

“Vocabulary of Venture Capital Investing”

Investing in venture capital funds involves a different vocabulary than investing in mutual funds, public stocks, or even angel investing directly in companies. To make educated investment decisions, of course you need to know the language. Here's a short summary of common vocabulary terms associated with investing in venture capital funds:

How is a VC fund structured?

Most funds are structured as limited partnerships. The investors are limited partners (“LPs”) and the fund is managed by the general partner (“GP”). The GP is usually set up as a limited liability corporation, or “LLC”, of which the actual fund managers are “members” or owners. So, to use a fictitious example: John Doe, the famous venture capitalist, is a member (owner) of Superfund Management LLC. Superfund Management LLC is the General Partner (the manager) of Superfund III Limited Partnership. As an investor, you would be one of the LPs of Superfund III Limited Partnership.

How are VCs paid?

VCs are paid in two ways:

1. The General Partner is paid an annual “**management fee**” by the Limited Partnership. This fee usually ranges from 1.5% to 3% per year, as a percent of total money that has been committed to the fund by investors. Usually the larger the fund, the smaller percentage fee, since this money is intended to cover the overhead of operating the fund, and the overhead doesn't grow proportionately with the size of the fund.
2. The General Partner is also paid a “**carry**,” or percentage of the profits on the fund's investments. The carry usually ranges from 20-30% of the difference between the gross proceeds from the fund's investments and the money originally invested. When one of the portfolio companies is sold, first the original investment money is paid back to the investors, and then the General Partner takes a “carry” on the remaining gain.

Note: some funds take their “carry” after the cumulative total investments of the fund as a whole have been repaid; other funds take their “carry” on an investment-by-investment basis. The former calculation is more protective of investors than the latter.

When do investors actually put money into the fund?

You can think of putting money into a fund in three stages:

- The “**commitment**”
- The “**close**”
- The “**call down schedule**”

The “**commitment**” is the total dollar amount that you are promising to invest in the fund. This is a legal commitment; if you default, there will be penalties, as spelled out in the fund's partnership agreement (the “**LP Agreement**”). You make your “commitment” by signing the “**Subscription Agreement**.” Your “commitment” is the total maximum amount you will be required to invest over the life of the fund, unlike direct (angel) investing in companies, where you may be asked to put in additional money because things aren't working out as planned.

The “**close**” is a legal process in which all the commitments to date are gathered together and an ownership group is defined. It can take 6-18 months to form a fund, and if the fund managers have begun



to identify interesting deals during this time, they may hold two or three “closes” on commitments made so far so that they can start investing in deals. Investors are usually required to pay in a small percentage (10-20%) of your total commitment at the time of the “close” which you are a part of.

The remainder of your commitment will be “called” by the fund according to the “**call down schedule.**” For venture funds, which are long term investments, the call down schedule usually stretches out over 3-4 years, as investments are identified and require successive rounds of capital. The VC provides prospective investors with a forecast of the call down schedule (e.g., 25% per year,) but this schedule may be accelerated or extended depending on how fast appropriate deals are identified. VCs try not to call down money any sooner than it’s absolutely needed, so that they don’t dilute their return on investment track record by having money sitting idle (see “IRR” below.)

The VC will issue a “**capital call**” letter and/or email each time additional money is needed; usually you have 2-4 weeks to respond.

How do VCs calculate their return on investment?

There are several important vocabulary definitions to understand when evaluating VC presentations of their return on investment track records. If the definition of a particular measurement is unclear, it’s crucial to ask for clarification so that you can compare apples to apples among funds and between funds and industry data.

- **IRR** (internal rate of return) is the average annual rate of return on investment that the fund has achieved through a specified date. A correct IRR calculation takes into account the “timing” of capital calls: money is considered “invested” at the time it’s called down from limited partners. VCs call money only when it’s needed for a deal, so that their IRR isn’t dragged down by money sitting around in low interest rate accounts.
- **Gross IRR** is a straight calculation of dollars invested vs. total dollars returned by the investments, before the deduction of fund expenses.
- **Net IRR** is the IRR to Limited Partners, net of fund management fees and “carry.”
- “**Multiple**” is the ratio of dollars returned by investments divided by the dollars invested. Multiples do not take into account fund expenses, or the timing of the investments and returns. For example, if you invested \$100 and got \$300 back, your “multiple” would be “3x”, regardless of whether it took 2 years or 10 years to get the money back.
- “**Realized**” returns are actual payouts of cash or marketable securities; “**unrealized**” returns are increases in the book value of the portfolio due to price-setting events such as new financing rounds. Obviously there is an element of risk in unrealized returns, so the VC should specify the degree to which realized and unrealized returns are included in any IRRs they present.

When do I get my money back?

Venture capital funds are considered risky, long term investments: there is no guarantee of any return, and even in successful funds the payout is anticipated to be spread out over 2-10 years. Investors get money back when there are “**liquidity events**” (i.e., the sale or IPO of a portfolio company), the proceeds of which are paid out in “**distributions.**” Generally the fund may not re-invest the proceeds of liquidity events without the permission of the investors.

Other frequently heard terms:

“**Dry powder**” refers to commitments that have been reserved for, but not yet called down and invested in, a portfolio company. Dry powder gives funds a safety margin in case deals need more money than that which has been invested so far. You may hear that a fund is “100% committed” although it hasn’t called down all of its investors’ money yet, because it is saving the uncalled portion as “dry powder.”



“**Pay to play**” refers to a variety of situations in which the fund must invest more in a deal in order to get, or preserve, an advantageous shareholder position. It's good to have “dry powder” available in these situations.

“**Warrants**” are rights to buy additional stock in a company. Warrants are awarded as a bonus to the VC fund when it loans money to a portfolio company as a “bridge” to a future equity financing round. When the future round occurs, the loan is converted into stock, but the VC fund also gets additional stock at a nominal cost by exercising its warrants. For example, a \$100,000 loan with 30% “warrant coverage” will convert into \$130,000 worth of stock. The warrants compensate the VC fund for the growth in the company's value between the time the loan was made and the time that it is converted into stock.

Finally, while most VC funds are structured fairly similarly, before you invest it's always important to read the detailed documents governing the fund you're considering:

- the **Private Placement Memorandum**, sometimes called the **PPM** or the **Offering Memorandum**, which describes the fund's objectives and risks;
- the **Limited Partnership Agreement**, which defines the fund's operating rules; and
- the **Subscription Agreement**, with which you make your legally binding commitment to the fund.

Funds are required by law to provide you with, and require that you assert you've read, these documents before you make your investment commitment.

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