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CHAPTER 5

Finding Investments

After reading this chapter, you will be able to:

- Understand the three ways venture capitalists find investments.
- Develop strategies for proactive outreach to entrepreneurs.
- Invest in and around major new technology platforms.
- Work with universities to commercialize innovation.
- Appreciate the emerging role of venture capital affiliated incubators.
- Create an Entrepreneur in Residence program.
- Understand how the needs of entrepreneurs and venture capitalists make opportunities for alternative strategies.

There are many resources for entrepreneurs looking for financing, but few for venture capitalists on where to find the best investments. This may be because if an entrepreneur doesn't connect with money to grow, he or she goes out of business. A venture

capitalist, on the other hand, feels no similar sense of desperation. It's possible for an investor to go a year or more without writing a single check.

But eventually the investor must make investments. The question is where to look for the best opportunities.

It is useful to think of the venture capital industry as an early Neolithic society, dating back some 12,000 years ago, which relies on hunting and gathering for the majority of its subsistence and has only begun to experiment with agriculture.

Venture investors use those same three techniques for finding the majority of their investments. They gather business cards at conferences and business plans through online drop-boxes. They hunt for their own investments by making calls, connecting with their friends, or stalking down innovators working on new technology platforms inside universities. Venture capitalists can also grow their own investment opportunities by hiring Entrepreneurs in Residence or by working with start-up incubators.

We'll consider a handful of alternative strategies for getting in on good investments once we've covered how the majority of deals go down. Investors too new or too small to engage in the same practices as the established venture firms may find these alternative investment concepts particularly useful.

Gathering Opportunities

Entrepreneurs are always looking for investment capital. That can be a big help to venture capitalists. It's like a zebra inviting a lion to lunch.

One frequently sees entrepreneurs rushing up to investors who speak at technology conferences, thrusting business cards in front of them. It quite literally becomes a scrum tantamount to what you might see in a rugby game, full of pressed flesh and protruding elbows as one entrepreneur tries to edge out another for an investor's attention.

If an entrepreneur makes it through to the investor and successfully inserts his or her business card into the waiting hand, it's then time to fly into an "elevator pitch," where he or she tries to describe the opportunity in 15 seconds or less.

Venture capitalists will either be annoyed or thrilled by the attention, depending on their temperament. They tend to go to conferences early in their career as a form of self-marketing, specifically to collect a lot of business cards and see a large number of entrepreneurs. However, as an investor becomes successful, he or she is less likely to attend such events, since they typically yield a low number of really great investment opportunities.

In order to see an almost unlimited supply of start-ups looking for cash, a venture capital firm may invite entrepreneurs to submit business plans through its web site.

Pitches submitted through the web site are generally considered to be low-value opportunities. In fact, not every venture firm actually checks the submissions. The task of sifting through these pitches often falls to the most junior investor in the firm. About the best treatment such pitches can expect is to be printed out once a quarter to ensure that the venture firm has not overlooked some hidden gem.

John Doerr, a prominent investor from Kleiner Perkins Caufield & Byers who invested in Netscape, Amazon, and Google, said that

his firm received 3,000 business plans from its web site each year. It financed zero of those plans, he told *The New Yorker* in 1997. "Most of these plans are crazy," he said. "People who want to put up a dome over Los Angeles to keep out the smog. Seriously."[1] Intel Capital, the successful venture investing arm of the semiconductor giant, sees a similar level of inbound submissions, says director of strategic investments Eghosa Omoigui. It has only ever invested in one such unsolicited business plan submission.

Venture capitalists can also take meetings with financing fixers, people who contract with start-ups to help them raise money in exchange for a fee. The fixers will meet with the venture capitalist and pitch half a dozen different start-ups at the same time.

Investors also attend special luncheons designed to showcase potential investments. They may pay a membership fee to participate in these pitch meetings. The luncheons typically feature mediocre food and an equivalent level of quality among start-ups.

Gathering investment opportunities in these fashions seldom gives serious venture capitalists enough high-quality deals to sustain themselves. It's like spending a day collecting nuts and berries instead of hunting for a substantial meal.

Hunting for Investments

Some firms don't wait for the best start-ups to come to them. Instead, they turn to proactive measures to find investments.

Few investors will talk explicitly about what they do. Each feels as though he or she has stumbled upon some secret of investing guaranteed to garner great returns. They're nervous that

their competition would readily duplicate whatever trick they've developed for finding the best entrepreneurs or the hottest technologies.

Some venture investors, such as Vinod Khosla, obsessively read scientific and professional journals, looking for breakthroughs they might be able to commercialize. Others track government documents, such as new company registration filings, looking for start-ups that may have managed to slip under the radar. One well-known European investor says he calls a friend who works in the finance division of a large credit card company to find out what start-ups have managed to book big revenue recently.

Personal Connections

There's little secret to how most venture capitalists go hunting for deals though. They first look to the people they know.

More than anything else, this serves as a filter. It's easy for a venture capitalist to feel as though he or she is sitting on a duffle bag full of cash in the center of a gigantic sports arena, with everyone shouting their ideas and pressing forward with outstretched hands. Turning to friends, associates, and other connections first helps quiet the din. It makes the job of venture capitalist more like attending a noisy cocktail party.

The best connections are the people an investor has worked with in the past. It helps if those people have proven themselves to be successful already. These first-order connections can either be entrepreneurs themselves looking to finance a new start-up, or people who can point the investor to an entrepreneur that they know.

"Thou shalt come by way of introduction," says Intel Capital's Eghosa Omoigui to prospective entrepreneurs. And he's not joking. Venture capitalists like to rely on their acquaintances to vet potential investments for several reasons. Successful technology executives are likely to know entrepreneurs within their industry and may be able to offer some insight into what new venture has the potential to be successful. They may also be able to spot other people with the potential to be successful.

Other professionals, such as bankers, lawyers, or academics, may have a vague sense of what investors look for in a start-up and will steer promising investment opportunities to their friends.

Good investment opportunities are often referred by other venture capitalists. These investors may be looking to fill out an investment syndicate, or may be focused on bigger, smaller, or just different kinds of start-ups. Some referrals come from angel investors, or early stage venture capitalists looking to help their portfolio companies connect with a second round of financing.

A sly trick works well for some experienced entrepreneurs. They will approach a venture capitalist to whom they may have some tenuous connection and ask for advice. This can be someone that they swapped business cards with at a conference, someone that they went to business school with a decade or more ago, or even a friend of a friend of a friend.

They'll research what kind of investments the venture capitalist makes and start off a meeting by saying: "I know you don't invest in the kind of company that I'm working to build, but I thought you might be able to offer me some advice as to whether the business makes sense or who I might approach."

It's a great way to garner introductions. The venture capitalist will look seriously at the start-up, relieved of the burden of having to say "no" to its financing, and will likely offer solid suggestions of how to improve it. The venture capitalist is grateful for the opportunity to lecture. Once finished, he or she may be good for an e-mail introduction to another venture capitalist who actually does invest in whatever industry the entrepreneur is pitching.

Young venture capitalists may spend years attending networking events for entrepreneurs and going to technology conferences to build their network of connections. They pass out business cards and chat with people who may not be working on a start-up right now, but are similarly anxious to expand their own Rolodexes. Once he or she is successful, people will thrust business cards into his or her hands at conferences.

A venture capitalist may then turn to these people to either point them toward attractive investments or act as experts to vet other incoming opportunities. Venture capitalists are increasingly using social networking services, such as LinkedIn, to keep track of their growing number of connections.

The best investors know how to really work a room. Point in case: Ron Conway. The angel investor was one of the early backers of search engine Ask Jeeves, and later, of Google. He regularly invests several hundred thousand dollars at a time in 20 to 40 start-ups a year. Watching him network is like observing some kind of pendulous hummingbird, buzzing from one entrepreneur to another, whispering in ears, tugging on arms, and glad-handing other investors with aplomb. He seems to know everybody, no matter how big the gathering.

"Smile and Dial"

A common deal-hunting tactic employed at big venture firms with more than a billion dollars to invest is often disparagingly referred to as "smile and dial."

Under this process, the venture firm will set out a series of guidelines for what it is looking for and then employ a dozen junior associates to cull through long lists of company names and phone numbers. The associate will put on his or her best smile and then dial up each company's telephone number to learn if it is a fit for the firm's investment parameters. Senior partners then review any company that answers the phone and looks as though it might be a match.

The specific criteria junior associates look for varies from firm to firm. But the best-known implementations of such a strategy are at firms such as TA Associates and Summit Partners. These firms aim to be the first institutional investors in companies that are either historically family-owned or have successfully self-financed or "bootstrapped" to serious revenue of $50 million or more.

That net can dredge up any number of investment opportunities in diverse industries across the United States. Many will be unsuitable for a venture capital style investment because of the nature of whatever business they're in. Most companies will not be looking for venture capital investment and may need to be persuaded that they need money to grow faster or expand internationally.

The last mile of consulting, cajoling, and convincing a company that it needs investment capital is the role of the senior investors at the firm. They set the parameters of the junior investors'

search, telling them where to fish. Once a junior investor has a company on the hook, the senior investors will reel it in. This dynamic makes "smile and dial" a strategy that works best in vertically structured firms.

Still, "smile and dial" has something of a negative connotation among venture investors, who would prefer to believe that their work is more art than simply the brute force of junior associates searching for prospects and banging the telephones.

Universities

Venture capitalists have always looked for innovation in and around university campuses.[2] Now, university research is becoming increasingly useful in venture capital-backed start-ups, especially as they look toward alternative energy and efficiency applications.

There's more innovation to take advantage of too. In fact, there's been a 45 percent increase in the number of patents granted to the top research universities over the last decade. And those patents are finding their way into start-ups, typically via licensing agreements. In fact, some 600 start-ups are formed based on university research each year, according to the Association of University Technology Managers.[3]

Still, many venture capitalists have a difficult time figuring out how best to approach schools. There are problems of licensing lab-created technology from the school and a generation gap between investors and undergraduate and graduate-level students. But there are a handful of strategies that do work when approaching universities; see *Tips and Techniques: Dealing with Universities*.

TIPS AND TECHNIQUES

Dealing with Universities

University deals are difficult and time consuming. Even when you find the right technical founder, there's no assurance that the deal will work out. ''Just because somebody's a great researcher doesn't mean that they've got the verve to start Amgen,'' says John Balen, a partner with Canaan Partners.

But if you absolutely must fight your way through the tangle of departmental politics or wrench intellectual property out of the grip of tech transfer officers, at least take some advice from the venture capitalists who have done it:

Educate the Educators

Dan Watkins, DFJ Mercury: ''We like to get to know the university researcher and what they expect to get out of it. Some of them want just to further advance their research and this is just another source of money to them. They all typically have to learn what founders may expect to end up with if they acquire capital.''

Figure Out How to Pay the University

Hanson Gifford, The Foundry: ''Some of these things take easily over a year to conclude. There are a whole lot of compensation plans that can be created. Looking at different plans can help you find an arrangement that's mutually acceptable. Most universities have ended up focused primarily on royalties, and start-up companies are focused primarily on equity and are less sensitive to the impact of royalties, so everyone can come away feeling good about it.''

Watch Out for Corporate Sponsors

Todd Kimmel, Mayfield Fund: ''Let's say I'm spinning something out of the chemistry department. Well, whoever is funding the

chemistry department has to look at the IP [intellectual property] first to see if it's interesting. I don't have a problem with that, but I don't know why it has to take 60 to 90 days.''

Connect with People Who Can Help

Carl Weissman, Accelerator: ''It's just a relationship process. My prime relationship at Caltech was with Larry Gilbert [director of tech transfer] and at University of Washington it's Fiona Wills [director of invention licensing]. They get what it takes to move an early stage technology backed by venture capitalists to an exit. They've been extremely creative in coming up with deal structures that can work with our venture capital syndicate.''

Platforms

When great white sharks swim through the ocean near the coast of California they're often accompanied by remora. The remora fish latches on to the stomach and sides of the great white and picks up the scraps that the enormous predator leaves behind. It's one of the classic examples of a symbiotic relationship.

Venture capitalists periodically want to invest in the remoras of the business world, start-ups that latch on to an enormous corporate technology platform and ride along with it.

Just as computers need software and the Internet needs web sites, large corporations sometimes need smaller companies to adopt their technology to make products people will find useful.

Investing in start-ups to populate an emerging technology ecosystem seems to be a popular thing for venture capitalists to do every

half a decade or so. Sometimes the investors will launch a dedicated venture fund to target new tech platforms. It's a move that garners a lot of attention, especially from those entrepreneurs focused on developing applications using or targeting the new platform.

Few firms make this move with as much panache as Kleiner Perkins Caufield & Byers (KPCB). The firm opened a $100 million "Java Fund" to invest in start-ups using a powerful new programming language developed by Sun Microsystems in the mid-1990s. Sun, a large computer maker originally funded by KPCB and later acquired by database company Oracle, had developed the Java language to make Internet sites more interactive. The venture capital firm believed that more people using the Java language would make it more powerful as an alternative to other programming platforms.[4]

The fund had mixed results. It was a financial success, at least so says Ted Schlein, the KPCB partner who ran the fund.[5] But the start-ups it financed are largely unmemorable, and Sun was unable to take advantage of its burgeoning Java ecosystem in a meaningful way.

More than a decade later, KPCB launched another platform play, this one targeted at start-ups developing applications for Apple's iPhone. The firm's $100 million "iFund" brought many of the hottest iPhone application developers to KPCB's doors.[6]

Other firms have recently begun platform-play investment strategies targeted at different technology ecosystems. Accel Partners and the Founders Fund teamed up with social networking company Facebook to create a $10 million "fbFund," which invests in start-ups building games and tools to work inside Facebook's platform.[7] Bessemer Venture Partners and Bay Partners said they would work with customer-relations management company Salesforce.com to

find and finance start-ups using the company's Internet-hosted software platform. The two firms committed a combined $25 million to the effort in 2007.[8] The technologies these platform funds are focused on come and go. Yet the underlying strategy of launching platform-focused funds to attract entrepreneurs periodically flares up as a popular thing to do.

A Fund for Friends

One of the most effective hunting strategies is to increase the size of your hunting party. The more people you take out into the woods, the more likely you are to spot big game and bring it down.

Venture capital firms have a neat trick for doing just this. They recruit lawyers, bankers, prominent executives, or other successful entrepreneurs to help find great start-ups.

Of course, these high-profile people don't work for free. So the venture firm creates a special fund and invites these people to invest in it. The special fund is called a *sidecar* because it invests beside the venture firm's main fund. Whenever the venture firm makes an investment, a small percentage of the money used will be pulled from the sidecar, and if the venture capital firm earns a return on its investment, some money will be distributed back to the investors in the sidecar. A typical sidecar fund is smaller than $10 million and may be collected from around 100 individuals.

This practice aligns the incentives of a variety of important players in the innovation ecosystem with the interests of the venture capital firm. It's a cheap way to recruit eyes and ears to the goal of finding investments.

IN THE REAL WORLD

Sequoia's Sidecar

The participants in most sidecar funds are a well-kept secret. But Sequoia Capital found itself forced to disclose who had invested in one of its sidecar funds when it sold Internet video company YouTube to Google in 2006.[a] The start-up had raised $11.5 million from investors before selling to Google for stock worth $1.6 billion.

The list of who received stock payouts reads like a Who's Who of Silicon Valley, with more than 70 names of high-profile entrepreneurs, executives, and even entertainers that had invested in Sequoia's sidecar. See Exhibit 5.1 for a sample of the winners from the fund and an approximation of what they made just from the YouTube sale.

EXHIBIT 5.1

Gains from Sequoia's Sidecar Fund

Person	Position	Payout
Carol Ann Bartz	Former CEO of Autodesk, now CEO of Yahoo	$160,000
Dan Warmenhoven	CEO of Network Appliance	$160,000
David Hitz	Founder of Network Appliance	$160,000
Jerry Yang	Cofounder of Yahoo	$160,000
T. J. Rodgers	Cypress Semiconductor Corp. founder and CEO	$160,000
Asheem Chandna	Venture capitalist with Greylock Partners	$120,000
Marc Andreessen	Cofounder of Netscape	$120,000
Michael Marks	Former partner at buyout firm Kohlberg Kravis Roberts & Co., now the founder and managing partner of Riverwood Capital	$120,000
Forrest Sawyer	NBC News anchor	$80,000
Maury Povich	Talk show host	$80,000
Ron Conway	Angel investor	$80,000

It's hard to say exactly what the big-shot insiders who participate in Sequoia's sidecar fund bring in when it comes to deal making—but if it didn't work, the firm probably wouldn't be doing it.

[a] "YouTube payoff benefits array of Sequoia investors," Thomson Reuters's *PE Week*, February 12, 2007, http://bit.ly/bic4oa.

Growing Your Own Investments

Gathering inbound investment opportunities from conferences and the Internet yields few substantive successes. Hunting through personal connections, smile and dial, and searching in universities can help venture capitalists connect with great companies, but it is always an uncertain process.

That's why some venture firms are increasingly growing their own investment opportunities. They're bringing entrepreneurs into their offices to germinate new start-ups and turning to incubators to nurture delicate companies through their most formative phases.

Both techniques give venture investors a high degree of control over the nascent start-ups.

Entrepreneurs in Residence

Why let innovation flourish in the wild when you can nurture it within the confines of your own office? That's the idea behind maintaining an Entrepreneur in Residence (EIR), an executive that may be found at any number of early stage venture capital firms.

The EIR is either a technologist or an experienced corporate manager who keeps an office inside a venture firm while working on a new start-up. EIR spots typically go to people who have proven their potential in some other role, such as successfully founding and running a start-up in the past.

Some people joke that EIR jobs are a form of venture capital welfare because they frequently go to out-of-work entrepreneurs or former founders who are just tired of hanging out at the golf course.

It's a good gig if you can get it. The venture firm pays the EIR a meaningful salary ($10,000 to $15,000 per month) for six months to a year.

During this time, the EIR typically offers part-time consulting to the venture capitalists, helping perform due diligence on potential investments or acting as a mentor to executives at other start-ups within the firm's portfolio. He or she also sits in on formal pitch meetings to hear what other entrepreneurs are working on. This can be a great way to brainstorm, learn about new markets, or take other people's ideas.

EIRs also spend this time working on their own start-ups—companies designed from the ground up to be attractive financing opportunities for the host venture capital firms.

The host venture capital firm may invest in the EIR's start-up once it reaches maturity. There is no obligation for the firm to invest in the resultant start-up. In fact, about half the time no start-up suitable for investment actually comes out of an EIR program. That doesn't seem to be a problem for the venture capitalists. It's cheaper for them to write off an EIR expense than to finance a start-up that's bound for failure. It's also cheaper than hiring someone to go out and look for investments.

There is seldom any contract in place that forces the EIR to pitch his or her start-up solely to the firm that has housed him and paid him for the past six months. However, it would be a major breach of decorum for an EIR to offer his or her start-up to a different venture capital firm first.

There are plenty of examples of successful start-ups born from EIRs. Consider the experience of Kai Li, a computer science professor on sabbatical. Li had been thinking about starting a company for some time, but had never fully committed to the idea. While on sabbatical, he ran into a friend from venture capital firm New Enterprise Associates and, a short while later, was installed as the firm's EIR. In 2001, Li founded Data Domain, a start-up that New Enterprise Associates invested in. Digital storage company EMC bought Data Domain for $2.3 billion during 2009.[9]

Beyond the salary and the exposure to great ideas, the EIR gets access to the firm's Rolodex of industry experts and executives. This can provide a big boost to an EIR hunting for help.

It can also be very useful to be associated with a marquee brand name, especially when an entrepreneur is working on the most formative stages of his or her start-up. A voicemail or e-mail from a random entrepreneur is easy to ignore, but no one in Silicon Valley would ignore the same message if it came from a representative of Accel Partners or Benchmark Capital.

Incubators

Incubator. Just the sound of the word may call to some minds raucous Internet entrepreneurs spinning around in Aeron chairs, burning through money.

Incubators are designed to give several start-up companies a place to work and some degree of back-office support while they are in their most formative stages. The idea is that half a dozen start-ups can occupy the same office space when each has only three or four employees and can move out into bigger offices when they raise venture capital dollars or develop a level of self-sustaining sales. It's a good way for small companies to pool their resources and save money.

The dot-com boom changed the way many people perceive incubators. Several real estate firms in San Francisco opened trendy office space in South Park and other areas in the South of Market area of the city to start-ups looking for a home. The real estate owners took stock options in lieu of rent, hoping their tenants would create billion-dollar Internet companies.

It was a scheme that worked for some, no doubt. But real estate owners are not especially well suited to evaluate early stage start-ups. So a decade after the boom, incubators are seen by many as a cesspool of amateur entrepreneurs and poorly executed start-ups.

Venture capitalists have since adopted the idea of incubators and made them a part of their operations to further vet interesting start-ups and keep costs low while companies develop their first products.

This is particularly useful in the health-care and life-sciences industries, where start-up costs are high due to the need for expensive prototyping equipment and laboratories. For this reason, several venture firms have banded together to provide space, tools, and management skills to the most promising medical innovations and researchers.

Two of the most prominent incubators are The Foundry, which focuses on medical device start-ups, and Accelerator, which works

with health care–focused biotechnology start-ups. Each is designed to do a lot of the hand-holding that is necessary for an early stage technology venture without taking up lots of resources.

The Foundry is backed by Split Rock Ventures and Morganthaler Ventures, each a well-known venture firm with significant life sciences experience. It works with one or two start-ups at a time, helping them navigate intellectual property agreements with universities, giving them office space to work, loaning them tools to prototype their medical devices, and lending a hand with the management and administration of the start-up.

Accelerator is a management company created by a group of health care–focused venture firms, a real-estate firm and the Seattle-based Institute for Systems Biology. Its aim is to utilize the same management, office space, and resources to save on costs for the three to five start-ups looking to prove their worth. Accelerator's executives focus on getting start-ups to critical milestones as quickly as possible. That can help the start-ups raise less money when they go on to collect later rounds of venture capital investment.

Working with The Foundry or Accelerator doesn't oblige a start-up to raise venture capital dollars from the firms that support each incubator. But it does give the venture firms a close relationship with the start-up, making it likely that they will work together for a subsequent financing round.

Alternative Methods

Most venture capitalists are content to gather, hunt, and farm investments. Yet not all are able to. Some firms are too new, too small, or

just too content doing what they do to engage in the same investment strategies as the established venture firms. Instead, these investors have developed their own ways for getting cut into good deals.

Some of these strategies are designed to lure entrepreneurs by solving the problems they face. A venture capital firm called the Founders Fund created a special class of stock to help entrepreneurs who face increasingly long holding periods for their shares. EB Exchange Funds invented a stock-swapping program that allows founders to diversify their holdings.

Another set of adaptive strategies is targeted at alleviating the problems venture capital firms have. Follow-the-leader firms set valuations for later round start-up financings, a service many early stage venture firms welcome. Venture debt and leasing firms give start-ups expansion capital without further diluting the existing venture capital shareholders.

One seldom sees these methods in practice. Today they are at the fringes of the venture capital industry. But they are innovations and have the potential to gain wider adoption if they prove to be successful.

Founders Fund Stock

The Founders Fund is a peculiar venture capital firm created by Peter Theil, a founder of PayPal, and several other former entrepreneurs. The firm began as a formal version of the successful angel investing Theil and the others were doing.

The investors took a number of lessons from working closely with entrepreneurs in the earliest stages of start-up development. The most salient was the long time start-up founders had to

have their personal wealth locked into the common stock of the start-up.

The entrepreneurs involved in a start-up typically leave well-paid jobs to begin their own companies and work for a salary substantially less than they might earn working elsewhere. They may even mortgage their house and max out their credit cards.

The Founders Fund wants to join the best investments and offers a deal to entrepreneurs who are looking at a decade or more wait before their start-ups go public or are acquired. If the start-up agrees to take an investment from the Founders Fund, the venture firm will help the entrepreneurs see cash payouts at regular intervals.

The setup is simple. The Founders Fund first makes a major, multimillion-dollar investment in the start-up, just like any other venture capital firm. Then it agrees to buy a certain number of additional shares at some point in the future. These shares come from the entrepreneur's holding of common stock and the entrepreneur can pick when he or she wants to sell them. The Founders Fund agrees to pay the entrepreneur the same price that the most recent round of preferred shares sold for.

This provision gives the entrepreneurs a guaranteed buyer for their shares and a way to sell their stock at higher prices as the start-up grows. It provides a convenient way for the start-up executives to experience some measure of payment before the start-up goes public or is bought. It's like offering a swig of water to someone crossing a desert.

That helps the Founders Fund find its way into investments it otherwise might not have had access to.[10] Other venture capital firms have attempted to create similar entrepreneur-friendly solutions, such

as establishing credit lines secured by common stock for entrepreneurs who may need money.

Stock Swaps

A small San Francisco firm offers a creative solution to entrepreneurs looking to diversify their holdings while they wait for their start-up to mature to a point where its shares will be liquid.

The firm, EB Exchange Funds, lets entrepreneurs contribute 10 to 15 percent of their common stock to a pool, from which they each share distributions when any of the companies in the pool goes public or is sold.[11] Firm founder Larry Albukerk vets participants and manages the holdings on behalf of the pool, which may include shares from 20 to 30 start-ups.

Steve Larsen, former CEO of Krugle, a start-up search engine for computer code, contributed stock to participate in EB Exchange's third investment pool. He thinks it's a great idea. "Having been through situations where a lot of my family's wealth and savings were in a single stock, having the opportunity to diversify that with people who were in the same boat as me seemed like a great idea," says Larsen, who started four companies prior to Krugle.

The firm's first pool of start-ups had one big hit from the 11 companies that contributed stock. San Francisco–based OpenTable, an Internet-enabled restaurant reservation service that went public in 2009, distributing a fair swath of valuable shares to the other participants in the EB Exchange Funds stock swap.

Albukerk notes that even small returns can have a big impact for an entrepreneur. For example, if an entrepreneur's company fails, he

or she would be thrilled to get just $500,000 from stock in an initial public offering (IPO) delivered to him through the fund, he says. "To the guys that have had an IPO, the difference between $65 million and $60 million doesn't mean much," he says, "but the difference between zero and half a million is big for everyone else."

Follow-the-Leader Investing

Some firms only invest behind well-respected early stage venture capitalists. These follow-the-leader firms will be invited into a Series B investment round by the existing investors to help ratify a start-up valuation and provide a measure of additional capital. They may or may not take seats on the board of directors.

Follow-the-leader firms are ultimately beholden to the leaders for access to good investments. That can mean several things. For example, it can encourage the following firm to arrive at a lower valuation for the start-up's round than a completely independent firm would. This would allow first round investor to continue buying shares in the start-up at a low price.

Although follow-the-leader firms have a fiduciary duty to any start-up on which they take a board seat, they have a strong, long-term financial interest in aligning themselves with whatever the leading venture firms want to do.

The most well-known venture firm to effectively employ a follow-the-leader strategy to gain access to promising investments is Duff Ackerman & Goodrich, which often just goes by DAG Ventures. The firm invests primarily in tandem with Accel Partners, Benchmark Capital, Sequoia Capital, or Kleiner Perkins Caufield & Byers. Each is

a well-respected early stage firm. DAG has made 100 deals over the past decade, only 13 of which were not made alongside one of those four firms, according to data from Thomson Reuters.[12]

Venture Debt and Leasing

Start-ups usually finance their growth by selling equity—that's stock that represents an ownership stake in the company. But they can also borrow money and go into debt. Debt is a tricky proposition for many start-ups, which have no certain stream of revenue or even any major assets to use as collateral. Few banks will make loans to businesses that have yet to sell to customers or don't even own an office building that they can foreclose on.

Still, a handful of firms have sprung up to lend to start-ups. These firms expect both higher risk and higher return on their investment than a traditional bank would. Their role as a lender gets them involved in deals that can turn out to be very lucrative.

The lenders may, for example, write provisions into their contract that would convert the debt notes they hold into a certain number of shares of common stock in the start-up. If the start-up is bought, it could trigger this conversion and the lender's debt would become shares of common stock. That could significantly improve the return on their investment, but it is more generally used to ensure the lender gets paid if the start-up is subsumed into another company.

Entrepreneurs are more than happy to take on debt, when they can get it. Loans are *nondilutive*, meaning a founder doesn't have to trade shares for the cash that comes from a venture lender. That can

be very attractive to a founder who has seen his or her slice of the equity pie dwindle through a series of financing rounds with venture capitalists.

The venture capitalists appreciate venture lenders for the same reason. Fewer claims on a start-up's stock mean fewer people to pay if the start-up becomes successful and makes it to a liquidity event. They're generally very welcoming of venture lenders for this reason, though they may attempt to cap a lender's conversion ratio.

This is why lenders typically enjoy only a limited upside to their investment. About the best they can hope for is to have their principal returned with double-digit interest. The equity holders, such as the founders and the venture capitalists, may enjoy an unlimited investment return. They own a percentage of the company and the company may skyrocket in value.

Missed Opportunities

Few firms will admit to missing out on the next big thing, but it happens all the time. A general partner will fail to spot an emerging industry, or won't be able to see past a brilliant start-up founder's long hair or lack of experience.

Bessemer Venture Partners maintains an "anti-portfolio" of start-ups it had the chance to invest in but, for whatever reason, passed on. The firm's successes are numerous, but its list of misses is impressive. Most notable was David Cowan's shot at Google:

> Cowan's college friend rented her garage to Sergey and Larry for their first year. In 1999 and 2000, she tried to introduce Cowan to "these two really smart Stanford students writing a search engine." Students? A new

> search engine? In the most important moment ever for Bessemer's anti-portfolio, Cowan asked her, "How can I get out of this house without going anywhere near your garage?"[13]

Cowan's story goes to show that you can be in the right place at the right time and still miss out on the right investment.

Summary

Finding promising deals isn't always easy for venture capital investors. There are three major ways to get investment opportunities.

The first is to gather them from the environment. Entrepreneurs pitch venture capitalists on their ideas at any opportunity. An investor need only appear at an industry conference to go home with several dozen business cards and a fistful of business ideas. Unsolicited business pitches from unknown entrepreneurs are unlikely to get much attention from venture capitalists, but sometimes it works.

The second way to get investment opportunities is to hunt out the best entrepreneurs, innovations, and technologies. Most venture capitalists will only look seriously at investments that have been referred to them by a connection, either someone they know or have worked with in the past. Some firms engage in brute-force outreach programs that involve calling lots of companies and trying to convince a handful to accept growth financing.

Hunting for investment opportunities in universities can be difficult because the innovators there are not necessarily focused on commercializing their ideas. There are techniques that work for approaching researchers and their institutions to extract useful technology.

Investing in start-ups that develop modules for emerging technology platforms is a good way for venture capitalists to benefit from the success of corporate giants.

Successful venture capital firms enlist a community of mutual interest to help them find investments. Firms such as Sequoia Capital use a sidecar fund to invest a wider group of people in the success of the firm. The hope is that these executives, lawyers, bankers, and industry luminaries will refer exciting start-ups to the venture firm.

The third way venture capitalists cultivate investment opportunities is to grow them at home. Firms pay EIRs to work on new ideas inside their offices. This can be a low-cost way of connecting with a great start-up in its most formative stages.

Incubators can also help venture capitalists nurture start-ups to a point where they will be ready for serious investment. Sharing resources between early stage companies can help them achieve critical milestones inexpensively.

Beyond the three most basic ways of finding potential investments, firms on the fringe have developed a handful of alternative strategies for getting in on deals.

Some are tailored to fit the specific problems that start-ups and entrepreneurs face. For example, the Founders Fund developed a class of stock that allows entrepreneurs a measure of liquidity before they sell their company or take it public. Stock swapping consortiums, such as EB Exchange Funds, give entrepreneurs the opportunity to diversify their holdings by trading a small portion of their equity with other, similarly situated executives.

Other strategies give investors a way to play a role in promising start-ups by supporting the most successful venture capitalists. DAG Ventures, for example, is well known for cultivating relationships with top early stage firms to gain access into those firms' promising investments. Venture lending and leasing firms provide cash to start-ups without diluting shareholders. That's a big help to venture capitalists and ensures that the venture lenders can have a seat at the table when it's time for a start-up to raise cash.

Notes

1. "The Networker," *The New Yorker*, August 11, 1997.
2. Adapted from "Scaling the Ivory Tower," *Venture Capital Journal*, June 1, 2008, http://bit.ly/cbjjDA.
3. AUTM U.S. Licensing Activity Survey: FY2008, http://bit.ly/cQ2pqL.
4. Java was considered a potential competitor to Microsoft as a programming platform. CNet has a detailed story about the corporate investors who partnered to help the fund and information on the start-ups it backed. See "Java Fund Looks to Long Term," CNet, June 15, 1998, http://bit.ly/9RX5T0.
5. Ted Schlein told me the fund was a financial success. Others have reported the fund earned 50 percent IRR. See "Correcting the Record: Java Fund Not a Flop," *SiliconBeat*, July 20, 2005, http://bit.ly/9LfmRM.
6. The "iFund" is a bit of a misnomer as it is not actually a fund. Rather than establish a $100 million venture fund, the firm decided to pull the money from its existing funds. This affords

the firm greater flexibility, as it may choose to stop investing in Apple applications at any time without the legal restrictions imposed by having a dedicated fund which must invest a certain amount of money for a certain number of years. For a full profile of the fund, read "Kleiner Takes a Shine to Apple," *Venture Capital Journal*, April 2008, http://bit.ly/d82oTi.

7. The fund was initially conceived as a grant-giving program. See "Facebook, Accel and Founders Fund Launch fbFund; To Give Grants to Facebook App Startups," TechCrunch, September 17, 2007, http://tcrn.ch/b7vWi7.
8. Bay Partners had previously launched a program similar to the fbFund, targeted at financing start-ups developing for the Facebook platform called AppFactory. Salesforce.com approached Bay about starting a similar program for developers building apps around its Force.com platform. It turned out that the software-as-a-service (SaaS) giant maintains an internal list of the 50 or so strategic companies that are developing on its platform. "We came to know that six of them were our investments," says Bay Partners's Salil Deshpande. "They saw the success of our AppFactory announcement and saw some of the deals we were doing and it just made sense for both sides." For more on this, see "How to Reboot a Venture Firm," *Venture Capital Journal*, November 1, 2007, http://bit.ly/cQ8Qcf.
9. "6 Months, $90,000 and (Maybe) a Great Idea," *New York Times*, February 28, 2010, http://nyti.ms/a7lV4R.
10. "'Little Rewards' Keep Founders Happy, Motivated," *Venture Capital Journal*, May 1, 2007, http://bit.ly/c5PmrT.

11. For more on EB Exchange Fund, see "Creative Solution for Founder Liquidity Problem," *Venture Capital Journal*, May 1, 2008, http://bit.ly/9Usprz.
12. For more, see "Can DAG Nab It?" *Venture Capital Journal*, October 1, 2008, http://bit.ly/cn40la.
13. From Bessemer Venture Partners's web site, http://bit.ly/a7KuFa.