Before You Invest in Venture Capital

You need to ask a few questions to make sure you're choosing the right capitalist.

By Edwin A. Goodman

Wealthy individuals, corporations, and institutional investors are negative about venture capital right now because they are still absorbing old bad news rather than assessing the current potential. VC has been out of favor because of the year 2000 stock market bubble and continued poor performance. Yet VC returns are consistently higher than those in the market, even in bad years: Compare the numbers in Figure 1 to the S&P or Dow. Also, investors can learn about new technologies and growth strategies as they assess VC investments.

But investing in VC involves more than evaluating past performance and current talent. In some ways, it's an intuitive process. A friend of mine who's a veteran investor in many venture capital funds recently suggested a set of revealing questions that prospective investors should ask firm general partners. I am in his debt and, with his permission, share them with you here, along with my comments.

Describe a deal you missed that you wish you'd done. What happened? What did you learn?

Be wary of the VC who can't recall missing an appealing deal. This suggests that he/she can't admit to any shortcomings and isn't casting his/her net broadly enough to identify quality prospective transactions that attract competitive capital. Assuming the VC lost a deal, that should yield a valuable lesson or two. Perhaps he mishandled the relationship with the entrepreneur. Or she pushed too hard on price or structure. Or his due diligence process was too lengthy.

What are the behavioral or professional challenges among you and your partners right now? How will they be addressed to improve your firm?

If you hear something like, "I can't think of any," be concerned that you might be dealing with arrogance, insensitivity, and lack of self-awareness, emotional intelligence, or analytical ability—all problematic qualities for the would-be successful investor. If a VC can't provide useful insights into his/her own firm and operation, it's unlikely that he/she will bring such talent to bear on prospective investments. You also may simply be encountering a lack of candor—a poor foundation on which to build an investor/investee relationship.

Most VC firms *do* have issues with which they must grapple. Some of the common ones include compensating and motivating the firm's professionals in a harmonious way, integrating technology productively into the firm's operations, planning for generational change, and arriving at a sensible division of labor and effective decision making among the partners.

Figure 1: **Performance of Private Equity Funds**

Fund Type	1YR	3YR	5YR	10YR	20YR
	Net IRR to Investors for Investment Horizon Ending 6/30/2003 for Private Equity Funds				
Seed/Early Focused	-26.1	-21.7	47.9	35.7	19.8
Balanced Focused	-13.6	-16.5	18.6	21.4	13.9
Later-Stage Focused	-45.1	-22.0	7.3	19.5	14.3
All Venture	**-27.4**	**-20.0**	**24.2**	**26.2**	**16.1**
Buyout Funds	2.6	-6.1	0.6	8.8	12.1
Mezzanine	3.7	1.7	6.1	8.4	9.8
All Private Equity	**-6.9**	**-9.9**	**6.1**	**14.2**	**13.8**
NASDAQ	10.8	-25.8	-3.1	8.7	12.7
S&P 500	-1.5	-12.5	-3.0	8.0	11.6

Source: Thomson Venture Economics/National Venture Capital Association

Is there an interesting intellectual controversy in your firm right now about (a) the industry? (b) how to deal with company managements? (c) how to deal with co-investors? If so, what is it?

This gives the VC the chance to demonstrate how his firm is responding to the current turmoil in the VC community. Depending on the size of the firm and its strategy, it will have to respond to the lack of an IPO market, the disappearance of funds from the market, the shrinking of funds, the shift of funds to financing later-stage transactions, the preoccupation of VCs with troubled portfolio companies, the reluctance of corporations to invest in technology, the sluggish growth of GDP, and the volatility of the stock market—to cite several disruptive developments.

Describe the three most important characteristics you seek in a company founder and a recruited CEO.

This query invites a response fraught with myriad clichés about intelligence, resourcefulness, tenacity, vision, domain expertise, energy, integrity, and a highly developed work ethic. The challenge is to go deeper—beyond these generally agreed characteristics—to see if the VC can offer additional insights based on his experience. Try to elicit concrete examples.

If you could live the last 12 months over professionally, what would you do differently?

Here the VC can shine with candor, giving responses like, "The last year was so horrible no course correction would have helped" or "I would have closed the office and gone to Tahiti with a bag of books I have always intended to read." (I would want to know which books and why.)

The question also may suggest that the VC has a sense of humor, an excellent, if not essential, attribute for all human beings, including VCs. It is always preferable to work with people who take their work, but not themselves, very seriously.

Where will VC firms make the biggest mistakes in the next few years?

This is a useful query because if the VC is sensitive to the greater pitfalls, she's more likely to avoid them. It will also reflect whether she has learned from VC investing history.

Name the venture capitalist you have actually worked with and most admire. Explain why.

This offers you "in the trenches experiences," which are at the heart of the venture business. You'll find you most admire not only the VCs who have the intuitive gift for spotting a great commercial opportunity but those who, in the face of adversity, can help turn a loser into a modest success or even a big winner.

Complete the following sentence, and elaborate: "If I could improve the quality of our firm's deal flow in one way, I would . . ."

See if the VC can point to unique approaches to this perennial challenge. There are many very smart people in the VC community, and there's one school of thought among astute investors that believes the difference between the great firms—and their high returns—and the rest of the pack is that the blue chip firms have old and voluminous Rolodexes (now databases), which provide the cream of new deal referrals.

Personally, what is your secret weapon? What is your firm's secret weapon? What is your blind spot?

All venture capitalists claim they add value and have unique strategies. My experience is that no VCs have unique approaches, but some do have distinct advantages. These range from deep domain expertise to hefty Rolodexes to special conduits of deal flow to lubricated relationships with investment bankers to geographic dominance.

As for blind spots, VCs, like other people, are loath to discuss their shortcomings, but pressing them in this area can trigger a defensive tirade or simple denial—definite danger signs—or elicit a greater degree of openness.

Briefly discuss the typical terms of Series A, B, and C financing two years ago and today.

This delves into the "plumbing" of the venture business. Can the partner in question knowledgeably discuss the nuts and bolts—the details of deal making—or is he a generalist, an overview guy who doesn't get his hands dirty? Such details are important in the business; they tend to limit losses.

The issue of timing determines if the VC is familiar with the changing landscape and how variables influence deal-making terms. The corollary question is, "Has the firm evolved to meet the new conditions?"

What are the three most important things to remember after making a bad investment?

This gives you insight into whether the VC has "studied failure," an important undertaking if you're going to be successful. If the VC can't recall ever making a bad investment, don't invest with her.

Complete the following sentence, and elaborate: "Most of the time the difference between a good investment and one that just didn't work out is . . ."

This is a trick question. Most often, there is no single reason; rather, a complex set of factors coalesces and results in bad investments. This query provides the VC with the opportunity to share his hindsight on poor deals, which can produce many useful insights about him, his firm, and their investment process.

What's the single best way to hedge your risk when making a venture investment?

Again there's no simple answer: Responses will range from strategies for deep due diligence to defensive deal structuring to the use of consultants to corralling knowledgeable co-investors.

Complete this sentence, and elaborate: "If I had to start a venture-backed company tomorrow in a favorite industry of mine, the company's business would be __________, and its special advantage would be________________."

This draws out the VC and challenges her to think like an entrepreneur and position her imaginary company for financing. It also will help the investor assess whether "advantage" intrinsic to the company's technology or products is of great importance to the VC relative to other elements such as management, market size, market growth rate, foreseeable exits, and competitive landscape.

What changed in the last few years in the venture industry that most VCs don't fully appreciate?

This tough question challenges the VC to come up with insights beyond the conventional received wisdom of the day. The VC gets great credit for a perceptive response but fails if he obfuscates or repeats the widely shared observations.

Complete the following, and elaborate: "The thing that limited partners really don't understand about our venture capital partnership and our firm is . . ."

Now that VCs have endured appalling returns, shrinking funds, reduced venture asset allocations, finger pointing, and, in some cases, litigation, the quality and clarity of communication must be improved. These questions are a good way to clear the air and build good communications between general partner and limited partner.

A GOOD START

This list isn't intended to be conclusive—it's supposed to illustrate the dialogue the conductor of due diligence hopes to foster. You should pose these questions in addition to the more traditional queries that seek to uncover historical rates of return, a list of portfolio companies, and formal statements of strategy. The goal is to explore issues that speak to the more intuitive talents of the general partners. Beyond past performance and a mastery of the prerequisite VC skills, we aim to get at the essential question of whether the general partner group has a strategy and working relationships that mitigate risk and hold out the promise of superior performance in the prospective environment. ■

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