

“Criteria for Evaluating VC Fund Investment Opportunities”

Venture capital (VC) funds are unique investment vehicles:

- they have long investment time horizons (typically 5-10 years),
- they deliberately look for high risk/high return investment opportunities,
- they are not publicly traded, so they are difficult to liquidate before their natural maturity, and
- in most cases, you don't know what specific deals they will be investing in at the time you make your commitment to the fund (they are “blind pools.”)

What criteria can you examine before you invest to try to identify the funds with the highest likelihood of successful outcomes?

1. Team

Like the old adage that the most important criteria in real estate are “location, location, and location,” the most important criteria in venture capital fund investing are “team, team, and team.” The managing team members are the individuals who will be finding, negotiating, and directing the investment of your money. They need to be smart, trustworthy, and expert in evaluating the type of deals the fund intends to focus on.

Additionally, venture fund managing partnerships tend to have a high “divorce rate”: teams sometimes find they have irreconcilable management differences and need to be restructured mid-fund, which is akin to changing horses in the middle of the stream. Look for teams that not only have the skills to succeed, but also are likely to have formed stable, long-lasting partnerships. Past track records are important indicators of this. Don't hesitate to ask pointed questions.

2. Deal Flow

VC funds compete fiercely for the best deal flow. While entrepreneurs often feel that money is hard to come by, VCs actually feel it's even tougher on their side of the table, in search of deals that will provide the super-high returns venture investors are targeting.

To be credible in their promise of strong results, venture funds must demonstrate how they intend to secure the cream of the crop deals in their target industries. Do the partners have referenceable, preferred relationships with universities, technologists, or serial entrepreneurs? Do they possess deep, specialized expertise that helps them identify value in deals other VCs won't notice? Do they have unusual cultural or political connections to help grow their portfolio companies at an above-market rate? Ask the team to articulate their unique strengths.

3. Focus Area

Some markets are hot, some markets are not. The ideal industry for a venture fund to target is one that (a) is potentially huge, (b) anticipates an exponentially high growth curve ahead, and (c) is stalked by several cash-rich companies looking for acquisition candidates. Note that these characteristics should describe the future expectations for the target industry over the next ten years, not how it has performed over the past decade.

Since potentially large, high growth, liquid markets like this attract a lot of attention, the managing team should explain its strategy for aggressively cornering the best deals in this environment (see “Deal Flow” above.)

Beware the so-called “opportunistic” investment strategy, which holds that the venture team will stumble across attractive investments, screen them by gut feel rather than particular expertise, and attain above-average investment returns because markets are inefficient. That’s unlikely to happen.

4. Follow-on Relationships and Syndication

Almost no one can go it alone. The vast majority of venture funds depend on mutually supportive relationships with other VCs to co-finance (syndicate) deals, particularly as their portfolio companies grow and need additional capital (“follow-on rounds”). Syndication lets funds diversify by investing in more deals for less money, reducing their overall portfolio risk. Syndication partners can also bring special talents to the table, to help portfolio companies with management recruiting, business development, and liquidity (finding acquirers for the company).

Positive, reliable relationships with syndication partners can also help protect a fund if it doesn't have enough money to lead or take its pro-rata share of a follow-on round. If the fund has the respect and support of other members of the private equity community, it is less likely to face a “cram down” or other hostile, hard-ball treatment from VCs with more negotiating power.

5. Last but not least... Track Record

One of the golden rules of investing is that “past performance does not guarantee future results.” If the team you’re considering investing with has not adequately provided for the above factors –

- partner suitability and harmony,
- competitive deal flow access,
- focus in an industry that anticipates high growth and healthy exits, and
- supportive syndication relationships

- bragging about past returns should not reassure you.

Ask yourself, and the VCs, what the key success factors were in achieving their past results, and whether these same elements are present in their new fund. A strong track record is important, but only if you believe they have the ability to duplicate it with your money.

Finally, make sure you know what those historical rate of return numbers really mean. Are they “gross” or “net” IRRs? Do they include “unrealized” gains, or are they actual pay outs? Were they achieved by the team you’re talking to, or were other partners involved who are no longer with the fund? And, how do they compare to industry statistics on top VC returns for the same time period? The VCs you’re interviewing should answer all these questions clearly and candidly.

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