



“Venture Capital Fund Due Diligence: New Standards in Transparency”

Historically, when prospective investors carry out due diligence of VC (venture capital) funds they are considering investing in, their approach has been much more subjective, and less structured, than diligence of hedge funds and many other asset classes. Why has this been the case, and how is it changing in response to the new economic and regulatory climate?

Introduction: The Way It Was

One reason for the lighter diligence effort is that there is simply less data to analyze in venture capital, even for funds that have operated for generations. VCs make relatively few investments: dozens of transactions over the life of a fund, compared to hundreds, thousands or millions of trades in a hedge fund. With fewer numbers to crunch, investors naturally focus more attention on qualitative fund characteristics, which are solely subjective.

Secondly, VC portfolios are entirely shaped by the abilities and interests of the fund partners. Investment decisions are not driven by algorithms, indices, or risk-constraining rules against which past performance can be tested. The emphasis on individual partner skill and judgment is reflected in the fact that most VC “pitch books” include photos of each team member, whereas hedge, debt, and real estate funds presentations almost never do. From the start, VC fund relationships with investors are more personalized.

Thirdly, VC-backed companies can't be concretely valued until there are exit events (ie, companies are sold or go public). If their stock trades at all, it is through private transactions with inefficient pricing. The majority of these companies are not yet profitable, so they can't be valued using traditional methods such as discounted cash flow analysis or industry comparables. Since true return on investment is not known until many years after the fund's inception, much of the performance data available to be analyzed is heavily assumption-based, requiring subjective interpretation.

Finally, the venture capital category as a whole absorbs a much smaller gross amount of dollars than buyout or hedge funds: the private equity fund market is roughly 10 times the size of the VC market, and the hedge fund market is 10 times that again. As a result, there tend to be a proportionately higher number of smaller investors in VC funds, and relatively less involvement by the mega-institutions which set the bar for the most structured diligence processes.

However, alarmed by the scandals that surfacing during the 2008-2009 market crash, investors at all levels, along with their advisors (including consultants, financial managers, accountants and lawyers,) are demanding more rigorous diligence practices. This paper discusses three due diligence tools which have moved from optional to requisite in serious VC fund diligence efforts: DDQs, EDRs, and professional background checks.

DDQs (Due Diligence Questionnaires)

DDQs have been a standard component of fundraising materials in the hedge fund industry for a long time. The AIMA (Alternative Investment Management Association) has published boilerplate DDQ formats for use by hedge funds and investors. DDQs are almost unheard of, however, in the venture capital industry, except in response to special requests from particularly fiduciary-minded investors such as some pension funds and fund-of-funds.

At VC Privé we strongly recommend every client fund prepare a DDQ and offer it to investors. The initial time invested to create it is more than recouped by later time savings in addressing investors' questions individually on an ad hoc basis. More importantly, it ensures that every prospective investor is given consistent, timely, and well thought out responses to commonly asked questions; this is critical from both



marketing effectiveness and regulatory compliance standpoints. Finally, offering potential investors a comprehensive DDQ is an indication of the fund's willingness to share information transparently, and of its overall professionalism in dealing with investor queries and concerns.

EDRs (Electronic Data Rooms)

Lawyers have used EDRs for decades to warehouse electronically, share, and control access to the vast number of documents used in corporate transactions and law suits. The price of these services has plummeted recently due to advances in "cloud computing" technology and storage capability. EDR services are now affordable tools through which to share, update, track and control access to documents for projects of any size, including most due diligence efforts.

We recommend all our client funds use an EDR for the duration of their fundraising effort. All due diligence material, such as powerpoints, offering memoranda, partnership agreements, subscription forms, audited financial statements, the DDQ, etc., can be uploaded to the EDR, and updated as needed. Individual passwords are assigned to prospective investors to authorize and track which documents they look at. Benefits to both parties include avoiding problems in sending/receiving large document files by email; ability to make updated documents available immediately by alerting investors to changes rather than having to re-distribute files repeatedly, and avoiding the associated version confusion; avoiding the risk that an investor has either lost or never received a critical document required to be provided to them under securities law; and reduced printing and mailing costs, which are typically charged to the fund. EDRs are becoming an expected "best practice" element of investment diligence for all institutions serious about informational quality standards.

Background Checks

Very few investors commit dollars to a fund without feeling that they have done some form of reference checking. However, historically in the VC world, remarkably few have required professional verification of the investment team's credentials in key areas relevant to the role of an investment fiduciary, such as:

- Measures of financial stability: credit scores, home ownership, indebtedness, bankruptcies
- Criminal convictions
- Regulatory matters: status of securities licenses and any related actions or inquiries
- Biographical veracity: confirmation of job history and academic credentials.

A variety of service providers can facilitate this research, ranging from simple online database searches to in-depth customized investigations. At VC Privé, we only accept funds as clients if their managers agree to give prospective investors the necessary written authorization to do appropriate background checks. Unwillingness to do so will, increasingly, become a diligence deal-killer.

Conclusion

The venture capital industry is a relatively small community of long-term fund managers, executing a small number of transactions per year, and these characteristics simplify investor due diligence in many ways. However, as overall sophistication in alternative asset investing grows, sometimes through painful experience, investors will increasingly utilize professional tools to refine the quality, comprehensiveness, and consistency of their diligence efforts. Top tier funds will move proactively to meet these needs.

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