



“Five FAQs (frequently asked questions) for Private Investors in VC Funds”

The realm of investing in venture capital (VC) funds is private, exclusive, and can be fraught with arcane terms and limited information sharing. Typically the minimum qualification for consideration as a limited partner in these funds is “accredited investor” status (currently, \$1mm in net worth); but most accredited investors face a variety of hurdles to getting information on which appropriate funds are available.

Since funds are prohibited by the SEC from advertising publicly, the only source of contact must come through personal referrals and licensed intermediaries. In any situation where channels are limited, communication is difficult, and misinformation can flourish.

Here are a five of the most commonly heard FAQs (frequently-asked questions) from private investors interested in VC funds, with some current, market-based answers:

1. “I’ve heard private investors can’t get into the really good funds. Why would we want to invest in the kind of fund that wants us?”

The fortunate news for private investors (those committing between \$100,000 and \$2 million per fund) is that there is a wide range of funds currently available that can, and do, accept investments in this range. Don't lower your standards: no investor should accept a poorer return on investment because you are investing a relatively small amount of money.

Many small funds have credentials just as impressive as the big gorillas. In fact, there are some small funds with top-tier performance that large institutional investors wish they could participate in, but can't, for the simple reason that many institutions have to invest money in bigger chunks than these funds can handle. Some well-known VCs refuse to raise very large funds, because they feel their investing strategy works better by deploying smaller amounts of capital in early stage or niche markets: their credo is “small is beautiful.” This philosophy works to the advantage of the private investor.

2. “The really big name funds don’t accept private investors.”

You'd be surprised at some of the big name funds that do accept private investors, either directly or in “sidecar” or “entrepreneur” funds. Part of the decision is up to you: not only do you need an appropriate introduction to the fund (cold calls are not warmly accepted!), but you also have to ask yourself what you can offer the fund in addition to money.

For example, if you are well known within certain business or technology circles, how comfortable are you with your name being used in private marketing efforts to draw more investors into the fund? Obviously sports, entertainment and political figures are offered investment opportunities because their names bring visibility and panache to a fund, but the same rule applies within more specialized industry inner circles. You also might feel you can be helpful in deal sourcing, or in finding acquirers for portfolio companies. The person or intermediary who introduces you to the fund can be very helpful in “positioning” you as a desirable limited partner in this regard.

In short, if there's a fund raising money that you really want to get into, there's a reasonable chance you can do so, if you approach them through the right channels, with the right story.

3. “What criteria should I look for in evaluating venture fund investments?”

Private investors should look at VC funds the same way you look at other investments, along two vectors:

- *Credibility of expected future returns:* In this context, look at the partners' past IRR performance; their depth of knowledge in the sector the fund focuses on; the integrity of their competitive strategy to get access to the best deals; their plan for bringing in additional investors ("syndication") as the portfolio companies grow, while protecting their own fund's position ("dry powder"); and the consistency of the team members and the investment strategy from past fund(s) to future fund.
- *Friendliness to private investors:* Are you being offered the same terms as larger investors for management fees, "carry," and future investment rights? If not, your long term performance can be disadvantaged. Seek out funds that respect your contributions and treat you equitably.

4. "How do I get information on the fund's track record and competitive standing, so I can make a knowledgeable investment decision?"

Ask for it – VCs should provide explicit information on the past investing performance of their management team, and help you compare it to NVCA (National Venture Capital Association) survey data. Industry performance benchmarks are also available free on the PricewaterhouseCoopers' MoneyTree website, which is updated quarterly.

Be sure to look at several "vintages" of funds, since the industry is cyclical. When you look at IRRs (internal rates of return), differentiate between "gross" (total proceeds from an investment) vs. "net" (what's actually distributed to investors after management fees and "carry" are deducted.) Ask for clarification on whose performance you're looking at – this team's performance as a unit? A mash-up of these individuals' performance, before they worked together? Or does it include the performance of partners who are no longer with the team? Sometimes these details are not spelled out in the initial presentation.

5. "Should Angel investors put money into VC funds, or invest directly in individual early stage companies?"

It's not an either/or question: fund investing involves a different time commitment and risk profile than putting your own portfolio together through direct angel investing in companies.

As an individual investor, you may not get investment terms as favorable as a fund can negotiate (pricing, information rights, board seats, ratchets, reinvestment rights, liquidation preferences, etc.). On the other hand, direct investment in growing companies can provide the opportunity for mentoring, excitement, and personal impact that a "managed" investment doesn't.

You could think of VC funds and direct angel investments as entirely different "asset classes" – in the same sense that individual stock-picking is different from mutual fund investing, requiring different levels of involvement, and entailing different risks. Your choice of which asset classes to invest in, and how much money to put in each, depends on your own financial situation and risk preferences, and the categories aren't mutually exclusive.

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For more information about this article, VC Privé, or investing in venture capital funds, contact:

Laura Roden
Managing Director
VC Privé
Lrod@vcprive.com
650.206.2523