capitalists feel good about making money for them. More importantly, endowments and foundations have long investment time horizons that match those of venture capitalists. They have experience investing in alternative asset classes such as venture and seldom see spikes in their requirement for cash.

Leverage for Other Funds

A firm that earns great returns for its investors develops some power over its limited partners. For example, it can decide simply not to take money from an LP, or it can cut the *allocation* it gives to the LP. The allocation is the amount a venture firm allows the LP to invest in its fund.

Allocations can become a negotiating tool for successful firms. They almost always face a greater demand for investment allocations than they are able to supply. That allows them to dictate terms to limited partners.

One seldom hears about these negotiations unless they go wrong. This happened in 2007, when the Yale University endowment refused to invest in Sequoia Capital's China and Israel funds.

Sequoia had spent much of 2006 expanding its fund offerings into China, India, and growth stage investments. Some said the firm

was leveraging the brand it built up investing in U.S. start-ups such as PayPal and Google to extract ever-greater fees from a wider array of funds.

Not every limited partner wanted to back these newer add-on funds. Sequoia had built its reputation on doing early stage U.S. deals and had no previous experience investing in India and China. There was no guarantee that it would be successful in these emerging markets.

The *Wall Street Journal* reported that Sequoia kicked Yale out of its Silicon Valley–focused fund in retaliation for not investing in its add-on funds.[1] Sequoia wanted a blank check from its investors, according to a 39-page memo from Yale's investment office leaked to the newspaper.

The venture firm denied the implication that it was holding its most successful, Silicon Valley–focused fund up as a reward to any limited partner that backed its other offerings.

Fund-of-Funds: Friend or Foe?

A *fund-of-funds,* as its name implies, is a fund that invests in venture capital and private equity funds. A fund-of-funds is a good way for small investors to gain exposure to the private equity asset class without having to spend the time to find the best general partnerships to invest in. A fund-of-funds can give LPs access to venture funds they might not otherwise be invited into. But the manager of a fund-of-funds charges a fee and a percentage of the profits from investing, which can make the service expensive.

Some top-tier venture funds don't look favorably on fund-of-funds investors. They feel that their brand equity is used to drive

limited partner dollars to competing firms. The fund-of-funds managers tout their relationship with a single successful firm as a way of raising money for a handful of less successful competitors. Successful firms have been known to boot fund-of-funds investors from their limited partner roster for this reason.[2]

Why Invest in Funds That Lose Money?

One of the fundamental mysteries of venture capital is how firms that lose money are still able to raise new funds. In Chapter 1, you read about the investing results of Aberdare Ventures, a firm that had yet to return even the initial money CalPERS invested in it over the past decade at the time of this publication.

So how is the firm able to continue raising funds? I don't mean to pick on Aberdare, it was just at the top of the alphabetically organized list of CalPERS's holdings. And CalPERS has plenty of funds that do pay off.

Still, a large number of funds the pension invests in will lose money. The National Venture Capital Association's performance statistics presented in Chapter 1, which put the average return over 10 years at 17.3 percent, are misleading. The industry average may be that high, but that number includes a handful of super-performing funds that most limited partners don't have a chance to invest in. CalPERS, for example, probably never gets the chance to even look at private placement memorandums from firms such as Benchmark Capital, Kleiner Perkins Caufield & Byers, or Sequoia Capital simply because it is a public investor and subject to disclosure laws.

It's difficult to know how well CalPERS has done investing in venture capital firms. Since the inception of the CalPERS Alternative Investment Management (AIM) program in 1990, the pension fund calculates that AIM has had an annualized return of 5.5 percent. Venture capital makes up about 11 percent of the AIM portfolio, so it's not easy to figure out how the VC funds impact that overall number.

CalPERS has probably lost money investing in venture capital during recent years, or at least failed to make more than it would had it invested in the S&P 500. Since a handful of firms account for the lion's share of venture capital returns and CalPERS—or any other large public fund—is unlikely to be invited to invest in those top firms, it stands to reason that they're going to lose money investing in venture.

So why invest in venture capital at all then? CalPERS isn't alone in backing unsuccessful venture funds. There are plenty of other large limited partners that sustain an ecosystem of underperforming firms. To many, this may be one of the fundamental paradoxes of the venture capital industry. Why do LPs commit cash to firms that lose money?

Part of the problem lies with the people who make the decisions on what investments an institution makes, the limited partner investment officers. Investment officers are professional investors hired to invest money on behalf of the endowments, pension funds, and other large institutions they represent. They may be well intentioned, but the incentives they face often differ from those of the institution they represent.

There are five major reasons why limited partner investment officers put money behind losers:

1. They consider venture capital as an asset class and bet that an industry-wide boom will benefit every single fund.
2. They hope to get a hit with a first time fund and back a firm with little or no track record.
3. They are compensated based on hitting allocation targets instead of performance targets.
4. They act irrationally and invest in venture capital because they think it is fun or derive personal pleasure from it.
5. They get kickbacks or other sumptuous perks.

Betting on a Boom

Most firms will not make significant returns most of the time, but during a remarkable time, most of the same firms will manage to do remarkably well. For example, during the run up to the dot-com boom, venture capitalists almost had to go out of their way not to make money. As early venture capitalist Eugene Kleiner used to say, "Any turkey can fly in a high enough wind."

Venture capital, as an asset class, is pro-cyclical. That means that when times are flush and start-ups can easily go public or be acquired at attractive multiples, venture firms do very well. They do significantly better than the market as a whole. When times are tough, venture capitalists are hit harder than the rest of the market.

Investing in a portfolio of venture capital firms is like betting on the likelihood of a technology boom. Investment officers may choose

to allocate dollars to venture in order to boost their overall returns during a bull market. As one limited partner investment officer once explained to me, "Buying a lottery ticket can cover up a lot of mistakes if you hit the jackpot."

Hoping for a Hit with First-Time Funds

A limited partner may end up with a bevy of money-losing funds because it is trying to score a big win on a handful of first-time funds.

Imagine investing in a completely unknown firm offering its first fund. The firm could be amazing, a come-out-of-nowhere runaway success as Benchmark Capital was when it debuted its first fund. And although a great first fund is not a promise of a spectacular second fund, it certainly increases the chances of having one.

Or the firm can be a dud.

In one scenario, you make an amazing investment that will boast great returns, make you look smart, and grant you access to a slice of the firm's subsequent funds. In the other scenario, it will be years before the firm ends up an obvious failure.

To make the incentives for investing in first-time funds even more compelling, research shows that it's actually just as likely that a first-time fund will be a top performer as a second, third, or seventeenth fund.

Investing in a first-time fund is a gamble. The only problem is that you don't know the outcome of your initial bet until after you're called on to make a second bet. The venture firm will likely invest the majority of its capital within three or four years and go out to raise a second fund. But it may have yet to prove it can make money, as some start-ups take as long as a decade to come to fruition.

A limited partner investment officer may feel compelled to invest in the second fund because of all the reasons it invested in the first fund. "It's always a two-fund bet," says one investment officer. A third fund may soon follow after that, even though the firm's first fund has yet to record returns.

Suppose then that the first fund reaches the end of its 10-year fund life and the venture firm liquidates its portfolio and returns money to its limited partners. Only then will investors know if the general partners are good at what they do.

It is even more disappointing to find at that point that you've invested in not just one sorry fund, but three.

Allocation Targets

Nearly every white-collar job today features some sort of incentive-based pay and the investment officers at pension funds and university endowments are no different. But what is the proper metric for compensation?

An easy answer would be performance. If an endowment or pension fund's investments do well in a given year, its investment officers should benefit. This isn't always easy to do though, in part because it is difficult to distinguish good investments because they usually perform in tandem with the overall market economy. Compensation based on performance alone may set up the wrong incentives for investment officers, encouraging them to take excessive risks for short-term gains.

But performance isn't the only measurement used in evaluating investment officers. Another common metric is the investment

officer's ability to put money into certain types of assets in given ratios to each other. For example, the Pennsylvania State Employee Retirement System (PennSERS) had a mandate from its board of directors to put 47 percent of its assets into publicly traded stocks and 9.3 percent into private equity in 2009. Limited partner investment officers call these instructions on how to invest "allocation targets."

Each LP sets allocation targets differently, but at a large public pension plan the process can become political. Most pension funds are controlled by a board of directors, which includes elected officials. The board, advised by investment officers and outside analyst groups, comes up with a strategy for the fund to follow. The board then meets four or six times a year to approve potential investments and evaluate the fund's ability to pay out benefits.

Allocation targets may reflect political or popular beliefs instead of the best interests of the fund. Sometimes targets may just be slow to move, leaving an allocation set too high for investment officers to put the money efficiently to work.

That was the case immediately after the dot-com bubble, when pension fund boards looked at the positive performance of venture capital through the late 1990s and concluded that high levels of investment in venture funds should continue. But the limited partner investment officers actually charged with finding attractive funds to invest in would have been hard-pressed to find winning funds in the years after the boom—few, if any, firms were as successful after the dot-com boom as immediately before it.

An investment officer can, of course, hold back on making investments in venture funds when few funds appear to be capable

of producing excellent returns. But many have a "use it or lose it" mentality and fear that if they don't find funds to invest in, their power will diminish.

Others may fear that investing less than a mandated allocation will be seen as a failure to meet the board's goals. Even if their variable compensation is not directly tied to how close they come to their targets, they perceive that they will be rewarded for following orders.

Irrational Reasons

Some limited partner investment officers enjoy investing in venture capital. Meeting with technology experts can feel more like science fiction than finance. Investment officers may find it just more interesting than real estate or oil refineries.

A venture fund may appeal to the personal interests of a limited partner investment officer. It is easy to imagine an investment officer with diabetes putting money into a health care–focused venture fund. The investment may never lead to a direct personal benefit, but there is an undeniable psychological gratification.

Venture capital is also more of a gamble than other asset classes. Holding a corporate bond may be a financially sound investment, but it will never give the wild upside that a venture capital fund will. Some investment officers may seek out this risk because it is a rush.

Others just like to rub elbows with world-changing innovators. "It's cool to go to the annual meeting and see the CTO [chief technology officer] of Facebook, or the CEO of Google," one former fund-of-funds manager told me.

IN THE REAL WORLD

Just for Fun

Some limited partner investment officers just enjoy being involved with venture capital. That's what Udayan Gupta found when he interviewed Sequoia Capital founder Don Valentine for his 2000 book *Done Deals*.[a] Below are Valentine's words, excerpted from the book:

> For approximately ten years I campaigned fairly aggressively with lots of our limited partners that they were putting out too much money. I did not make very much progress. Over the years, after getting to know several limited partners fairly well, I said, ''We must talk about this, because I don't understand what you guys are doing. We have had limited partners with greater than $30 billion in assets. And, when they gave us $10 million and we compounded it at 100% a year, we had no impact on their fund. Why do this?'' The answer was, ''It was much more fun to do this than to invest in bonds. It's more fun than investing in real estate, where nothing happens for a long time.'' So, the reason why a significant portion of money is being deployed—for which I am eternally grateful—is that a whole bunch of people think it's fun.

[a] Udayan Gupta, *Done Deals* (Boston: HBS Press, 2000), p. 172.

Illegal Reasons

Not every investment officer is honest and the potential for personal gain when allocating state money is immense. Although no major cases of venture capital–related fraud have been exposed, the buyouts business is reeling from allegations that the New York State Pension Fund investment officers were accepting kickbacks in exchange for fund commitments.

The case is ongoing at the time of this writing, but the scheme was roughly this: The pension fund investment officers would ensure that a buyout firm got a multi-hundred million commitment if the buyout professionals agreed to pay a bribe.

The pension fund investment officers were unlikely to be held accountable if the buyout funds they invested in did not perform, therefore there was little incentive to pick winners. That makes fraud of this kind difficult to trace and hard to prove. The case in New York took two years of state and federal investigation to crack. It is very possible that a similar situation could be occurring inside the venture capital business but has yet to be detected.

In the Real World

Limited Partner Ethics

Increased scrutiny of the way public funds are allocated to private equity managers has caused some pension boards to beef up their ethics policies. For example, The Teachers' Retirement System of the State of Illinois (TRS) brought its Investment Management Agreement up to par with recent state laws regarding public funds.

It strengthened its ban on TRS representatives receiving finder's fees and rewrote its Code of Ethics and Conduct. Part of the changes require TRS trustees to take eight hours of ethics training each year, file annual statements of economic interest with the state and forbids them from receiving any gifts from those seeking state business. The updated Code of Ethics clarifies trustees' responsibility to avoid any personal benefit accruing to themselves or their relatives from TRS investment.

First-Time Funds

Raising a first-time fund isn't easy.[3] It's on par with a rookie baseball player pitching a no-hitter. Limited partner investment officers want to see a track record, proof of previous investing success, or at least a clear indication that a new venture capital firm isn't going to burn through their money and come away with nothing to show for it. LPs also want to see some sort of proof that the team is robust—that its partners will stick together and not lunge for each other's throats when the going gets rough. How do you prove such things?

There are eight proven strategies for raising a first-time fund:

1. Demonstrate your skill by investing your own money or by making money for your close friends and associates.
2. Quit your job at an established venture firm and hang your own shingle. Be sure to bring your Rolodex.
3. Get a vote of confidence from some other venture firm by signing on as an affiliated fund. But be ready to share your compensation.
4. Focus on a specific industry where you and your partners have the greatest strength and experience.
5. Get help from government programs designed to promote technology and small business. This is especially useful in countries with a commitment to nurturing an emerging tech industry.
6. Prove you can pick good companies and help them grow even without money. Once you've established a track record, take it to limited partners.

7. Get a top-flight general partner at a marquee venture firm to vouch for you.
8. Attract a “bell cow” that every other limited partner will want to follow.

Use Your Money First

One of the best ways to prove you can successfully run a first-time fund is to establish a track record investing your own money. Calling on friends and family can also help get you started.

That’s what the Founders Fund did. Started by successful executives from PayPal, the partners launched a $50 million fund in 2005 that came out of their own pockets and from their well-connected friends. Of course, they had some money to play with. PayPal was sold to eBay for $1.2 billion in 2002. The firm has had a number of successes and raised its $220 million second fund two years later.

Emergence Capital Partners followed a similar path. The firm focused on investing in the fast-moving business of “software-as-a-service,” which is a way of delivering software to users via the Internet.

Emergence was the brainchild of Gordon Ritter, Brian Jacobs, and Jason Green. The three men put together a $1 million first fund by dipping into their own pockets and tapping their friends and family. The only problem in raising money from your friends and family comes if you fail and lose their cash. A big pension fund can write off a loss, but these people know where you live.

Fortunately for the founders of Emergence, the fund’s only investment paid off handsomely. It invested in customer relations

management company Salesforce before it went public. The investment netted a handy return and rocketed two of the Emergence investors to the Forbes Midas List for superior returns.

The investment proved the firm's ability to back a winner and supported their thesis that software-as-a-service was going to be a big business. Emergence put together its first institutional fund shortly after that, collecting $125 million in 2004 from large limited partners.

Spinout from Another Firm

Another good way to prove that you can find good deals and work well with your partners is to split off from some other venture capital firm. The history of Silicon Valley is replete with examples. Opus Capital jumps to mind. The firm spun off from Lightspeed Venture Partners in 2005.

Lightspeed, founded in 1971 as Weiss Peck & Greer Venture Partners, had a rich history, but poor recent performance. At the time of the split, data from CalPERS, a Lightspeed LP, showed that the firm's 2000 fund, LVP VI, had an IRR of −17.2 percent. In a time when most vintage 2000 funds were underwater, this one was particularly bad, lower than the average of −13.3 percent. So Gill Cogan and Carl Showalter jumped ship, brought on repeat entrepreneur Dan Avida, and set out to establish a new firm.

Less than a year later, Opus Capital had signed up $280 million. Much of the money came from limited partners that had backed Showalter and Cogan at Lightspeed. The firm was able to leverage those commitments to entice other limited partners to join.

Affiliate with an Established Brand

Limited partners are more likely to invest in a firm that they've worked with before, so it can make a lot of sense for a nascent firm to partner with an established venture capital brand.

That's something Draper Fisher Jurvetson (DFJ) has used to its advantage, setting up a syndicate of venture funds that share investment opportunities, industry connections, and back-office administrative functions. It can be an expensive option for first-time firms since DFJ doesn't lend its brand for free. Although the terms of its agreements with affiliate funds have never been disclosed, it is clear that the core DFJ partnership gets a taste of both its affiliates' management fee and its carry.

But the deal can work wonders for a new firm. Consider the path of DFJ ePlanet Ventures, a $650 million fund raised in 2000 under the Draper Fisher Jurvetson flag. ePlanet's plan was to invest in start-ups outside the United States.

ePlanet invested in amazing start-ups such as Chinese search engine Baidu, advertising company Focus Media, and European Internet telephone company Skype. Each benefited the investors immensely. The syndication experience allowed ePlanet Ventures to show a track record to investors when it went out without DFJ's backing for its second fund.

Focus, Focus, Focus

One of the biggest problems a new firm has is differentiating itself from others. A focused fund can be particularly attractive to limited partners looking to follow a specific investment thesis, insinuate themselves into an emerging industry, or diversify their holdings.

Focus can also be an indicator of future success. It's easier to do just one thing well than to do a handful of things well.

Glen Schwaber launched Israel Cleantech Ventures with these ideas in mind. The name of the firm says it all: The general partners are looking to invest in Israeli-based cleantech start-ups. It has both a geographic and sector focus.

Being exclusively focused on cleantech made Schwaber's firm attractive to limited partners anxious to appear environmentally concerned. Few firms were looking exclusively at these deals and there was a sense that anything short of a complete immersion in the new field would yield poor results. "The larger all-purpose funds are going to have trouble generating good returns," Schwaber said at the time. "There's an opportunity to be a first mover here."[4]

Get Government Help

Elected officials periodically think technology investment is important or that small businesses drive job creation and improve a country's standard of living. So they open the purse strings of public funds to help out companies and firms that can fit certain politically-set specifications.

Consider the case of New Orleans–based Advantage Capital Partners. The firm recently raised $55 million from investors for a venture capital fund focused on low-income communities in Illinois. The fund qualifies for tax credits under the state's New Markets Development Program, a $125 million stimulus plan passed in 2008.

"We take the tax credits, we sell them and then plow them into the program," says Advantage Capital Managing Director Louis

Dubuque. The firm knows how much it will earn from tax credits based on how much it plans to invest. It can guarantee a certain tax credit for its LP investors once the fund is invested. It's a form of guaranteed return that the firm can use to boost its fundraising efforts. "Instead of raising $1, we get, say, $1.30. That makes the fund larger and allows us to do things that not everybody else is doing," says Dubuque.

It's a nice benefit, but forces the firm to focus on investments in companies that have at least half of their assets and operations in impoverished neighborhoods. Fortunately for Advantage, it has a lot of experience working with this type of program. It has raised more than $318 million over from investors looking for tax credits under the federal New Markets Development Program.

Prove You Can Add Value

San Mateo, California–based Tandem Entrepreneurs launched a $15 million first fund based on the idea that venture capitalists should be similar to service providers—a sort of hybrid financier and headhunter/consultant.

The firm makes an investment in a company and increases its equity stake based on how much help the start-up needs from the Tandem partners. For example, if the start-up calls on the firm to help it find a vice president of sales, the venture firm will get a swath of common stock for the service.

The cost of starting a software company decreased dramatically in the decade before Tandem Entrepreneurs launched its fund. Yet skilled executives and programmers became increasingly

difficult to find. Tandem concluded that start-ups need skills, not fat checks.

The firm's web site summarizes its creed:

> We do not consider ourselves a VC [venture capital] firm. There are three primary types of capital that are required to make a start-up successful—Financial Capital (money), Human Capital (sweat), and Social Capital (friends). VCs bring mainly financial capital, some social capital and limited sweat. We bring value in the reverse order—sweat, friends, and money (much more like entrepreneurs).

The idea behind Tandem's unique plan is to align the incentives of the venture firm with the incentives of the entrepreneur. Company founders expect to get help with meeting customers, recruiting key talent, and managing growth-related issues. The benefit to entrepreneurs of Tandem's twist on the standard venture capital model is that they only pay for the services they actually get instead of blindly hoping their investors will help them grow.

Get Sponsored

Nothing quite wakes up a limited partner like a letter of recommendation for a new venture fund signed by a mega-successful venture capitalist. It's a guaranteed attention getter. A new venture firm looking for investors may turn first to well-established and respected venture capitalists with the hope they will open their Rolodexes and reach out to limited partners.

Venture capital firm Andreessen Horowitz used this technique to get its inaugural $300 million venture fund off the ground during 2009, one of the toughest years on record for fundraising. The firm's

general partners, particularly Netscape cofounder Marc Andreessen, turned for help to the lead partners of three firms: John Doerr at Kleiner Perkins Caufield & Byers, Jim Breyer at Accel Partners, and Aneel Bhusri at Greylock, according to reports.[5] These investors made introductions to limited partners; and the new firm raised its first fund in record time.

Attract a "Bell Cow"

Entrepreneurs often complain that venture capitalists are lemmings that will follow one or two "thought leaders," even as they run off a cliff. No doubt venture capitalists feel the same about the people they get money from: limited partners.

The big limited partner investment officers are perhaps a little less lemming-like, thanks to the long-term nature of many of their investments. But they do watch for what the industry leaders are doing and try to emulate their success.

A successful institutional investor is like a "bell cow," or the one cow that knows enough to go home at night. She's just slightly smarter than all the other bovines, who only know to follow the sound of the bell that's attached to her neck.

Getting an investment from a limited partner that has successful experience backing venture capital firms can go a long way toward attracting other limited partners. Money from a major university endowment such as Princeton, Harvard, or Yale will suggest to other limited partners that a fund has been sufficiently well-researched and obtained a seal of approval.

Bigger Funds

For decades, venture has been one of the few businesses where it has paid to stay small. Venture capitalists have traditionally made their money in the earliest stages of company financing.

Having a big fund meant focusing on late stage companies well into their development. While early stage companies face problems like recruiting a CEO and getting their technology to work, late stage companies worry about securing international customers and going public. Venture firms have historically specialized in one type of investment or the other.

Yet at least half a dozen early stage venture capital firms have pitched what they call *growth funds* or supersized funds to their limited partners. A growth investment is different from a late stage deal and has characteristics similar to an early stage investment, but just requires more money.

The idea is that you can get the same risk-reward profile by investing in one $100 million deal as you would doing twenty $5 million deals. In fact, investing in early stage start-ups can yield invaluable insights into developing markets and technology trends, according to the firms pitching growth funds.

It's an attractive strategy for successful venture firms for several reasons. Bigger funds mean more management fees, for one. But more importantly, they allow general partners to put their skills to work with greater impact. A venture capitalist with one big investment can focus on making that company better, without worrying about doing anything else.

Limited partners have an appetite for venture investing and would prefer to invest with firms that have performed well in the past. Raising a growth fund can be a natural extension of a venture firm's regular operations, if managed well.

IN THE REAL WORLD

Putting Big Money to Work

New Enterprise Associates (NEA) was a traditional early stage venture capital investor, but has been actively looking for mega-sized deals since the dot-com downturn. NEA went very much against the grain when it decided to become involved in growth deals. Most industry experts thought that small deals yielded the best returns and that doing big deals meant sacrificing capital gains. ''Common knowledge said you couldn't scale this business,'' cofounder C. Richard Kramlich said in 2007. ''If so, it would be the only business in the world [that doesn't scale]. We pay attention to every dollar we invest.''

The firm's criteria for making a growth investment are simple. It wants to see a company that needs its help for executive recruiting, strategic marketing, or technology improvements and can rapidly ramp up sales. ''That's really no different from how we approach early and mid-stage deals,'' says General Partner Ravi Viswanathan.

NEA's investment in positioning company Tele Atlas showed that large, growth-style investments could pay off in a big way. The firm, along with another venture capital group, put $210 million into the company in July 2004. NEA helped the company think through its key hires, flesh out its board of directors, and develop a strategy for expanding into Asia.

> The results of the effort were evident in December 2007, when navigation device maker TomTom agreed to buy Tele Atlas for $43.14 a share. NEA had bought into the company for less than $6 a share.[a]
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> [a] For more on growth strategies, see ''Gaga for Growth,'' *Venture Capital Journal,* February 1, 2008, http://bit.ly/98wDfR.

The Future of Fundraising

Venture firms will likely raise funds in more or less the same way they always have, but there are a handful of emerging trends that may mold the way firms operate in the future.

Solo General Partners

One-man venture capital firms or "solo GPs" have had increasing success in attracting institutional investors. These firms may never manage massive amounts of money, but a handful of great investments have proven that this can work as a firm structure.

There are obstacles to this trend catching on. Limited partner investment officers traditionally prefer to have a smaller number of commitments. It is easier for them to research and approve investment in one $500 million fund than five $100 million funds or fifty $10 million funds. Solo GP funds may someday be encouraged to combine.

Longer Fund Horizons

Venture capitalists have always been associated with a buy and hold investment strategy—they often expect to invest in a company and

wait five to seven years without seeing any return. It's like playing Russian roulette, only you pull the trigger now and don't know if you're dead or not for at least half a decade.

But the holding period of some investments is even longer. This is especially true in industries such as clean energy, where companies are working to not just develop technology, but build production facilities and begin massive installations. Venture firms are responding to this by increasing the time horizon of their investment and the lifespan of their funds to 15 or 20 years.

A longer fund life may help venture firms capture bigger returns. Some firms find themselves forced to liquidate their investment portfolios as their 10-year fund life draws to a close. That can mean selling start-ups before they meet critical milestones that would dramatically improve their valuation. A longer fund life would give venture firms more time to see these start-ups fully mature before selling.

Some limited partners already allow venture firms to extend the life of their funds in extenuating circumstances, such as a global macroeconomic crisis or major recession. Venture firms must annually justify extensions to limited partners, typically by promising that at least one of their start-ups will either go public or be acquired very soon.

Streamlined Limited Partner Agreements

Limited partner agreements, or LPAs, have taken on a mind-numbing complexity. These legal contracts establish the rights of

investors and the requirements of the general partners and can run well over 100 pages.

There may be an opportunity to streamline the legal process and make these contracts simpler. Such collaboration between GPs and LPs would lessen the load for those engaged in the due diligence of investment opportunities and prevent hundreds of thousands of dollars going to lawyers.

Summary

Venture capitalists get paid once they've raised a fund, which makes fundraising of paramount importance.

Limited partner investment officers want to invest in firms that have a track record of success. Barring that, they prefer firms in which the general partners have worked together before or have been successful in other ventures. Many limited partners will require the venture capitalists to invest some portion of their personal wealth into the fund they raise, to ensure they are aligned with the interests of the fund.

Successful venture firms may try to pick and choose their limited partners to better protect themselves from public exposure, to diversify their base of investors, or to avoid limited partners who may disappear when times are tough. Some venture firms will save space for nonprofit endowments to invest in their funds, press their limited partners to invest in noncore funds, or may specifically exclude fund-of-fund investors.

Despite careful research and high standards, limited partner investment officers often invest in venture funds that don't make

their money back. Making such a mistake once is understandable, but some investment officers consistently pick poor-performing firms. They do this because of the way they are compensated, because they hope for another industry-wide boom, because they are trying to get a hit with a first-time fund, or because of other irrational or illegal reasons.

Raising a first-time fund is very difficult, in part because LP investment officers evaluate a firm by its track record and first-time funds don't have any record. Venture capitalists looking to get a foothold may consider investing their own savings to prove they can make money or working with an established venture firm for a number of years before going out on their own. Other strategies include affiliating with well-known funds, focusing on an underserved technology sector, working within government programs, or proving they can help start-ups even without money.

Once a firm raises a fund, it may look to raise even larger sums from its limited partners. Bigger funds allow firms to make more investments and possibly get even bigger paychecks. These supersized funds have forced firms to seek new investment strategies.

Fundraising has changed little during the past several decades and seems unlikely to change much in the coming years. Still, a handful of interesting trends could catch on and add new wrinkles to the process. One-man firms are finding favor with investors, some firms are looking to invest for longer time periods, and there is a chance that streamlined limited partner agreements could make the process easier for both GPs and LPs.

Notes

1. "Venture Firms vs. Investors," *Wall Street Journal*, August 28, 2007, http://bit.ly/bbd4DP.
2. "Sequoia Tells Some of Its LPs to Forget about Fund XII: VC Firm Will Likely Not Accept Most Funds-of-Funds in the New Vehicle, LPs say," *PE Week*, May 29, 2006, http://bit.ly/csC2d8.
3. For more on first-time fundraising, consult an excellent article "A Fund Is Born," *Venture Capital Journal*, May 2004, http://bit.ly/99JEmZ.
4. "Israel Cleantech Holds First Close," *Venture Capital Journal*, April 1, 2007, http://bit.ly/cx84Qt.
5. "Made Men: Why Venture Capitalists Sponsor Other VCs," *BusinessWeek.com*, July 7, 2009, http://bit.ly/aOqRKY.