THE KEMBALL GROUP

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Venture Capital

The term venture capital was first used in The USA during the vexatious times facing the world in the aftermath of World War II. Then as now the challenge was how to meet society's need to fund new companies exploiting new technologies to rebuild economies. Then as now risk capital was available for high growth rate firms in existing industries such as shoe manufacturers and clothing manufacturers, whose demands for capital financing exceeded the capacity of local banks to provide it. Factoring boomed, even warranting an article in the Harvard Business Review in 1949. Then as now factoring alone did not work for very high rates of growth and new firms with new technologies creating new products for new markets, B2B or consumer.

Amongst the public minded individuals who took action to meet that challenge was a wealthy former prisoner of war who had had time to reflect on the troika of new technologies, new markets, and new firms. In early 1946 Jock Whitney put up $10,000,000 of his inheritance to form a fund, J.H Whitney & Co to invest in these situations.

Almost immediately the new fund faced a marketing problem. The New York Times repeatedly mislabeled it as an investment bank. In response Whitney's labeled his new business, venture capital and thereby "created" a new market segment in the world of finance. The term was adopted by others who had risen to the challenge. Amongst them was ARD headed by the industry's seminal figure, Harvard Business School Professor, General George Doriot whose lectures inspired the first crop of venture capitalists across the USA.

Gen. Doriot's enduring vision was to change economies through entrepreneurship. He identified the key task of venture capitalists:

> "We have to judge a man and an idea. The two cannot be divorced.
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> "Judging, measuring, evaluating a man as he is today is not too difficult. There is a record of what he has done under the circumstances.
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> "Where the problem is very much harder is where one wants to foresee how the person to be considered to create and build an enterprise will behave and perform in an entirely new and changing environment very often, if a new technique or method or idea is involved a new environment has to be created." (Original source Gen Doriot's class notes.)

The gold rush had begun. The trouble started when venture capital became a rate of return driven asset class. This focus always a feature of the venture industry on the east migrated west. A bubble ensued. In 1980 the industry raised $5B on the "promise" of a twenty five percent return. The logical inference was that by 1990 1000 New Fortune Five Hundred Companies would be created. During the 1960's and 70's the VC industry had created 10 Fortune 500 Firms. The major difference between the housing bubble of the first decade of the twenty first century and the first venture bubble was scale. By the middle of the second decade of the twenty first century the gold rush was over, the reflated bubble finally burst. Industry returns had been dismal and the number of venture firms was in decline. Experienced practitioners hung up their swords or moved on to other less demanding endeavours. Major sources of funds such as CALPERS withdrew funds from the industry.

There was a silver lining. Amongst the industry carnage it was clear that most of the returns had been generated by a handful. Examination of the distribution of the returns amongst venture capitalists makes clear that a few intellectual descendants of Gen Doriot demonstrated that they up to the task described in his class notes. They demonstrated that it is possible to make a stream of judgments to cope with the troubling troika: prolonged uncertainty during the time required to introduce new products; sell them to new customers in new markets; and build a profitable new company. Doing so is the preserve of a talented few.

Industry structure and problems

The original structures used by Whitney and ARD, single funder and public entity respectively, were supplanted by Limited Partnerships, a financial structure first used by General William Draper. These structures contain a General Partnership organization, whose members earn fees plus an upside on profitable exits, and Limited Partners who put up the bulk of the cash and pay a fee for the privilege, as do investors in mutual funds. Almost all Limited Partnerships are for a defined period of time, ten years is typical, and extensions are common.

The prevalent time frame and compensation arrangements of Limited Partnerships fails to align incentives between the General Partner and Limited Partners, a point made clear by The Kaufman Foundation in 2012, nor between the venture firm and entrepreneurs.

A notable exception to this time frame was and remains Sutter Hill Ventures. Their fund is evergreen. Evergreen funds do not have to focus on the next fund or spend time raising it. Sutter Hill's website explains what this means for entrepreneurs. "Our limited partners have committed long-term support to our evergreen fund which allows us to make long-term commitments to our companies. In addition, a significant portion of every dollar we invest is our own money, and each one of us participates in every investment. This direct investment reinforces each partner's commitment to every company in our portfolio and ensures that we bring every available resource to bear in helping our companies succeed."

The second of three structural problems is that the venture capital industry's high returns depended on the existence of four key investment banks employing analysts dedicated to following firms financed by the venture capital industry before and after initial public stock issues. The so called Four Horsemen were unhorsed by a major disruption in their industry, the disappearance of fixed commission rates on sales of stocks.

The third long standing structural feature of the venture industry is its dependence upon fortuitous coincidence to achieve its promised IRR, occurrence of a point in time where the firm is ready to issue shares to the public and the markets are receptive. Getting the target IRR to satisfy Limited Partners expectations requires such luck. Clearly there is no means to orchestrate the required happy coincidence a decade before hand. The alternative exit, an acquisition, is similarly vulnerable to the state of the stock market. However such exits do permit sales of firms to acquirers the majority of which are for $15 M or under.

It is noteworthy that a principal of one of the Four Horsemen has recently invested in a financial organization seeking royalties on the sales of the companies they fund as the means of exiting from investments. This alleviates the problems associated with requiring a fortuitous coincidence of company readiness and stock market ebullience.

Venture capital in the hands of venture capitalists capable of repeatedly making the judgments described by Gen Doriot more than fifty years ago remains a key resource in any economy. Such people are scarce, as scarce as entrepreneurs with the capability to build wealth creating businesses. The key change is that Post World War II the demographics were favourable, now they are unfavourable.

As it was in the 1940's when the venture industry got its name, venture capital is not the only type of risk capital available to entrepreneurs. Today those who seek to grow businesses whose requirements for other peoples' money are beyond the banks' capacity have angel capital as an option. Angel capital provides at least as much funding as venture capital and can satisfy the needs of many who seek venture capital but will not get it. However attention will have to be paid to exits for angels beyond IPO's and acquisitions. Angel funding can also be combined with factoring, itself a form of risk capital, to provide all the capital needed to grow a business. Venture capital has utilized this combination for years.

Crowd funding platforms, such as GUST, AngelList, and Kickstarter, play a role in making funds available from more sources. It is estimated that 2 to 3% of firms on AngelList that have merit. Few are candidates for venture capital. The advent of this class of platform has disrupted a centuries old tradition of access to funding tied to who you know, “Rolodex” access, with access based on merit as assessed by a global marketplace.

Gen. Doriot’s vision endures. The validity of his description of the task facing potential supporters endures. All who seek to profitably support building good products and bringing them to market by a purpose built organization, succeed based upon excelling at the task Gen. Doriot described or based upon luck.

One aspect of the challenge for entrepreneurs leading high growth rate firms has decreased -- identification of sources of funds. But the core of the entrepreneurs’ challenge remains. Should they use other peoples’ money? Then as now, entrepreneurs need to choose wisely from amongst the plethora of sources of capital. Getting the right kind of money from the right kind of people for their business and their capabilities lets them achieve more and keep more.