Assessing Venture Capital Funds

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What is Venture Capital?

- “Business of building businesses”
- It is investing in companies that have developing products or revenue
- It has an emphasis on entrepreneurial undertaking and less mature businesses
- It is providing money and other resources to high-growth potential businesses in the hope of making a high return. These ***other resources*** are key differentiating factors for investors to evaluate when selecting a venture capitalist fund manager.

eBay

1996 - Benchmark Capital invests $6.7 ***m***illion

1999 - Benchmark investment worth $6.7 ***b***illion

What is a Venture Capitalist?

"I would want to be a venture capitalist without question.
….you get to be wrong 9 times out of 10 and still get paid!"

-Scott Adams, July 1997

Distribution of Venture Capital Returns

- 50% of investee companies will lose money for their VC investors: return < 1x
- 45% of companies will provide returns of 1x to 3x
- 5% of companies will provide more than 3x return to investors

Source: FLAG Capital Management, 2005.

What Do Venture Capitalists Do?

- Raise Money
- Identify and Screen Opportunities
- Transact and Close Deals
- Monitor and Add Value
- Harvest
- Raise More Money

Key to Investing in Venture Capital Funds

Returns are Manager Specific

- No “premium” for venture capital investments
- No underlying asset class return for VC funds
- Indices do not capture manager specific risk

Venture Capital Returns

Cumulative Since Inception Annual Returns As At June 30, 2007

	1st Q	median	3rd Q
Canada	8.0	(0.8)	(8.7)
USA	15.9	4.7	(2.4)
Europe	5.5	(0.4)	(7.3)

	20 year	10 year	5 year
NASDAQ	9.5	6.0	14.4
S&P 500	8.3	5.4	10.5

Source: Thomson Financial

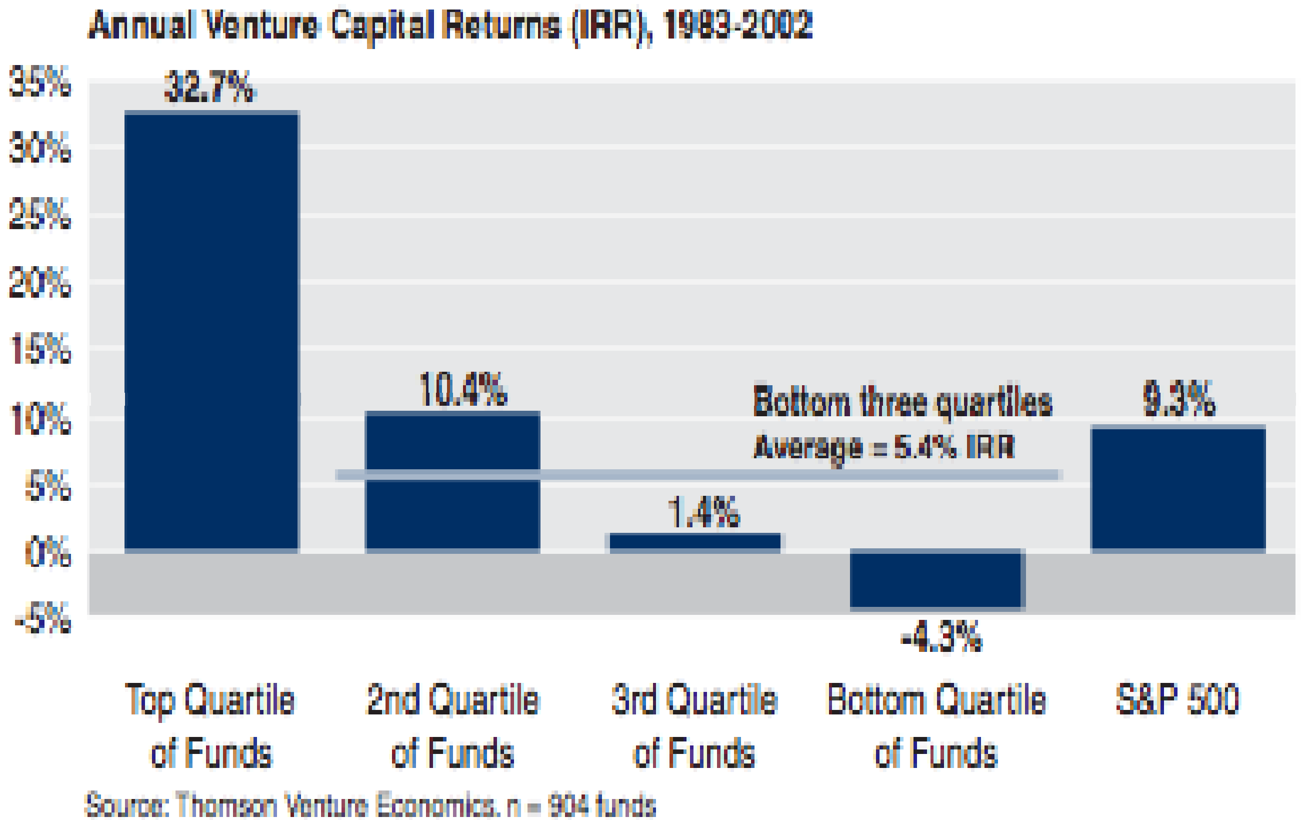
Opportunity for Active Management Returns

Annual Returns by Quartile, Ten Years Ending Dec. 31, 1997

Asset Class	First Quartile	Median	Third Quartile	Range
US Fixed Income	9.7%	9.2%	8.5%	1.2%
US Equity	19.5%	18.3%	17.0%	2.5%
International Equity	12.6%	11.0%	9.7%	2.9%
Real Estate	5.9%	3.9%	1.2%	4.7%
Leveraged Buyouts	23.1%	16.9%	10.1%	13.0%
Venture Capital	25.1%	12.4%	3.9%	21.2%

Source: Swensen, David F., Pioneering Portfolio Management

Top Quartile Funds Outperform Rest of VC Industry



Source: Focus Ventures

Concentration of VC Returns

- 29 VC Fund Managers accounted for 14% of all capital raised 1986 to 1999 in the USA
- These 29 managers accounted for 51% of total industry distributions to fund investors
- These 29 managers distributed 3.6x to investors
- The other 500-600 fund managers returned only 40-60% of their capital or 0.4x to 0.6x

Source: FLAG Capital Management, 2005.

What Makes a Successful Venture Capitalist?

…. venture capital is truly an apprenticeship business. It takes years of mentoring to learn how to assess investment opportunities, set pricing and strategy, build and motivate management teams, deal with inevitable and unpredictable threats to the businesses, source additional capital and strategic partners, and, finally, divest (for better or worse) these illiquid investments. FLAG Ventures

"Training a venture capitalist can be costly; I'd guess up to $30 million of losses." John Doerr, Kleiner Perkins

Research on Venture Capitalist Performance by Kaplan and Schoar

- The average net returns of VC funds were approximately equal to the S&P 500
- Fund managers that outperform the market in one fund are likely to outperform in the next fund
- Fund managers that underperform the market in one fund are likely to underperform in the next fund.
- First-time funds tend to have below-average returns
- Industry returns are lower after periods of increased entry into the market by new fund managers

Source: Private Equity Performance: Returns, Persistence and Capital Flows, Stephen Kaplan and Antoinette Schoar, 2005.

Research on Returns to Institutional Investors in VC Funds

Investor Type	Early-stage VC Fund IRR%	Later-stage VC Fund IRR%
Endowments	34.7	19.3
Public Pension Funds	12.1	10.8
Corporate Pension funds	9.4	10.9
Insurance Cos.	2.6	12.3
Advisors/FOFs	(0.5)	(1.0)
Other Investors	(6.8)	17.8
Banks & Finance cos.	(13.9)	1.0
Overall	12.8	9.4

Source: "Smart Institutions, Foolish Choices: The Limited Partner Performance Puzzle", *Journal of Finance*, April 2007.

Key Due Diligence Areas

- **The general partner’s investment strategy / proposed terms**
- **Verifying a general partner’s performance**
- **Alignment of interests between the GP and LP**
- **The general partner’s background and reputation**

Due Diligence: Investment Strategy and Market Opportunity

- **Verify that the strategy is clear and very similar to that on which the manager's track record is founded**
- **Evaluate whether the proposed fund is filling a gap in the market**
- **Verify sources of value-added such as corporate contacts, board activity, recruitment, exiting management skills and business strategy**

Due Diligence: Track Record

- **Verify what deals were done by whom**
- **Examine IRRs on investments in conjunction with multiples of original costs realized**
- **Consistent upper quartile returns over an extended period of time and a good number of realized investments are preferred**
- **In respect to unrealized investments, review the valuation policy closely**

Due Diligence: Investment Team

- **Each individual should have solid experience as a venture capital manager**
- **Consider whether or not the individuals have worked together in the past - will the team be able to work well together?**
- **Speak to business counterparts of each manager**
- **Managers must be able to demonstrate some key skills including:**
  - **Well connected in order to receive the best deal flow**
  - **Value-added focus**
  - **Governance and Control**

Fund of Funds

Why Invest in a Fund of Funds?

- Specialized expertise with proven track record
- Access to top tier funds
- Diversification
- Administrative efficiency – consolidated cash management/reporting
- No conflict in allocation of investment opportunities among clients
- Increased clout due to size of pooled assets
- Potential for earlier returns through secondary investments

Criteria for Selecting a Fund of Funds Manager

- Reputation
- Quality and stability of organization
- Relevant experience in private equity asset class
- Investment due diligence process
- Relationships with top-tier managers
- Track record
- Experienced back office – legal, accounting, cash management
- Ability to accommodate client needs
- Quality of investor base
- Ethical behaviour

Conclusions

Returns in Venture Capital are Manager Specific

- No “premium” for venture capital investments
- No underlying asset class return for VC funds
- Indices do not capture manager specific risk
- Access to top-quartile or top-decile fund managers is required to justify lack of liquidity and risk in venture capital

Devote Adequate Resources to Ensure Active Management

- Understand intricacies of VC fund investments
- Conduct thorough due diligence
- Avoid VC fund investments if adequate resources are not available

Thank You!

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