

## How do venture capitalists create value?

The purpose of this article is to help startups and investors in venture capital funds understand what VCs (venture capitalists) do to create value. VCs are focused on creating financial returns for their investors. VCs often have other objectives, such as helping women founders, or having social impact. Many startups apply to VCs. VCs go through a multi-stage process to filter out startups before making an investment decision.

### Very few startups succeed.

Andreessen Horowitz, a U.S. VC fund with over \$10 billion of asset under administration, has public shared their experience<sup>1</sup>. They receive 3,000 startup applications per year. 200 startups are looked at seriously. 20 startups are funded. Only 8% succeed i.e. 92% failure rate.

### What do VCs actually do to achieve their objectives?

The following facts are from a survey of institutional VC firms (i.e. not private equity, angels investors, etc.) which included: 63% of all VC U.S. assets under management, 9 of the top 10 VC firms and 38 of the top 50 VC firms. The survey results are averages. A startup or VC fund investor needs to research what each individual VC does. I have focused on early stage investments. There are different survey results for late stage VC investments.

#### #01 What is the source of closed deals?

1. 12% of closed deals resulted from a startup making an application
2. 65% came from referrals and the VCs professional network
3. 23% are proactively self-generated by the VC

Startups need to build relationships with the VCs network, in order to enable valuable warm introductions.

Startups also need to build social presence and a network of relationships to enable VCs to find the startup.

#### #02 What does the median deal funnel look like for a VC firm?

- 1) 250 startups are seriously considered
  - 2) 60 result in management meetings
  - 3) 20 are reviewed with partners
  - 4) 13 undergo due diligence
  - 5) 5 are offered a term sheet
  - 6) 4 close
- 1.6% of the seriously considered startups are funded.

#### #03 What financial metrics are used by VCs to analyze investments?

The average VC uses close to 2 metrics. The most common metrics are:

- 1) 56% cash on cash multiple
  - 2) 26% IRR
  - 3) 17% no financial metrics
  - 4) 12% NPV
  - 5) However, 48% often make gut investment decisions and only 12% quantitatively analyze past investments.
- Financial metrics are often used, but the investment decision is not driven by financial metrics. The assessment of the team is the most important factor.

#### #04 What are the VCs IRR and Cash-on-cash multiple requirements for an individual investment?

- 1) IRR 33%
- 2) Cash-on-cash 7.5

The requirements are high because the few investments that do succeed must cover-off the vast majority of investments that fail. Part of the VCs' filtering process is eliminating those startups that do not have the potential for a large number of customers leading to a large amount of revenue.

#### #05 What exit multiple have the VCs achieved according to the survey?

The average is 4.2

27% of the time it's less than 1 i.e. lost money

12% of the time it's 10X

To make an overall profit, VC must have these 10X home runs.

#06 What is the most important factor when deciding to invest?

- 1) 53% is the team
- 2) 13% fit with the fund 12% product
- 3) 7% market
- 4) 7% business model

By the time an investment decision is being made, a lot of filtering has already occurred. Poor products and small markets have already been filtered out. Most VCs focus on the ability of the team to both execute and to make the necessary changes as the team learns more about the market.

#07 What % of VCs believe is the most important factor in the success of their investment?

- 1) 64% the team
- 2) 11% timing i.e. being either too early or too late costs money.
- 3) 7% luck
- 4) 6% technology
- 5) 6% industry
- 6) 4% business model
- 7) 1% market
- 8) 1% misc.
- 9) 0% board of directors. 32% of VCs believe the board of directors is an important factor.

#08 What % of VCs believe is the most important factor in the failure of their investment?

- 1) 60% the team
- 2) 10% industry
- 3) 8% timing
- 4) 7% business model
- 5) 6% technology
- 6) 4% luck
- 7) 3% market
- 8) 2% board of directors

#09 What % of VCs believe is among the most important factors for the team?

- 1) 65% ability
- 2) 59% passion. Passion is a combination of execution and vision.
- 3) 58% industry experience
- 4) 52% teamwork
- 5) 48% Entrepreneurial experience

#10 What does deal closing look like?

- 1) 73 days to close the deal
- 2) 81 hours on due diligence
- 3) 8 references called

Many VCs use consultants to conduct part of the due diligence. Reference calls may be made to: current and lost customers, former employees, suppliers and other partners, other investors etc.

#11 What are the key items VCs demand in their contracts?

- 1) Pro-rata rights
- 2) Liquidation preferences
- 3) Anti-dilution provisions

#12 What % of VCs say their interaction with portfolio companies is in the first 6 months after investment?

- 1) 2% every day
- 2) 28% multiple times a week
- 3) 33% once a week i.e. 63% of VCs interact at least once a week.
- 4) 23% 2-3 times a month
- 5) 13% once month
- 6) 1% less than monthly

A startup needs to be prepared for frequent interactions with their VCs.

#13 What % of VCs take specific actions in portfolio companies?

- 1) 86% strategic guidance
- 2) 81% connect with other investors
- 3) 69% connect with customers
- 4) 65% operational guidance
- 5) 55% hire board members
- 6) 51% hire employees

#14 What benchmarks do VCs think are the most important to LPs (Limited Partners, the investors in the VC fund)?

59% Cash-on-cash multiple  
26% net IRR  
9% relative to VC funds  
2% relative to S&P 500

#15 What are the performance results reported in the survey?

- 1) Cash-on-cash 4.0

#16 What do VCs market to their LPs?

- 1) IRR will be 24%
- 2) Cash-on-cash will be 3.8
- 3) 93% of VC say that they will out-perform the stock market.

**Next steps if you are a startup**

- 1) Find your lead investor who will have the network to draw in your other investors.
- 2) Target VCs who may be interested in your type of startup.
- 3) Define what your VC requirements are (e.g. ability to introduce to customers) and target those investors
- 4) Stay in touch with potential VC with a brief monthly update.
- 5) Understand what the VC needs from an exit and how your startup meets those exit requirements.
- 6) Do reference checks on your potential VCs.

**Next steps if you are an investor in a VC fund**

- 1) Define the role the VC investment class within your overall asset allocation and long-term financial plan.
- 2) Define your financial and non-financial requirements for your VC investments.
- 3) Ask your potential VC for the necessary facts. Cash-on-cash results should be from the investor perspective i.e. net of all fees. Understand whether VC IRR results are based on valuations or exist, and if reflect net investor returns.
- 4) Do reference checks on your potential VC.

**Footnotes:**

<sup>1</sup> <https://corporatefinanceinstitute.com/resources/knowledge/other/how-vcs-look-at-startups-and-founders/>

<sup>2</sup> Paul Compers, Harvard Business School, Will Gornall, University of British Columbia Sauder School of Business, Steven N. Kaplan, University of Chicago Booth School of Business, Ilya A. Strebulaev, Graduate School of Business Stanford, "How do venture capitalists make decisions", April 2017, Page 42 This survey of VC firms included: 63% of all VC US assets under management, 9 of the top 10 VC firms and 38 of the top 50 VC firms.