The VC Industry at a Crossroads: Current Issues and Thoughts

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LPs Perception of the VC Model

LPs View on VC in 2010

VC Return

- **"Show Me The Money":**
  - Average VC returns post bubble have been negative
  - Few venture-backed IPO over the past two years
- **"The Lake Wobegon Effect":**
  - Every GP can't be above average
  - Only top GPs are interesting and they are hard to get into

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VC Risk

- **Heightened Liquidity Risk:**
  - Liquidity isn't there when I need it
- **Heightened Agency Risk:**
  - GPs are doing well on fees alone, regardless of LP return
  - Funds are too large & some GPs may be "asset gathering"

GPs Perception of the VC Model

GPs View on VC in 2010

VC Return

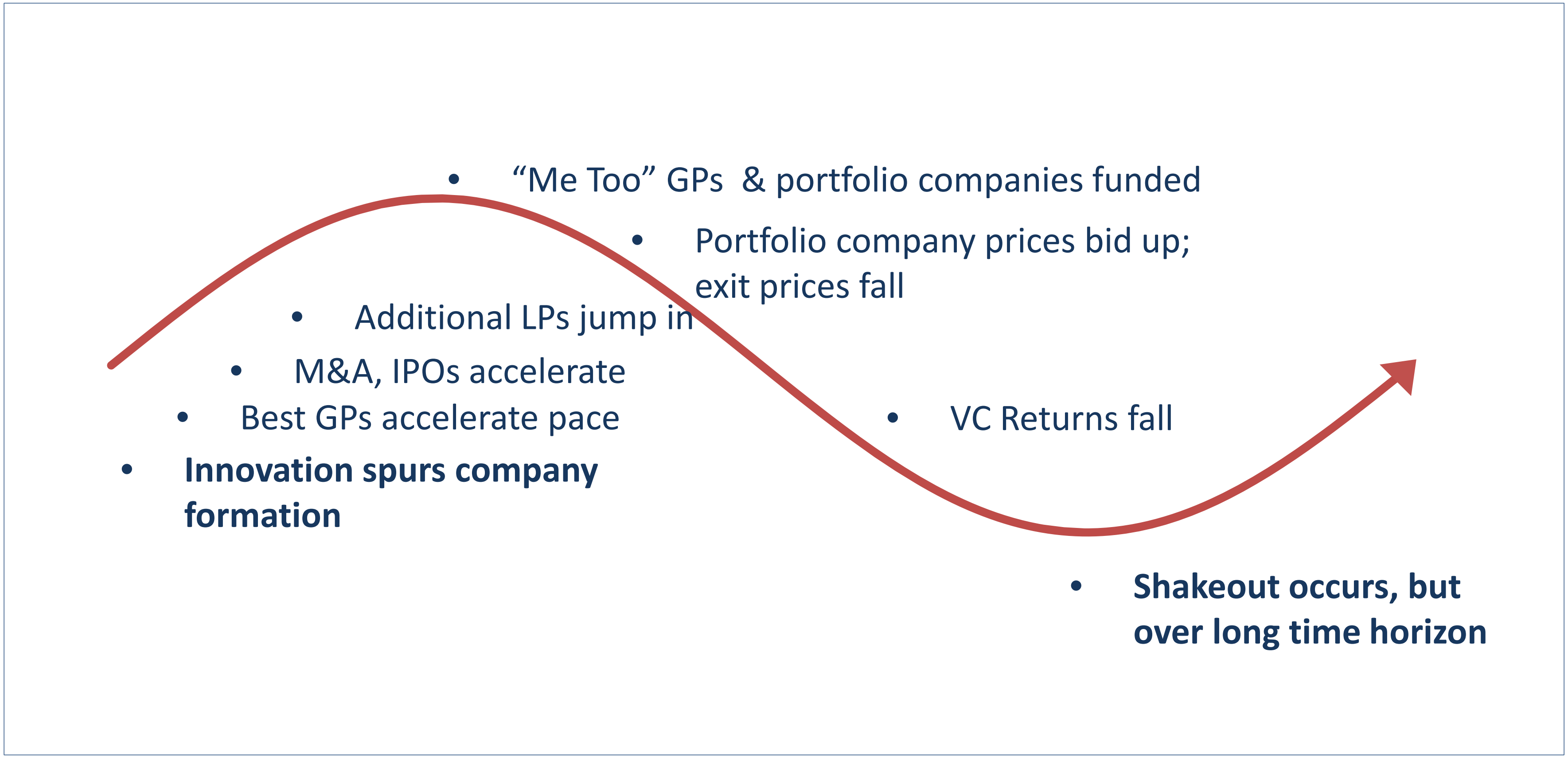
- **The Returns *Are* There:**
  - Returns post bubble after fees beat public market returns
  - There is a backlog of VC-companies poised to go public
- **Survival of the Fittest:**
  - LPs funded too many “me-too” GPs and companies
  - Indiscriminate funding has contributed to lower average returns

VC Risk

- **VC is About Building Great Companies, Not Flipping Assets:**
  - Long time horizon is needed to build world class companies
- **The World Has Changed:**
  - VC no longer just a Silicon Valley – Boston – NY game; larger funds and fees needed to staff and build a global VC practice

Who Is Right? Observation #1

<u>The Long "Boom and Bust" Cycle Exacerbates This Debate</u>



Who Is Right? Observation #2

Changes in the IPO Market for Tech Companies Exacerbate This Debate

Fewer new companies started and funded by VCs immediately post bubble

VCs' focus on existing companies after internet and telecom bust

Time to IPO lengthened for all companies

Sarb-Ox and greater investor demands on profitability

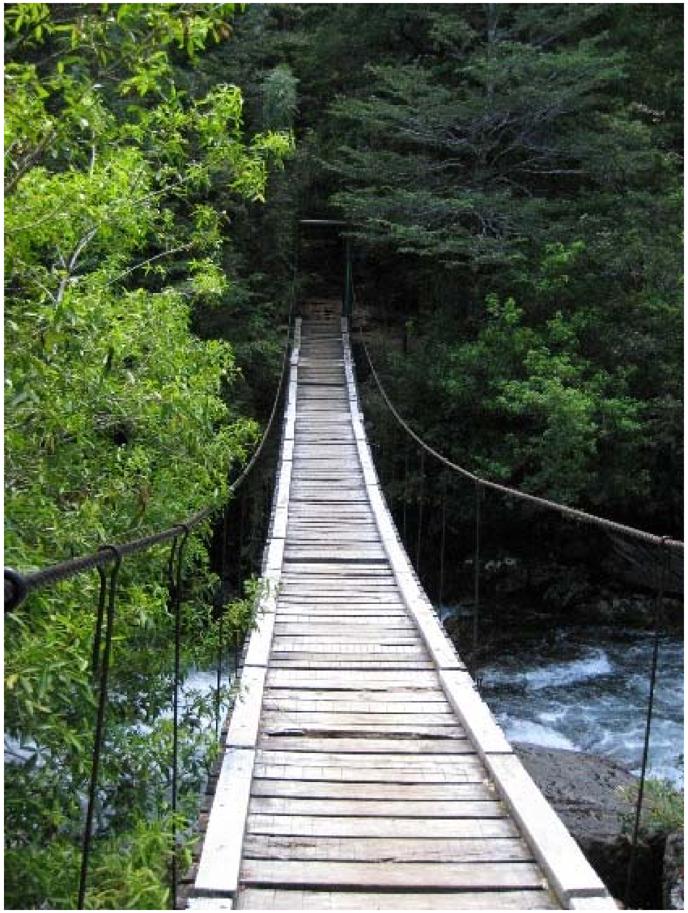
Tech investment bank boutiques disappear

"Four horsemen" disappear; larger Banks exit business of taking small taking Tech companies public

Bridging the Gap Between LPs and GPs

<u>Three Areas to Consider</u>

1. Venture Capital Terms
2. Venture Capital Governance
3. Venture Capital Reporting & Transparency



Bridging the Gap Between LPs and GPs

Consideration #1

1. **Venture Capital Terms**
2. Venture Capital Governance
3. Venture Capital Reporting & Transparency

- Alter fundraising cycle to more closely match liquidity cycle?
- Move towards budget based or scaling of fees?
- Change carry % depending on ultimate fund performance (perhaps even against relative benchmark)?
- Significant GP Co-Investment?

But consider track record …
LPs are slow to embrace new terms or unusual fund models

Bridging the Gap Between LPs and GPs

Consideration #2

1. Venture Capital Terms
2. **Venture Capital Governance**
3. Venture Capital Reporting & Transparency

- Strengthen LP rights?
- Investment period early termination?
- Greater advisory board rights and monitoring?

But consider track record ...
Governance waxes and wanes depending on market conditions, individual GP success

Bridging the Gap Between LPs and GPs

Consideration #3

1. Venture Capital Terms
2. Venture Capital Governance
3. **Venture Capital Reporting & Transparency**

- Would better reporting help bridge this gap?
- Better VC valuation standards?
- Reporting "net" of fees and carry?
- Better disclosure during fundraising?

But consider track record ...
LP agreement complexity and portfolio company deal terms makes this hard to do!

What Pace of Change Can We Expect?

History Would Suggest that Change Will Occur Incrementally ...

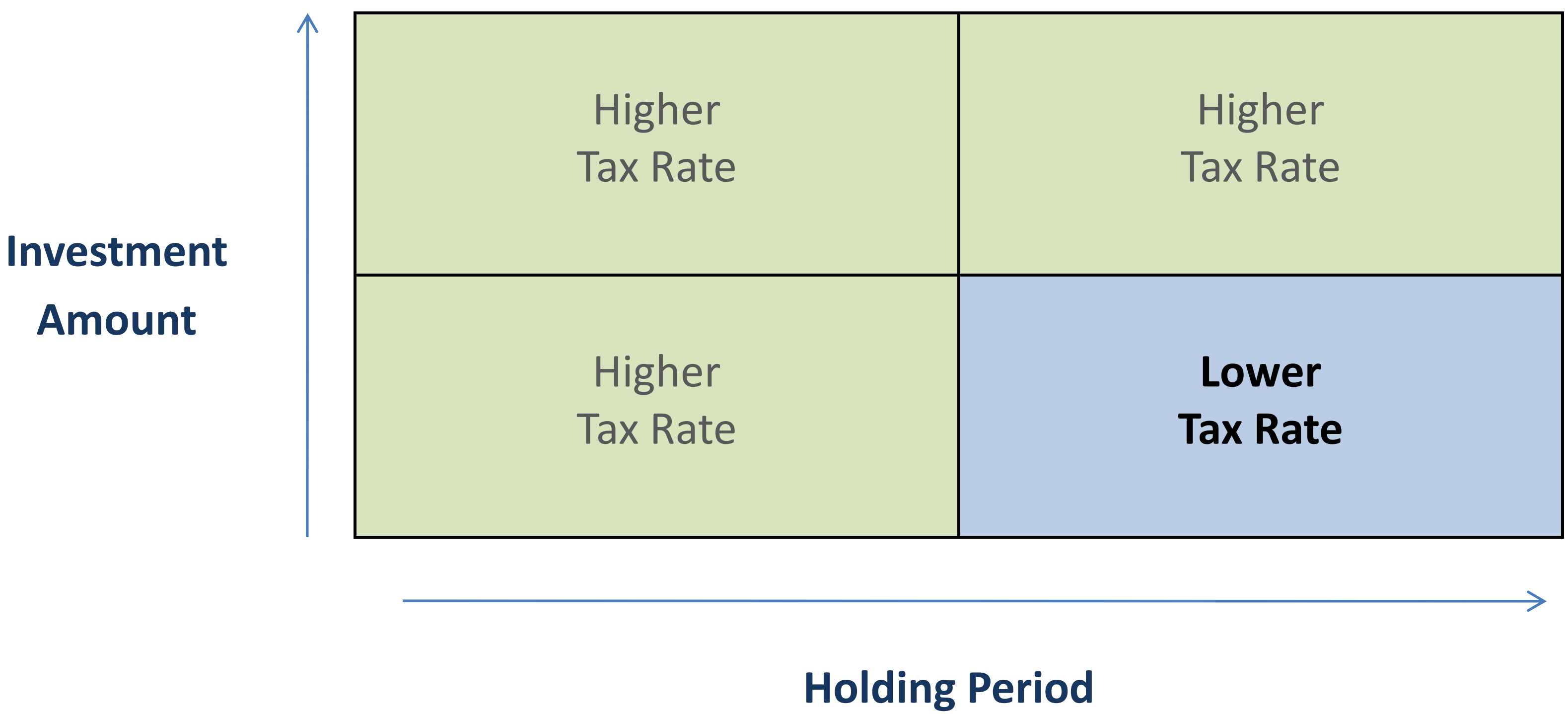
What Pace of Change Can We Expect?

... But The LP World Has Been Turned Upside Down

- New VC investors may help drive changes in the model
- GPs may be willing to consider new models in difficult fundraising environment
- Some interesting VC models are already out there - funds with:
  - Non-traditional fundraising cycles
  - Significant GP co-investment
  - Budget based fees
  - Scaling carry %

One Area Both LPs and GPs Can Agree On?

Consider Lower Tax Rate for Those Building Companies



In Conclusion

Why I Am Optimistic About VC

- Innovation is the foundation of US growth: New company formation has accounted for most of US job growth since 1980
- VCs play a significant role: VCs fund well less than 1% of new US companies, yet participate in majority of IPOs each year[1] (2,000+ public companies financed by VCs since 1970)
- VC returns have outperformed the broader market after fees, more so for top tier funds
- VCs believe IPOs are poised to return, and with it performance will rebound, especially among top tier funds
- Less capital in VC will lead to some very good vintages

1. See Kaplan and Lerner (Dec 2009): 1/6 of 1% VC funded, yet VCs accounted for 60% of IPOs since 2000