What Happened to Venture Capital?

University of British Columbia
Sauder School of Business

MBA Entrepreneurial Finance Course

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Format this morning

- My goal is to describe the changes in entrepreneurial finance over the past decade
- It’s a big topic
- I’d like to run quickly through this presentation
- To complete the big picture
- And then answer questions

My Background and Perspective

- I am a geek, techie, nerd
- PhD in Electrical and Computer Engineering from University of British Columbia in 1982
- Started my first company at grad school
- Nexus grew to be the world's 2nd largest manufacturer of cable TV headends
- Sold in 1993 to Scientific Atlanta and is now part of Cisco

My Tech Investment Funds

- When we sold Nexus, it was the first time I had money to invest
- Been an enthusiastic tech investor since
- Founded and managed a:
- Hedge fund – 1996 to 2000
- Venture Capital Seed fund – 2002 to 2006
- Angel fund – 2005 to 2011
- Now run a boutique M&A Advisory firm

My Investments and Financings

- I’ve made about 100 early-stage technology investments
- Slightly less than half produced a return
- I’ve been directly involved in over 100 technology company financings
- All were successfully completed
- I’ve worked directly on several dozen exits

The World Has Changed

- Many big parts of the financial ecosystem
- That worked for a hundred years
- Don’t work at all anymore
- The economy has changed
- The whole world is changing
- Faster than ever before

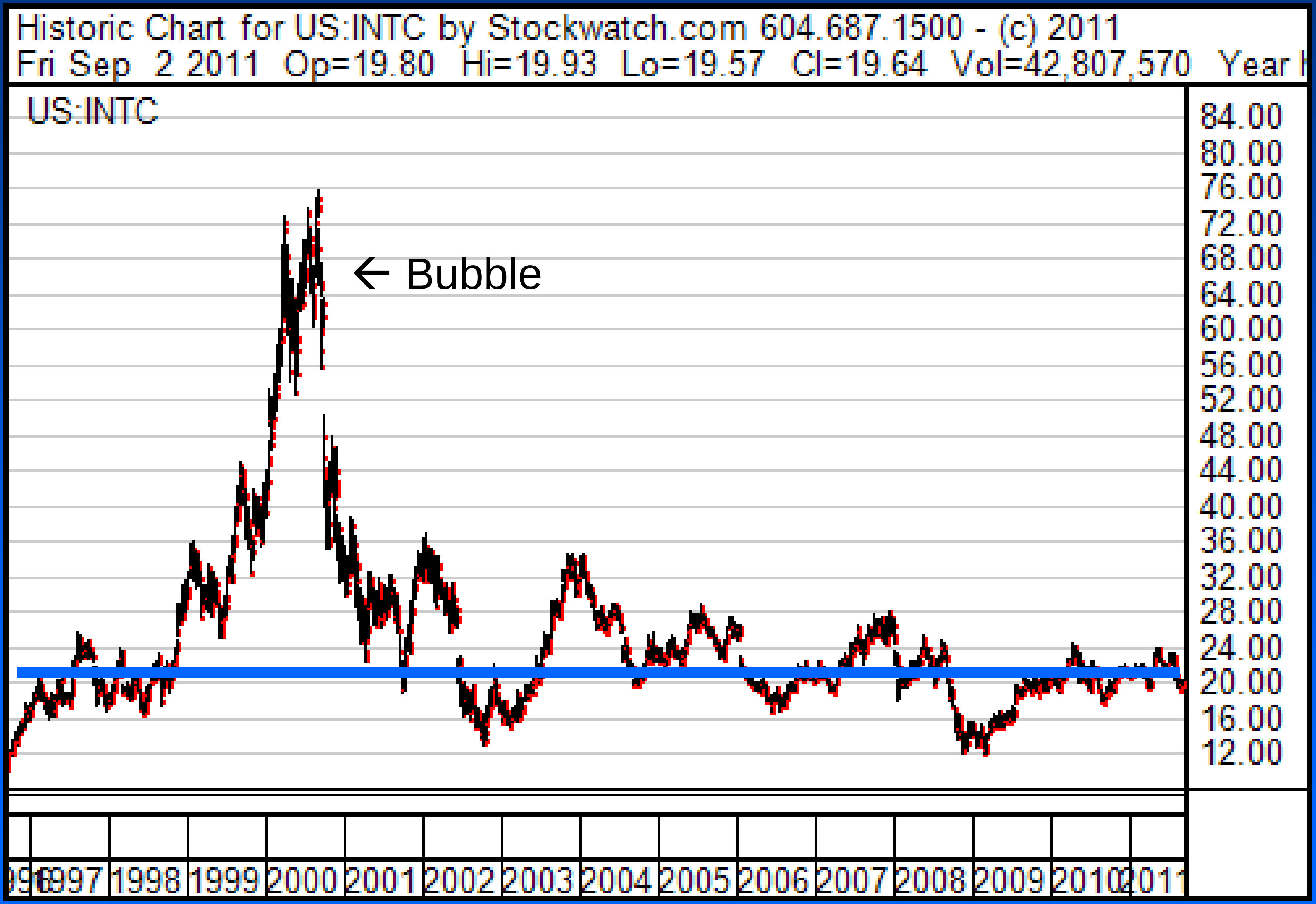
Canada’s Most Valuable Corp

- Nortel was founded in 1882
- In 2000, Nortel’s value was a third of the entire TSX index – Canada’s most valuable
- Market cap was $398 Billion
- Employed 94,500 people
- Bankrupt in 2009
- Assets sold to companies around the world

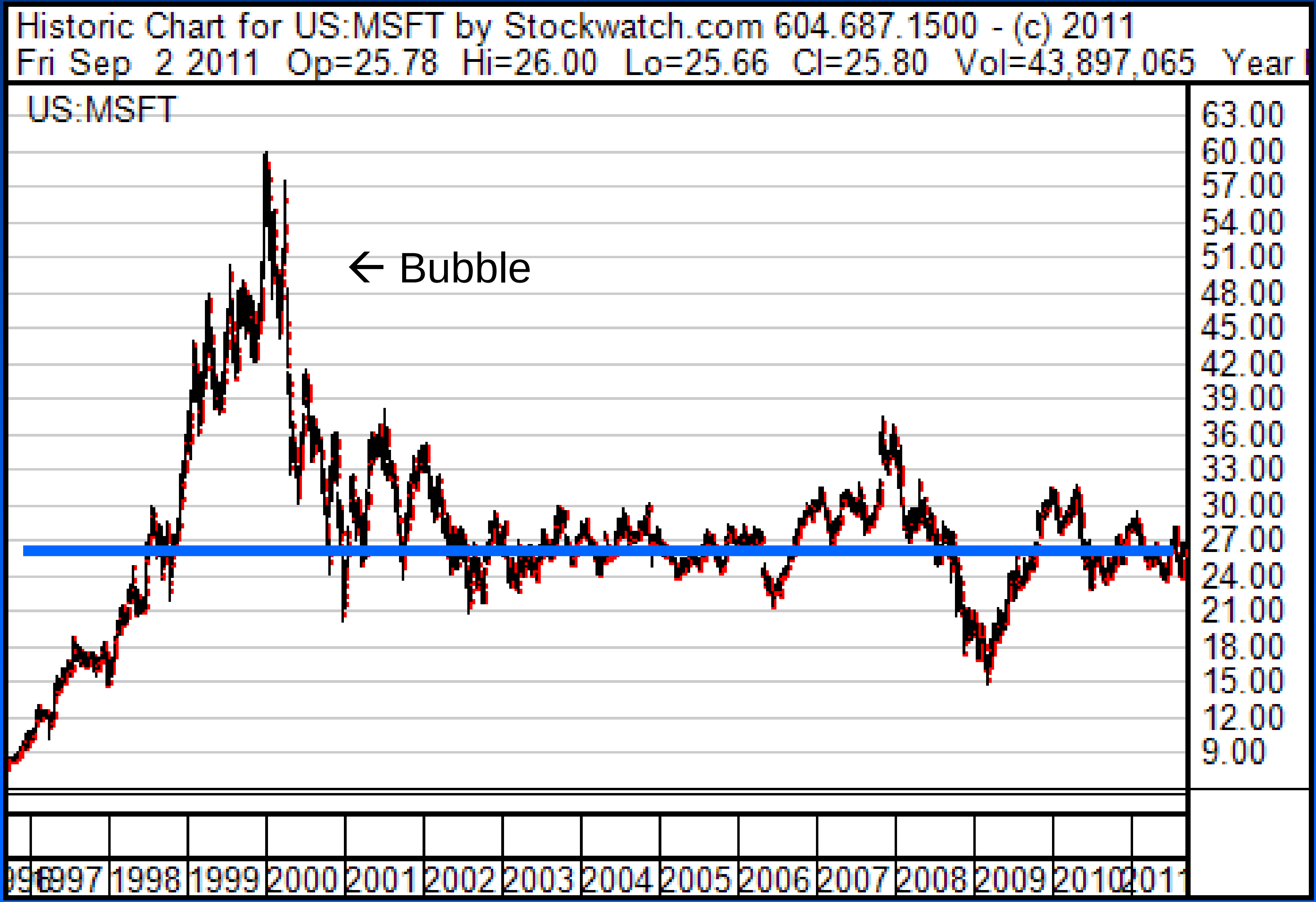
Other Big Tech Companies

- Was Nortel just a single example?
- Or a made in Canada failure?
- What about the other big, great tech companies?

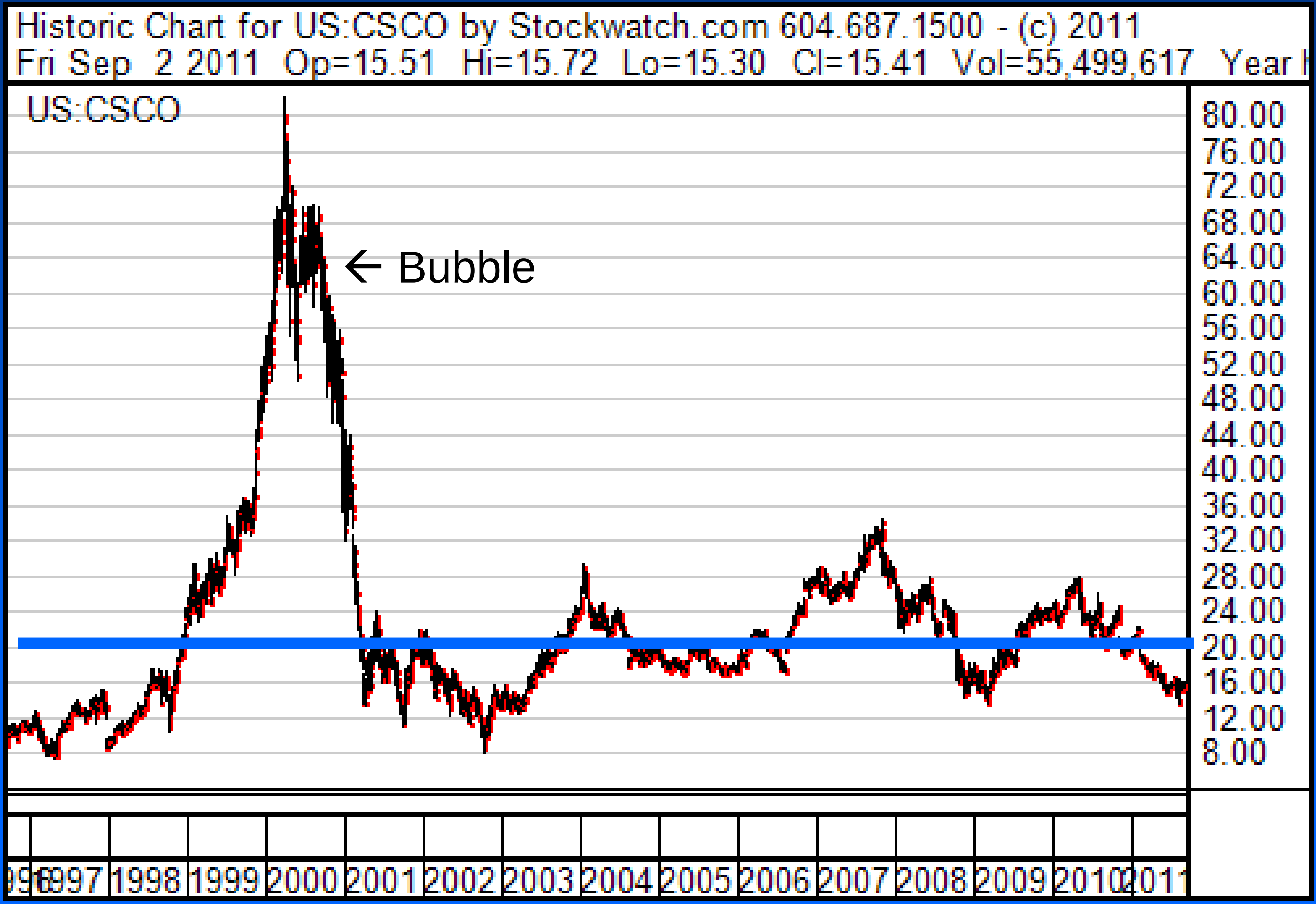
Intel – 15 years



Microsoft – 15 years



Cisco – 15 years



None Are Creating Wealth

- For their investors,
- And more importantly for their employees
- For decades, these greats were all built on the increasing value of their stock options
- That’s what used to bring, and retain, the best and the brightest
- To these big companies

Opportunities Then and Now

- When I graduated from university,
- Most of the new grads wanted to get jobs in the big companies
- To learn ‘how it was done’
- To work somewhere that was safe and stable
- Today, working in a big company seems to be a pretty risky proposition
- And certainly not a very lucrative one

What Changed? Innovation

Big Companies Can’t Innovate

- This is perhaps the most important truth to absorb if you want to really understand entrepreneurial finance today
- Why? Has bothered me for decades
- I finally understand - new research out of the Harvard Business School Forum for Growth and Innovation
- By Maxell Wessel in HBR – a must read
- Big companies are not designed to innovate!

How Big Companies Think Now

- One of my friends from a Fortune 500 company explained it this way:
  - We (big companies) know we aren’t good at new ideas or startups
  - We basically suck at building businesses from zero to $20 million in value
  - But we think of ourselves as really good at growing values from $20 million to $200 million or more

"Under $20 Million Is Easy"

- – A company priced at $100 million is already out of our sweet spot to buy
- – $100 million also requires board approval
- – But at $20 million, it's really easy for me to get it approved just inside my division

- Many big companies are spending more on M&A than internal R&D
- Today, it's the best way for them to grow

Google Wants Even Earlier Exits

- I was surprised recently to learn just how early Google wants to do acquisitions
- Charles Rim one of the top Google M&A guys:
- “90% plus of our transactions are small transactions. … less than 20 people, less than $20 million and that is truly the sweet spot”
- “we do prefer companies that are pre-revenue”
- http://www.exits.com/blog/google-wants-even-earlier-exits-than-in-early-exits/

Most M&A Exits are under $15 million – possibly $12 million

We Always Hear About The Big Exits

- The media always reports the really big exits
- Like YouTube selling for $1.6 billion,
- Club Penguin selling for $350 million, or
- AdMob selling for $750 million
- Those exits are now very rare occurrences
- The ‘new’ big story is the number of smaller exits

Most Exits Are Under $15 Million

- Mergerstat database shows the median price of private company acquisitions is under $20 million, when price is disclosed
- But the price is not disclosed in most smaller transactions
- I estimate the median to be under $15 million
- Possibly under $12 million
- We don’t have the data to know for sure

Capital Efficiency

New Startup Economics

- It’s amazing how little it costs to build a tech company today
- Back when I was an entrepreneur, hardware and software companies needed $10s millions
- Which gave rise to the huge VC funds
- And was one of the reasons innovation used to happen primarily in big companies
- Today, entrepreneurs can build companies for $100,000s and, in some cases, $10,000s

Why It Costs So Little Today

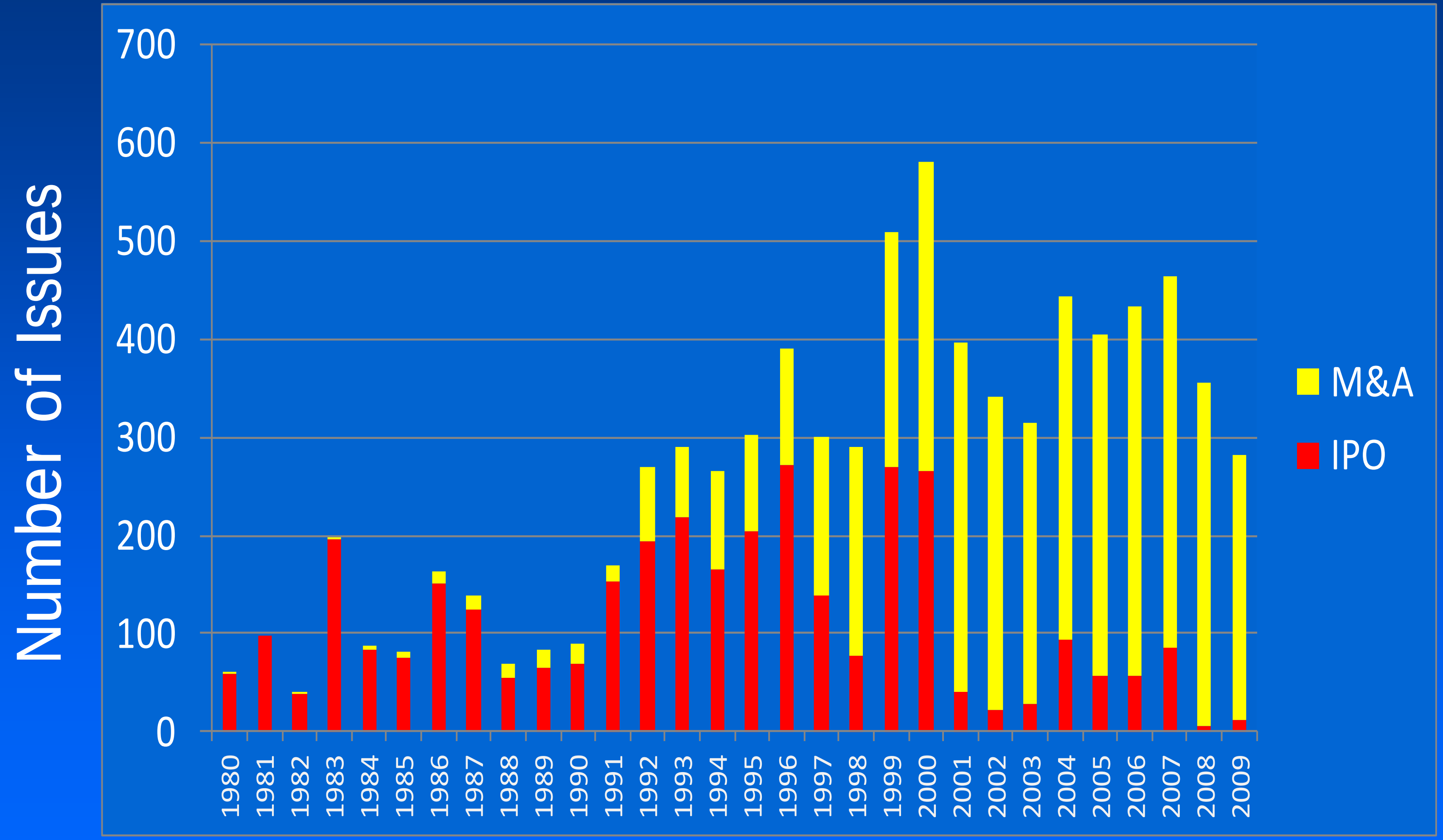
- It’s the internet
- Fundamentally changing how we work
- And build companies
- Instant access to the entire global market
- Another example - open source software
- More importantly - virtual companies

Many Startups Need No Capital

- After being an investor for 20 years,
- I’m amazed by how many of the most successful companies I see
- Or have helped to sell
- Have raised no capital at all
- Or just a little from friends and family
- These bootstrapped companies are usually stronger and produce higher returns

Finance -
It All Starts With
The Exit

A Decade of Completely Different Exits



Source: NVCA

Big Corps Have Too Much Cash

- For a decade, big companies have been accumulating cash
- Many big companies have so much cash that it's a problem – shareholders complain
- Google has $20 billion
- Cisco has $45 billion
- Microsoft has $57 billion
- Apple has $95 billion ← cash and investments

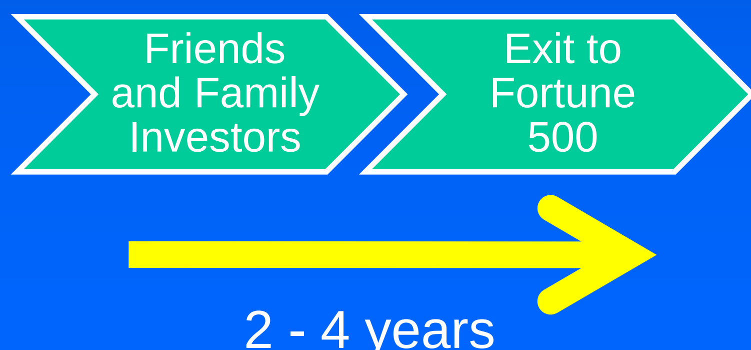
Big Companies versus VCs

- Big company corporate development and M&A teams now consider VCs their competitors, a fascinating development
- They know VCs will hold on for huge exits and don’t see VCs as adding a lot of value
- So they acquire exciting companies <u>before</u> VCs invest

Tech Companies Then and Now

Nexus and many 1990's tech companies

Club Penguin, Flickr, and today's tech companies



Examples of Early Exits

Weekender Sold in 10 Days

- “Weekender” – build a company in a weekend
- In 2009 when I wrote “Early Exits”
- I speculated that one day: “They’ll probably define an early exit as selling the company before the end of the weekender”
- That almost happened in November 2009
- A team of entrepreneurs in London built a business in one day and sold it online in ten days: www.24hour-startup.com <– great video

A B.C. Really Early Exit

- This is a Vancouver company but they asked me to keep their details confidential – for now
- This startup wanted to test the idea for their first product, so they called on a US customer
- The customer asked to buy the company
- The CEO called me for help
- Three months later the money was in the bank
- Company was less than 12 months from startup and still hadn’t launched the first product

Big Exits In Just 2 – 3 Years

- Flickr sold for $30 million at 1.5 years old
- Delicious sold for $30+million 2 years from startup
- Club Penguin for $350 million at 2 years old
- YouTube sold for $1.6 billion at 2 years old
- Playfish sold for $275 million at 2 years old
- Mint sold for $170 million at 3 years old
- AdMob sold for $750 million at 3.5 years old

A Golden Era For Entrepreneurs

- There has never been a time before when
- It was so easy for so many entrepreneurs
- To create such valuable companies
- On so little capital, and
- Sell them so early
- For so much money

Angel Investors -
The Predominant Source of Capital

Angel Investing Is Still New

- Organized angel investing is still quite new – first groups formed in mid 1990s.
- Angel investing today is where traditional Venture Capital was in the early 1980s
- We are still discovering the best practices and don’t have enough hard data
- ACA, the Kauffman Foundation and academics such as Rob Wiltbank and Josh Lerner are conducting invaluable new research

Who Are These Angel Investors?

- The biggest difference between VC funds and angel investors is
- That angels invest their own money
- Angels do not earn fees
- They only make money when the values of their investee companies increase
- They are not “intermediaries”
- Which completely changes their behavior

Angel Investor Math

- Small Investments ($10-25K) can make sense
- Returns > 300% over a few years are attractive
- Can easily reinvest the gains (unlike VCs)
- Exit objectives much <u>more aligned with entrepreneurs</u> than traditional VCs

Angel Syndication

- Just a couple of years ago, the conventional wisdom was that angel investment topped out at around $1 to 2 million per company
- ACEF and ACA started talking about co-investment just a couple of years ago
- Now I often see groups of angels investing $5 million to $10 million in one company, over several rounds
- Enough for 99._% of today's companies

Angels and VCs – Growing Apart

Today, we have a much clearer understanding of the difference between angels and VCs. From an exit perspective, there are three:

1. Minimum investment size
2. Minimum return required
3. Acceptable time to exit

Angels or VCs But Not Both

- Research May 2008 - University of Maryland - unique historical database of 182 Series A deals from the bankrupt Brobeck law firm
- “Outcomes inferior if angels and VCs co-invest”
- Angels alone “as likely as the VC-backed firms to have successful liquidity events”
- Does the current environment favor angels?

Angels, VCs and IPOs

- 2009 report by J. Sohl, Univ. of New Hampshire analyzed 665 IPOs from 2001 to 2007
- 13% had only angels, 33% only VCs, 16% both
- VC backed firms had “higher underpricing”
- “Angels’ incentives are more closely aligned with (nonVC) pre-IPO shareholders”
- “managers (entrepreneurs) prefer early stage funds from angels”

More Validating Research

- April 2010 - Kerr and Lerner from HBS
- Assisted by angels James Geshwiler, Warren Hanselman, Richard Sudek and John May
- “Angel funded firms are significantly more likely to survive at least four years and to raise additional financing”
- “Angel funded firms also more likely to show improved venture performance and growth”

Outcomes When VCs Co-Invest
(compared to angel-only returns)

Source: Robert Wiltbank, PhD Willamette University with Funding from the Kauffman Foundation

The Bottom Line

- When traditional Venture Capital funds follow on in angel investments, statistically:
  - It takes about a decade longer to exit
  - The risks increase substantially
- We don’t have data yet, but I believe today the extra time, higher risks and dilution mean <u>lower average returns for both the angels and entrepreneurs</u> when VCs invest

Is Co-Investing with VCs Ever OK?

- What we have shown are statistics
- There are, of course, situations where the best decision is to have VCs follow on
- It all depends on the type of company

When Do VCs Make Sense?

	Angels only	With VCs
Amount of capital required to prove the business model	Under $5 -10 million	Over $5 -10 million
Years before being able to exit	2 to 5 years	Over 10 to 12 years
Most likely value of the company at the time of the optimum exit	Under $50 million	Over $100 million

Not an option, or preference, this is pre-determined by the ‘type’ of company

How Many BC Companies Need VCs?

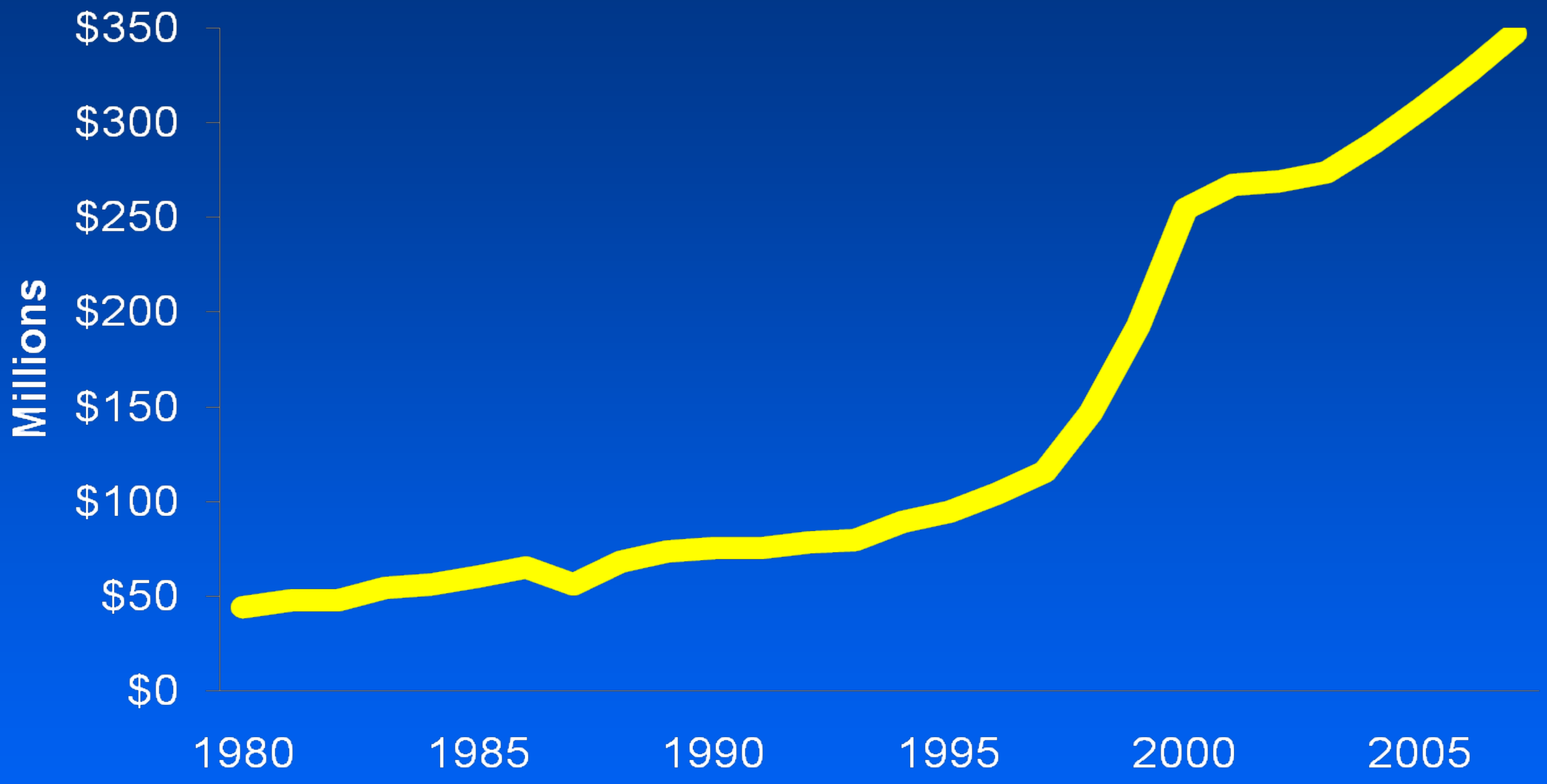
- I wish I was a professor and could hire a grad student to work on this
- This is my belief based on local observation,
- But without enough hard data to prove
- I watch most of the BC tech companies
- Since I started my VC fund in 2002
- I have been asking the question:

How Many BC Companies Need VCs?

- I believe that in the entire province
- In the technology sector
- That there have been fewer than five
- Companies that actually needed
- Venture Capital financing
- In the past <u>decade</u>
- Conclusion: There is still an excess of VC $

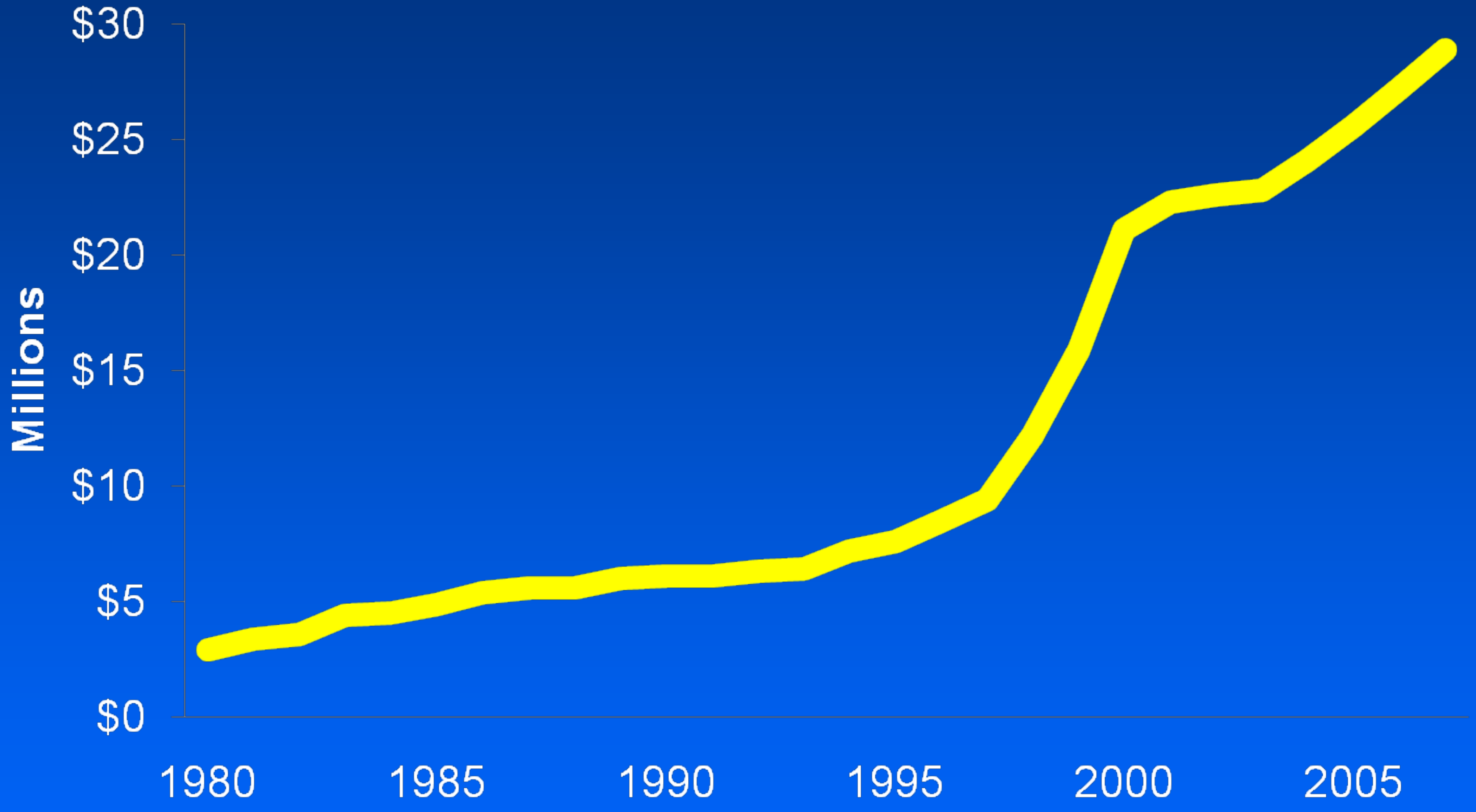
Why Venture Capital is Broken

Size of Average VC Firms



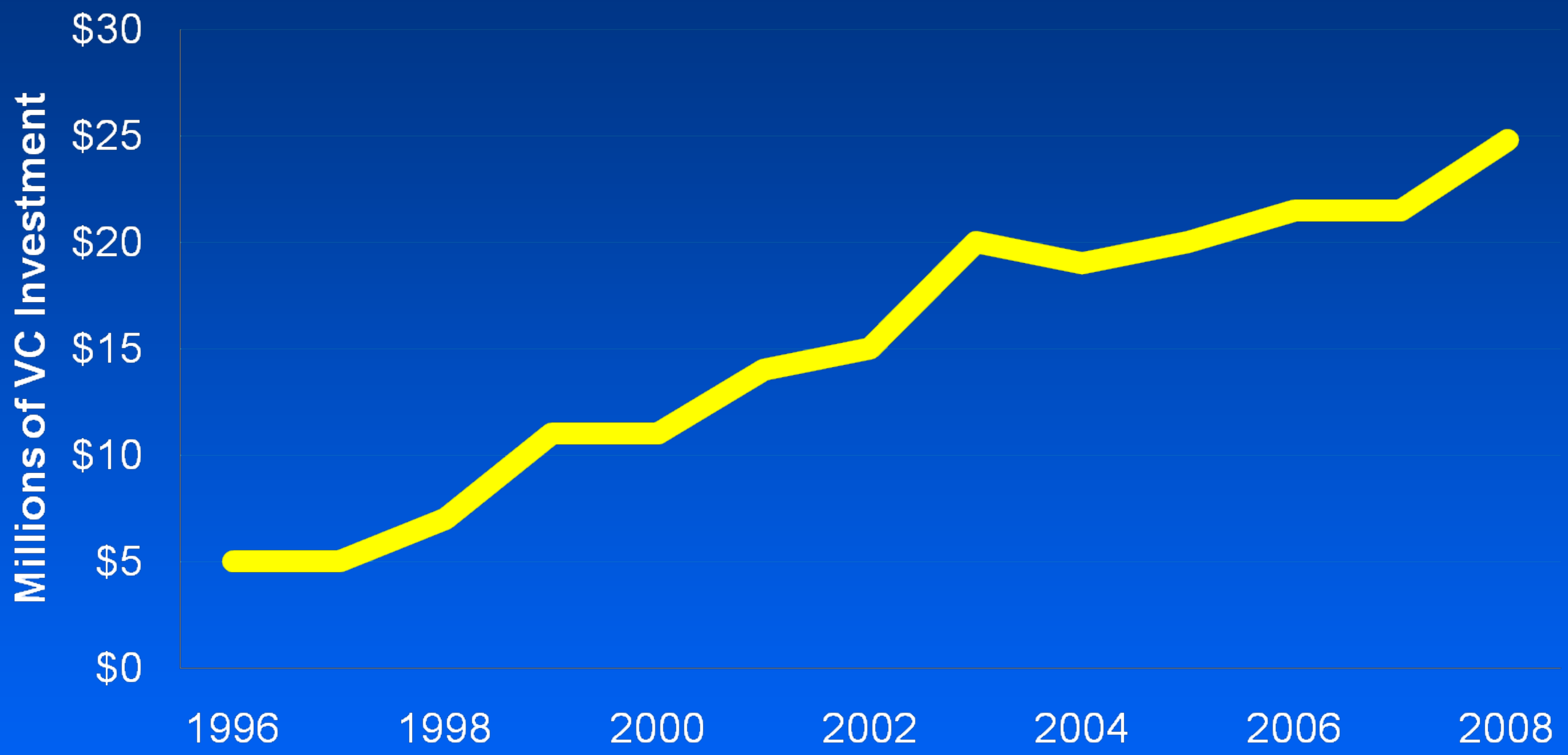
Source: US National Venture Capital Association, Thomson Financial

Average Capital per VC Principle



Source: US National Venture Capital Association, Thomson Financial

VC Investment Prior to M&A Exit



Amount of VC investment prior to M&A exit in millions. 2008 data for Q1
Source: Jeffries Broadview, Dow Jones VentureSource

VC Fund Math

- VC funds have gotten much larger
- Seldom write a check for under $5 million
- Traditional funds <u>only invest money once</u>
- All fund returns come from < 20% of deals
- Limited partners expect an IRR of 20%
- Simple math shows that VC’s winners must produce a <u>30x returns</u>

92+% of M&As Don't Work for VCs

VCs Need Exits over $100 million

Data from Mergerstat

VC Employment in BC

- I think I knew most of the Venture Capital fund managers in BC
- You won’t read about this in the press
- Over the past ten years, I have watched the number of people employed in the VC industry
- Fall by about 80%
- And it is still declining

Why Venture Capital Is Broken

Summary:

1. VC funds are far too large
2. Too few IPOs and huge M&A exits
3. Start-ups need less money
4. VCs don’t play well with Angels
5. Or entrepreneurs
6. Big companies consider VCs competitors

The End of Old Model VCs

- Traditional VC returns over the past decade
- Have been negative
- Based on inaccurate, very optimistic data
- Even after factoring out the bubble in 2000
- Not a cyclical change
- I think there may be a time when a new form of smaller, leaner VC funds can work

More On The Broken VC Model

- If you are interested in reading more on why the traditional VC model doesn’t work anymore:

  http://www.angelblog.net/The_VC_Model_is_Broken.html

Who Finances Startups Today?

- The majority of entrepreneurs still believe traditional VCs finance most startups
- Probably due to the NVCA's PR program and lobbying efforts
- The data shows that Angel Investors finance 27x more startups than traditional Venture Capital Funds
- More at: www.AngelBlog.net/Angels_Finance_27_Times_More_Start-ups_Than_VCs.html

Friends and Family is Bigger

- In America, Venture Capital Funds invest about $20 billion/year – and declining
- Angel investors also invest about $20 billion each year – and I think that number is growing
- Canada is about 10% of the US
- Even more surprising, Friends and Family investors invest about <u>3 to 5 times more</u> than either VCs or Angels
- From “Fools Gold” by Scott Shane 2009

New Financing Models

- It’s not just the economy that’s changing
- Business models are also changing
- New forms of startup capital are evolving
- Incubators
- Crowd sourced financing ← watch this
- Obama’s Jobs Act is very important
- And could create even bigger changes

Summary

- Entrepreneurial finance has changed dramatically in the past decade
- I do not believe these are cyclical changes
- Ongoing fundamental changes in the global economy
- And the entrepreneurial ecosystem
- Have dramatically changed how today’s entrepreneurial companies are financed

Resources

- www.Exits.com/Blog – blog on exits
- www.AngelBlog.net – blog for entrepreneurs and angel investors
- www.Early-Exits.com – book on exit strategies for entrepreneurs and Angel investors
- www.BasilPeters.com – for this PowerPoint and videos of previous talks