

# Venture Capital Back to Basics



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## Background

The origin of Venture Capital goes back to the mid 19th century. In 1854, Frenchmen Jacob and Isaac Péreire founded Crédit Mobilier to finance numerous infrastructure projects across the globe. The company leveraged the savings of middle class French investors as capital. Initially, Crédit Mobilier focused on mining and railroad constructions where it generated handsome returns. As the firm increased in stature, however, it expanded: It started funding insurance companies and banks. Soon it was a major funder of the Imperial Ottoman Bank. Losing focus, Crédit Mobilier underwent a severe crisis just twelve years after its funding. In 1866 The Péreire brothers were forced to resign. The bank never recovered.



History does not repeat itself. But it rhymes. And, today, the Venture Capital industry is undergoing a similar cycle: as established venture capital firms became successful, they expanded in size and scope. Intriguingly, an industry that drives its profit from small companies disrupting larger ones is suffering from the same ills that plague large companies: a bloated size and a loss of focus. In essence, Venture Capital firms today are facing their own Innovator's Dilemma.

## The early days on Sand Hill

The first venture backed firm in Silicon Valley is widely believed to be Fairchild Semiconductor, funded in 1957 by a loan from Arthur Rock, an early investor with the firm of Hayden Stone in New York. Arthur Rock had met the "Traitorous 8", founders of Fairchild, in a visit to California while they were still at Shockley Laboratories developing silicon semiconductors. (William Shockley,

a Nobel prize winner, had recruited a group of young PhD scientists to develop new semiconductor devices. But the scientists were unhappy with Shockley and wanted to set out and do something else.) Arthur convinced them to start Fairchild, and secured a loan for \$3M in return for 20% of the company. The remaining 80% was divided equally across the eight founders. The formula worked. Within a few years the company grew to twelve thousand employees and was generating north of \$120M per year. Within three decades, the amount of capital committed to venture capital included about \$10B annually in the mid-nineties. Returns were outstanding.

I knew they were probably pretty good people, and then when we met them I was very impressed and thought we could help them. I suggested to them that they might want to set up a company, and we told them we would see if we could get financing for the company.

- Arthur Rock on meeting the "Traitorous eight"



The formula for early stage venture capital was quite simply: back outstanding founders in the technology industry; write one of the first checks; have a large ownership; and get ready to roll up your sleeves and help the entrepreneur. There were no party rounds, no SPVs, no spray and pray strategy, and no series seed. Rather, it was Series A: the first significant check backing a daring founder.

And it worked. Within three decades, the amount of capital committed to venture capital increased by the mid-nineties to about \$10B annually. Venture firms by then had become a coveted asset class and were realizing a substantially higher return than the Public Market Equivalent (PME)—until the bust of the tech bubble in 2000. Since then, however, the data paints a more problematic picture: despite proliferation of new firms and new models, the returns have dropped substantially to roughly 1x equivalent to investing in the



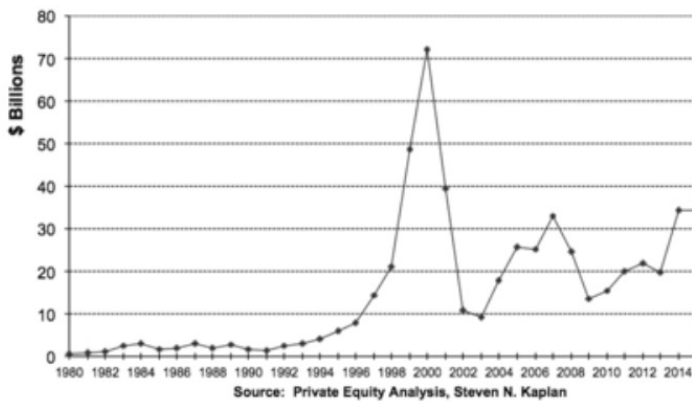
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public markets. Intriguingly, the top quartile of firms continue to realize outstanding returns, but the rest of the firms perform so poorly that the overall asset class returns are barely as good as investing in the public markets. We believe the decline in return is not cyclical but rather systematic and is the result of three interrelated problems: expansion in fund size, expansion in focus, and the shift away from company building into company financing.

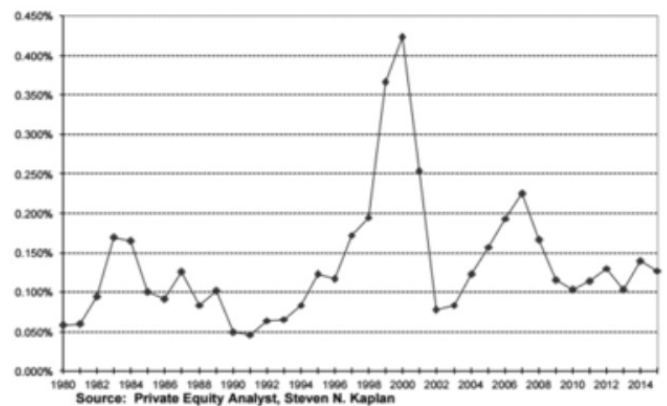
## Bigger is not better

A Venture Capital firm is a conduit between three key stakeholders: The Limited Partners, the General Partners, and the Entrepreneurs. As Venture Capital firms became successful, more money from Limited Partners started flowing in. Some firms resisted the urge to take more LP money and kept their fund size constant. But most succumbed—driven by a desire to have more ammo to deploy and, for some, by the allure of higher management fees. Slowly, the average fund size increased from a median of \$130M in the mid-nineties to over \$400M in 2015.

**Commitments to U.S. Venture Capital Partnerships  
1980 - 2015 (in \$ billions)**

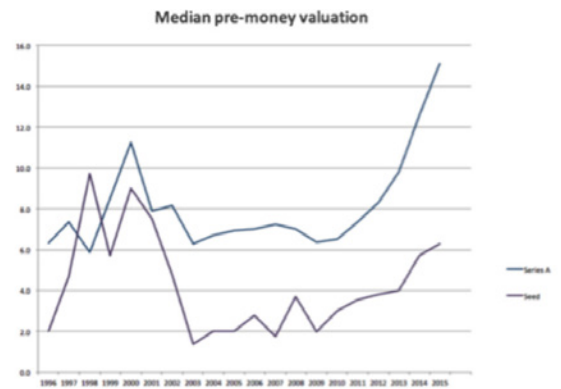


**Fundraising (U.S.) as % of market**  
Commitments to U.S. VC Partnerships as  
Fraction of Stock Market Capitalization 1980 - 2015



While commitments to Venture Capital are, short of 1999, in an all-time high at \$35B in 2015, as a fraction of the overall stock market capitalization VC commitments are fairly constant—at about 0.15%. In other words, the percentage of money allocated to Venture Capital has not increased, but the absolute dollar amount has—3x over the past 15 years.

A VC firm with a bloated fund size faces a dilemma: write larger checks or make too many investments. Both have negative results on returns. Larger checks limit the scope to later stage investments with larger valuations—where a 10x return on capital is less likely. Meanwhile increasingly the number of investments a fund makes beyond the manageable 20-30 count, a strategy often dubbed spray and pray, has historically resulted in poor returns. Most firms have opted to write larger check sizes. Thus, median pre-money valuation for a Series A investment has also increased from \$6M in 2003 to \$14M in 2015. While a Series A investment in 2002 typically started at the inception stage, today a Series A investment only takes place well after product market fit has been established. Larger fund sizes not only created an inflation in later stage valuation, but also created a funding gap for early stage companies. More importantly, they resulted in mediocre returns.



## The loss of focus

Historically, the Venture Capital industry focused on technology based investments with high gross margins. Once a technology product takes off, businesses can garner substantial valuations (whether via an IPO or an acquisition) and return a handsome multiple on the initial investments.

As more money funnels into the industry, however, Venture Capitalists tend to invest into auxiliary industries—from Clean Technology in the mid 2000s to online retail and, most recently, restaurants and coffee shops years. The clear majority of these investments resulted in substantial loss of capital.

Most investors point out that investments in these areas had a technology focus—be it a disruptive new battery technology or an improved food ordering process. But we now know that introducing software into an existing industry does not create venture return: specifically, software by itself does not increase the unit economics, the gross margins, or the valuation multiple of the business. A close look shows that financial tech companies are starting to trade at valuations more similar to a bank than to Facebook. Similarly, we believe Tesla will eventually trade with the multiples of an auto manufacturer. For VC funds to realize outsized returns, they must resist the temptation to expand into industries outside of technology or to products that lack the high gross margins necessary for venture return.

**Introducing software into an existing industry does not increase the margins or the valuation multiple for the business**



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## From Builders to Financiers

The last, and perhaps most alarming trend in venture capital, is the evolution of VC firms from company builders to company financiers. In the initial days of Venture, a firm typically wrote the initial check and owned well at least 10-20% of the company. As valuations and fund sizes grew, more firms starting engaging in financing activities not in line with the traditional model of Venture Capital such as Party Rounds and Special Purpose Vehicles (SPVs). In a party round, a number of investors, often more than a dozen, contribute capital to complete the round. The resulting ownership is typically minuscule and almost never creates venture return. A similar pattern in late stage investing takes place with SPVs, a single-investment fund which raises several issues from adverse selection of investments to misalignment of incentives. The result has been both a distraction and a drop in return.

## Back to the future

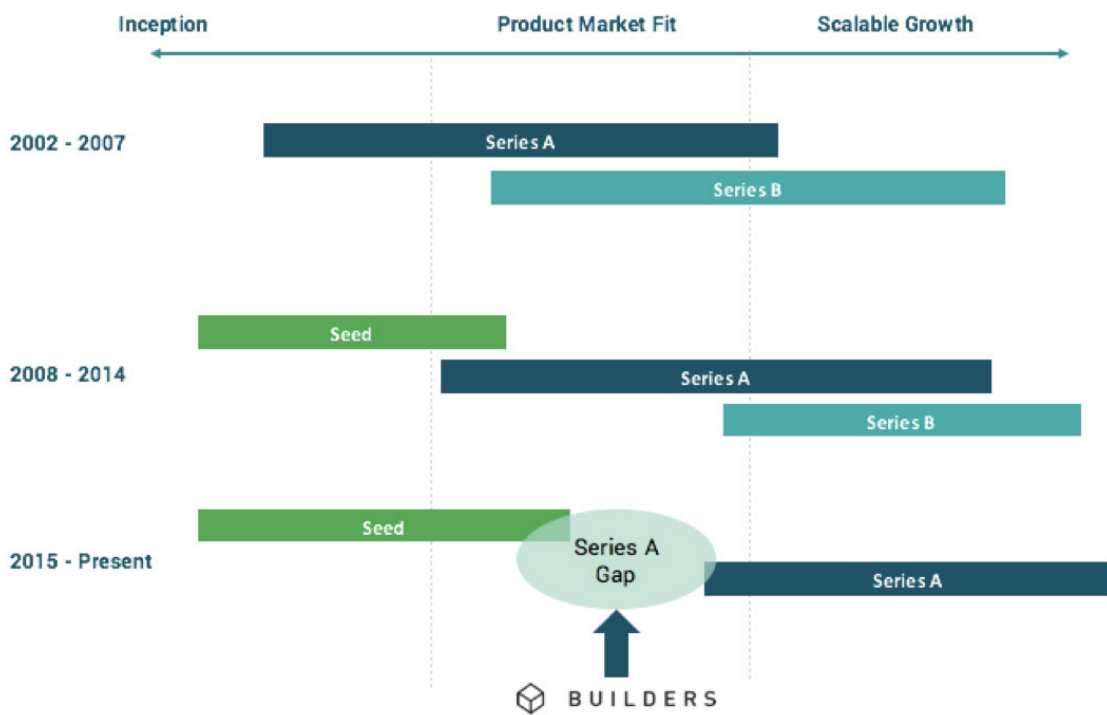
While the check size increased, the amount of capital required to launch a startup has remained constant and, in many cases, decreased. A new genre of capital, Seed Investing, evolved starting in the mid 2000s to fill the need for entrepreneurs. Unlike Series A investment where one or two investors lead the round, seed stage rounds typically include dozens of investors each allocating smaller checks, a phenomenon dubbed “party rounds.” Even though the average seed round increased from a few hundred thousand dollars in 2008 to \$2-\$3M in 2015, the gap separating the Seed stage and the Series A kept widening, hence the Series A Crunch. Today, hundreds of great companies are in formative stages. Some have raised seed capital, some have not. But none of them qualify for the \$10M Series A check of the modern era. These companies need smaller, \$3-\$7M check sizes from a firm that understands company building.

“Success for me is helping to build great companies. That’s how I get my kicks. I helped create companies. I helped create wealth for a lot of people. That gives me a great deal of satisfaction”

- Arthur Rock



We believe there is tremendous opportunity to fill the Series A gap in technology investment. The key to filling this gap however lies in approaching Venture Capital investments with the same principles that led to success in the early days: a medium fund size in the \$250M range, a concentrated focus on early stage founders, large ownership in companies, the vision and imagination to find and win the next wave of legendary founders, and GPs who can provide the tools and guidance to help companies succeed and to realize outsized returns for LPs.



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