What Do Venture Capitalists Really Do, and Where Do They Learn to Do It?

FRED DOTZLER

FRED DOTZLER
is a founder and managing director of
De Novo Ventures in
Menlo Park, CA.
fred@denovovc.com

Understanding the tasks performed by venture capitalists is important for a wide spectrum of professionals. Individuals considering pursuing a career in venture capital should have a clear conception of just what the job requires. Managers of partnerships must focus on these tasks as they analyze their hiring needs. Additionally, it is valuable for institutional investors to understand the various duties of venture capitalists so that their expectations of the venture capital partnerships they back are realistic and in line with the skills of the partners.

An excellent article in a previous edition of this journal summarized a survey of venture capitalists.[1] The intent was to develop insight into what makes a successful venture capitalist.

The objective of the present article is to shed additional light on the various activities of a venture capitalist, putting emphasis on the skills required and how these skills might be acquired. It will become obvious why "operating experience" is so important, especially to investors in seed and start-up financing rounds.

The five major activities of a venture capitalist are as follows:

- Solicit or create investment opportunities
- Evaluate companies
- Negotiate the terms of investments
- Help build successful companies
- Liquidate investments

I describe each activity and offer my perspective about where one might develop the necessary skills. After discussing these five crucial activities, I explore fundraising and many of the other functions of managing a venture capital partnership.

SOLICIT OR CREATE INVESTMENT OPPORTUNITIES

An incoming partner should be able to provide deal flow—a stream of business opportunities in which to invest—from past relationships. Without adequate opportunities to evaluate business proposals, a partnership is unable to make investments. Each partner of a typical venture capital partnership is expected to make two new investments per year, so sufficient deal flow of investable opportunities is critical. Following is a description of the wide variety of sources of these opportunities.

1. An individual's personal network can be a solid source of investment opportunities. This includes co-workers from previous employment, contacts within the industry where the person worked, and the individual's network of friends and acquaintances.
2. Another deal flow source stems from visibility within the industry. If the partner has been a spokesperson for his company or industry, or if he has gained visibility through publishing or speeches,

his name recognition is likely to prompt entrepreneurs or early-stage investors to approach him with business plans for fledgling companies.
3. One's network of professionals developed over the years—including law firms, patent attorneys, business consultants, accounting firms, etc.—may introduce entrepreneurs and send business plans to a venture capital partner.
4. A partner with an entrepreneurial bent might be able to launch a company from within a venture capital partnership. This individual would probably have technical training and start-up experience. Some partnerships start companies by having a partner work with an entrepreneur (sometimes an entrepreneur-in-residence) to generate ideas and refine a business plan.

Access to deal flow from a partner is more important for a newly established partnership, and perhaps less important to an existing partnership whose reputation and recognition are already established among the entrepreneurial community. An established partnership might have sufficient deal flow and need a new partner primarily to help evaluate opportunities already overflowing the desks of the partners.

In general, the major sources of deal flow for someone joining a venture capital partnership are contacts from previous employment—whether an operating company or a firm providing professional services.

For any partner, investment opportunities might be introduced by other venture capitalists, especially those who are co-investors in portfolio companies. Employees who leave successful companies that the partnership backed are potential founders of fundable start-ups.

EVALUATE COMPANIES

There are four major areas that venture capitalists evaluate when determining whether to invest in companies.

Products and the Technologies on Which They Are Based

In evaluating the products a start-up is developing, the venture investor wants to know that they can be developed within a reasonable time frame for an acceptable investment of capital; that they can be manufactured at a reasonable cost; and that they will likely be protected by patents or trade secrets. A prospective venture investor will usually look for a list of development steps and carefully analyze the cost required to complete each milestone. Investors decide whether the technology is expandable into a broad line of products over time. Patent attorneys can be engaged to validate the patentability of proposed products and make certain that the company has legal freedom to operate.

Awareness of industry technology trends is invaluable in projecting the readiness of the market to accept novel products and to assess the likelihood of product obsolescence. If a technology is particularly complex or esoteric, it might be impossible for the venture investor to perform a thorough analysis and evaluation. Usually the investor then employs a consultant with relevant expertise. Over time, venture investors develop networks of consultants who are familiar with different technologies.

An ideal background which would enable one to evaluate products and technologies would be technical training and work experience in an operating company in engineering, science, or clinical affairs. Someone who has worked in business development might also have the facility for evaluating companies in this technical dimension. Education in engineering, science, or medicine is helpful.

The Market and Marketing

A venture capital investor needs to determine whether there is a market need for the products under development by the target company, assess the size of the market and sales growth potential, and project the rate at which the new products will penetrate the market. Is the company pursuing a viable strategy to build a company with significant value? Are the parameters that the company used to prepare its forecast of sales and earnings reasonable? How do the proposed products compare with those already offered by competitors?

The venture investor must assess how the products will be sold (direct, indirect, OEM, or direct response), how they will be distributed, and what price will be charged. It is valuable to assess what market segments are likely to buy the products initially so that the fledgling company's scarce sales and marketing resources can be properly focused.

If the company is already selling a product, the prospective venture investor will want to talk with current customers as well as prospects. Are the customers using the product? Why or why not? What do they like and dislike about it? How can it be improved? Will they order it again? If prospects have not yet purchased the product, it is important to understand why.

Some industries have specific issues to consider before investing. For example, in the healthcare industry, investors must consider the time and costs required to obtain government approval to sell pharmaceuticals and medical devices. They want to ensure that payers (insurance companies, the government, or patients) are willing to provide reimbursement for the proposed products.

Investors who have functioned in a senior marketing position in an operating company, including president and CEO, have the requisite background to evaluate the market potential for products in the markets where they have competed. Similarly, those who have functioned in business development would have exposure to various market segments within their industry. A position in sales helps one to understand products, customers, and competition.

Industry analysts or partners in corporate finance at investment banking firms often have in-depth knowledge of the markets they have covered. Consultants who have performed strategic consulting assignments in specific industries would also have insight into the markets and may have developed well-honed assessments skills.

The Management Team

Venture investors have to judge the capabilities of management teams. Do they have a track record of success? Do they have the relevant industry and functional experience? Can they lead people and organize resources? Are they highly motivated? Are they honest and ethical?

Investors also have to assess how difficult it will be to recruit new team members. Some start-up opportunities are sufficiently large and obvious that recruiting is not a major obstacle. For other start-ups, recruitment may be a far more arduous proposition.

The best experience anyone can have for assessing and helping to hire management teams is prior experience hiring and managing people. Important hiring skills include the ability to interview and assess candidates, and the ability to check references.[2] These are skills that cannot be acquired in the abstract through reading books or talking to people.

Financial Considerations

A venture capitalist must be able to calculate a projected financial rate of return for a proposed investment. To do so, one must project the amount of money that will be invested over time, estimate the valuation at which capital will be raised, and anticipate a terminal value for the company. A model can be developed to facilitate this valuation analysis.

If a partnership is investing in a Series A Preferred round for a company that has no history, there is usually no significant past financial information to evaluate. The longer the company has been in business, the more important it is to examine historical balance sheets, profit and loss statements, and cash flow summaries. One must be able to assess the details used for creating the projected profit and loss statement and have the means to assess whether the major expense categories are adequately budgeted.

Financial skills are even more important in venture capital partnerships investing in late stage companies. Since the products and markets are often well defined in such companies, assessing these areas is more straightforward.

One can acquire financial evaluation skills as a financial officer in an operating company. Similarly, working in finance at an investment bank provides useful training. Educational courses in finance or accounting are also valuable.

NEGOTIATE THE TERMS OF INVESTMENTS

The most important negotiating point when investing in a private company is the pre-financing valuation—the price per share multiplied by the total number of shares outstanding prior to the financing, computed on a fully diluted basis. The major factors to take into account when establishing this pre-financing valuation include the strength of the product and technology, the market size and rate of penetration, the strength of the management team, and financial considerations.[3]

An important point of negotiation at the time of each financing is the size of the pool of stock options reserved. These options will be used to recruit new management team members and to incentivize existing management, and are usually factored into the pre-financing valuation.

Many other terms are negotiated in each financing, but liquidation preferences and anti-dilution provisions require particularly careful consideration. Liquidation preferences define in what order preferred shareholders will receive proceeds from a liquidation, sale, or merger of the company. Purchasers of preferred stock generally request return of invested capital prior to any distribution to common shareholders.

Anti-dilution provisions protect investors in the event that money is raised in the future at a price lower than the current financing. A pre-negotiated formula is used to calculate the number of additional shares that will be issued to current investors if a financing is completed at a lower price.

Other financing terms are summarized elsewhere.[4] A venture capitalist, with support from legal counsel, reviews and approves all legal documentation prior to making an investment.

Lawyers who represent start-up companies are adept at analyzing the impact of various financial terms. Additionally, senior management in start-up companies who have completed several rounds of financing have usually learned the importance of various terms of investment.

Of the five major tasks performed by venture capitalists, negotiating the terms of investments is probably the least important for someone joining a partnership. Although good general negotiating skills are valuable, the details of negotiating investments are often learned on the job by a new partner. Each partnership emphasizes different terms, so prior experience does not always apply to a new environment.

HELP BUILD SUCCESSFUL COMPANIES

To help determine where venture capitalists add value, I surveyed a representative sample of 10 presidents and founders of more than 20 life science companies. The questions that I posed are shown in Appendix A. In order to rank the responses, I assigned a value of 2 to represent "very important" (V), 1 to represent "moderate importance" (M), and 0 to represent "not important" (N).

The most important area where venture capitalists add value—as perceived by founders and CEOs—was in the arena of advice and introductions for financings. Among the factors considered in planning a financing are the amount of money to raise, when to raise it, and whom to target as prospective investors. It is valuable to understand what types of investments are preferred by other venture capital partnerships so that high-probability investors can be contacted first. Boards and management teams must discuss the pre-financing valuation to be sought and agree upon an acceptable range.

The best way to garner this experience is to work as a CEO, CFO, or founder of a start-up company that will complete several rounds of financing. One can also gain insight on these financing variables by reviewing the historical financings of other companies in the industry.

The second most highly ranked area of importance is help in establishing and reviewing the company's strategic focus. Skills that come into play in this arena would be developed either by running a company, working in a high-level marketing position, or advising high-level executives in the capacity of a strategy consultant.

Another highly rated area is recruiting and hiring senior management, including CEOs and vice presidents. Venture capitalists help evaluate candidates through the interview process, and they lend a measure of credibility and an aura of financial stability to the developing company. Venture investors with solid industry contacts can often identify potential board and advisory committee members.

The next most highly rated area is providing a sounding board for CEOs. This requires good listening skills and an operating experience base enabling one to provide helpful feedback.

Help with liquidity is next. A venture capitalist should have a strong sense of when a company is ready and market conditions are favorable to complete an initial public offering (IPO). An important contribution may be advice about whether to sell a company as a path to liquidity—either in response to an offer to buy the company or because the company is not meeting shareholder expectations. Helping introduce a company to investment banks interested in a particular industry, for an IPO or a sale, can be very important.

Advice on organizational planning and consultation rates next. Venture capitalists typically work with many different companies and are privy to the details of various compensation structures. They often subscribe to compensation surveys, which can be valuable aids in establishing compensation levels including salary, bonus, and equity.

Next on the list of tasks performed by venture capitalists is providing feedback on management's performance. Skills required include the ability to establish reasonable performance objectives, and to establish a trusting relationship with management so that feedback is provided by the company to the venture investor.

Three areas were rated so low that they hardly merit comment. These are 1) help in establishing strategic relations with other companies, 2) selection of professionals, and 3) functional advice. Apparently management teams feel confident in their own abilities in these areas and rarely seek their investors' input.

Most of the skills required to help management build successful companies are developed by serving in executive roles in operating companies. Experience in actually building companies is far more applicable than is a history of observing or advising companies. Taking courses and reading books and articles provides some insight into operating issues, but these are no substitute for getting into the trenches and learning the lessons firsthand.

LIQUIDATE INVESTMENTS

The final task of a venture capitalist is to liquidate investments. There are two different avenues for liquidation: a public offering and a sale of the company.

A public offering provides additional capital for building the enterprise. On the negative side, it does not offer immediate liquidity for existing shareholders, including management and venture investors: they are required to sign lock-up agreements prohibiting them from selling shares for at least six months. Public offerings usually are not feasible for single product companies, for those with low growth potential, and for companies with unpredictable earnings.

The primary alternative to an IPO is merging the company with a larger existing company, either public or private. A large company may want to acquire an early stage firm to enter a new market, to protect its franchise in a market or to take advantage of economies of scale. Mergers usually result in instant liquidity for all existing shareholders. The most important negative is that the upside potential of the company is capped unless an earn-out is negotiated. In addition, the present management team loses control of the corporation.

Investors in later stage companies typically place greater emphasis on developing strategies for liquidating investments. The potential for liquidity in a reasonable time frame is carefully assessed at the time of the initial investment. Contacts with investment bankers who concentrate on the specific industry are valuable, as are contacts with senior executives of potential acquiring companies.

Two career paths are likely to offer an eagle's eye view of liquidation events. Members of a start-up's senior management team—one that has gone public or been acquired—will understand the process. Second, investment bankers who have been involved in a variety of public offerings and acquisitions and mergers will garner tremendous experience and know-how.

If one has successfully built a solid company with a good management team and high growth potential, achieving liquidity is usually the easiest part of the venture process.

MANAGING A VENTURE CAPITAL PARTNERSHIP

I have described the five important steps performed by all partners in a venture capital partnership. In addition, one partner generally takes responsibility for overseeing the partnership's management. In a large firm, or one that has partners with appropriate skills, several partners can share these tasks. As partnerships evolve, the partners typically add a controller or administrative officer to help manage internal operations.

Fundraising is the most important component of managing a venture capital partnership. Before investing, a partnership must raise a significant amount of capital. To do this, partners continually identify and court institutions likely to be interested in partnerships with their particular focus—industry, stage, size, and geography.

Assuming the partnership has previously earned an acceptable rate of return for investors, venture capitalists employ certain critical skills during the fundraising process. First is the ability to organize historical investment data, the partners' backgrounds, and investment terms into a private placement memorandum for prospective investors. Next, they must convincingly present the material to the prospective investors. Finally, the partners must convince prospects to invest.

At least one partner should have successful prior investing experience. Lacking this, the partnership must have an involved advisor or mentor with prior venture capital experience to guide the partnership, lend credibility, and minimize investor risk.

Below is a list of some of the other tasks of managing a venture capital partnership.

- Project cash flows and the timing of capital calls
- Prepare an annual budget
- Manage partnership expenses
- Report to limited partners—financial reports and portfolio progress
- Manage legal documentation for the partnership
- Store and track stock certificates
- Recruit and manage staff
- Submit required filings—taxes and SEC reports
- Purchase appropriate insurance (directors' and officers' liability, workers' compensation, general liability, etc.)
- Administer benefits (health and dental insurance, 401K, etc.)
- Initiate public relations and marketing

Institutional investors evaluating venture capital partnerships will want to ensure that the partners are not all the same age; otherwise partnership succession may become an issue. Some diversity in backgrounds of the partners may be valuable so that different perspectives go into the decision-making process.

SUMMARY

A broad range of skills is required to perform the many tasks of a venture capitalist. It is highly unlikely that any individual will be proficient in all of them upon first joining a partnership. Many skills are honed after joining a venture capital partnership by making investments and working with portfolio companies, and by interacting with experienced investors.

If one is considering pursuing a career in venture capital, one can review Appendix B to see where requisite skills can be developed. Since no single position will enable one to learn everything, it might be wise to plan a series of career steps prior to pursuing venture capital.

The job of a venture capitalist is broad based: To generate a stream of good investment opportunities. To carefully evaluate opportunities and decide whether to invest. To negotiate the terms of investment for any prospect that exceeds the investment criteria established by the partnership. To serve on boards of directors and help build successful companies. To help liquidate investments at valuations that earn all shareholders an acceptable rate of return. A series of relevant jobs and an appropriate educational background will help prepare someone interested in venture capital for this diverse and challenging career.

ENDNOTES

[1]Geoffrey Smart, Steve Payne, and Hidehiko Yuzaki, "What Makes a Successful Venture Capitalist?" *The Journal of Private Equity*, Fall 2000, pp. 7-29.

[2]Fred Dotzler, "Hiring an Interim Chief Executive to Run a Start-Up Company," 1994, http://www.denovovc.com/entrepreneurs.html

[3]Fred Dotzler, "What Percent of a Medical Company Should Founders Sell for Seed/Start-Up Venture Capital?" 1991, http://www.denovovc.com/entrepreneurs.html

[4]Fred Dotzler, "Raising Venture Capital: Tips for the Medical Start-Up," 1994, http://www.denovovc.com/entrepreneurs.html

APPENDIX A

Where Venture Capitalists Add Value

The following is a list of areas where venture capitalists purport to help private companies. Please rate these factors, V for very important, M for moderate importance, and N for not important, as you evaluate the contribution made by the venture capital investors in your company. (The factors have been rearranged in descending order by total score.)

Factor	Total Score
Financings, Advice and Introductions	19
Strategic Focus	17
Recruiting and Hiring Senior Management—CEOs and VPs	16
Sounding Board for CEO	15
Liquidity Planning and Execution	14
Organizational Planning and Compensation	12
Feedback on Performance of Management	11
Selection of Professionals, Law, Patent, Accounting, etc.	5
Strategic Relations with Other Companies	4
Functional Advice in Marketing, Engineering, etc.	2

For scoring and ranking 2 was assigned to V, 1 to M, and 0 to N.

Participants: G. Bang, D. Burns, R. Chess, J. Griffin, M.D., T. Kahlenberg, R. Lipps, L. Malchow, R. Rosenbluth, Ph.D., J. Wilson, R. Yamamoto. The total average score per respondent (out of a maximum possible of 2 × 10 = 20) was 11.5, the medium score was 11.5, and the range was 7 to 15.

Appendix B

Where Venture Capital Skills Can Be Acquired

STEP			COMPANY OPERATIONS						BUSINESS SERVICES				EDUCATION			
			(1) CEO	Founder	Licensing, Business Development	Marketing	Engineering, Research, Development	CFO	(2) Investment Banking	Consulting	(3) Legal	Executive Search	MBA	(4) Engineering, Science	Medicine	Law
I.		Generating Deal Flow	X	X	X	X	X				X					
II.		Evaluating Companies														
	1	Products/Technologies		X	X		X			X				X	X	
	2	Markets/Marketing	X		X	X			X	X			X			
	3	People	X			X	X	X				X				
	4	Financial	X					X	X				X			
III.		Negotiating Investment Terms	X	X	X			X			X					X
V.		Helping Build Successful Companies	X	X		X	X	X								
VI.		Liquidating Investments	X					X	X		X					

(1) CEO of early stage company; may be good at evaluating products and technologies if he or she has had prior technical experience or education.

(2) Has been involved in public offerings and mergers and acquisitions.

(3) A corporate lawyer representing early stage private companies.

(4) Bachelor's degree valuable, advanced degrees more valuable.