THE LITTLE BOOK *of* VENTURE CAPITAL INVESTING

Empowering Economic Growth and Investment Portfolios

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GERKEN CAPITAL ASSOCIATES
with WESLEY A. WHITTAKER

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The Little Book of Venture Capital Investing by Louis C. Gerken with Wesley A. Whittaker

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To my daughter Alexandra,
the hardest worker I know.

From my point of view VC is the ultimate in supply-side, and this Little Book captures this in a way not done before.

—Art Laffer, Laffer Associates

The only VC-related book I'm aware of, providing a lively and contemporary go-to synopsis on the state of the VC industry, the ins-and-outs of how to invest in the space, and a forward look at what's needed to re-ignite the VC growth engine.

—Frank J. Caufield, co-founder,
Kleiner Perkins Caufield & Byers

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Acknowledgments

It occurred to me as I started writing this book that I wanted to draft this section and compare it with how I felt about the contents when it was completed. In a book with as many invaluable sources as *The Little Book of Venture Capital Investing*, it goes without saying that there are many people from whom I am constantly learning and who have greatly influenced my thinking and views. *Venture Capital Investing* owes a great deal to Wesley Whittaker, my talented co-writer; thank you so much to John Wiley & Sons for the referral. Thanks to editor Debra Englander and her terrific colleagues at Wiley for believing in me as a first-time author. A special thank-you also goes out to my partners and professional staff at Gerken Capital; thank you Carla, Pankti, Anthony, Valerie, Pierre, Elizabeth, Peter, Laura, and

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I also wish to give recognition to all the VC industry pioneers, current pathfinders, and tomorrow's trailblazers who never cease to amaze me with their savvy determination and survival skills. I see no limit to what is possible by America's entrepreneurs when unbridled to do what they do best.

Special thanks also goes to the wealth of sources I accessed to write this book, where there is such an abundance of industry data and intellectual capital available for a first-time author to access.

Lastly, I give special recognition to my parents who started me on the path to investing when they seeded my first investment portfolio at age 12 (Litton Industries, LTV, and PSA—sadly now all defunct enterprises).

In closing, I trust that this *Little Book* will be helpful in some small way to small business owners—who make up 93 percent of all businesses in the United States, who work tirelessly and risk so much. They deserve better access to growth capital and the opportunity to become one-percenters.

An Introduction to Venture Capital Investing

Occupy Wall Street protesters are planning to occupy the subway in New York City; because if there's one place to confront the nation's wealthiest 1 percent, it's the subway.

—Conan O'Brien

Who Are the 99% and Why Are They So Angry?

In September of 2012, I saw a headline on the inner pages of my *Wall Street Journal*, "Occupy Movement Turns 1 Year Old. Its Effect Still Hard to Define." Under the headline were details of arrests for disorderly conduct and photos of what looked like the aftermath of a tornado. Clues to the protestors' incongruent discontent were scattered through the crowd on professionally printed signs and hand-painted placards in fractured disarray.

The CRISIS is CAPITALISM

IPO = I'm Pissed Off

Where is the CHANGE we voted for?

I'm so angry, I made a sign

The obvious disconnect was that the protestors were actually beneficiaries of the successful ventures of the 1 percent they so willingly maligned. The entire Occupy protest was conceived, coordinated, and thoroughly documented on various forms of social media, from Tumblr to Skype to Facebook to Twitter. The protests were photographed on Apple iPhones and Android phone cameras. The protestors kept up their energy by chugging Red Bull and eating LUNA bars. They filled Zucotti Park with nylon popup tents from Ozark Trail, slept in North Face sleeping bags, kept warm with Coleman heaters while sipping Starbucks lattes. Some signs were hand-painted, but many were printed professionally at FastSigns or FedEx Office. FedEx also delivered the Guy Fawkes masks and tricorner hats that were ordered from eBay. Donations to feed and support the long-term "committed" protestors were raised through KickStarter. Corporate logos adorned hoodies, shirts, shoes, and denim jeans everywhere. No matter how socially aware and progressive the 99-percenters fancied themselves, this disgruntled and unfocused multitude seemed blissfully ignorant of the fact that if it wasn't for capitalism, none of the resources they had relied on to fuel their righteous indignation would even exist. This global exercise of political democracy was only made possible by the economic democracy afforded by the brand of capitalism which has been practiced in America since the latter half of the twentieth century. As American philosopher and educator Mortimer Adler wrote in the preface of *The Capitalist Manifesto* (New York: Random House, 1958), which he co-wrote with Louis Kelso, "Democracy requires an economic system which supports the political ideas of liberty and equality for all. Men cannot exercise freedom in the political sphere when they are deprived of it in the economic system."

In other words, the Occupy protestors were right to be angry at the excesses and abuses of the elitist few, but their anger and frustration had been hijacked by those with a subversive political agenda against the only economic system that has actually improved the lives of all mankind. Fraud, deceit, and corruption in both the financial system and in the government regulatory sector are the true culprits. The crony capitalists definitely need to be brought to justice in order to restore the integrity of the real free market system; however, history has proven conclusively that socialism, communism, and anarchy are not the remedy for the excesses of criminals and evil doers.

The irony of the entire Occupy movement is that it was made possible by the very thing it decried—capitalism—and venture capitalists (VCs) in particular. Each of the companies represented by the countless logos and slogans that pervaded the Occupy protests and their multiple locales benefited, early in its conception, from an infusion of capital made by private investors who saw enormous potential and bore personal financial risk to fund the particular technology, product, or service that enabled the movement's effectiveness and the protestor's comfort. The return on that investment came about through persistent work, the maximization of available resources, the public's perception of a fair exchange of value, and YES a lot of luck. It is the true manifestation of the American Dream.

Capitalism, especially in the free market paradigm, is not the zero sum game the Occupy evangelists would have you believe. Every time people take a risk with their own money and end up winning, their good fortune does not mean that someone else lost. That is a ludicrous proposition believed only by the ill-informed or the leftist ideologue. That is the Big Lie told to fuel the envy and bigotry of the ignorant in order to promote a political and economic agenda. There is a much larger percentage of Americans who have achieved financial success than 1 percent of the population. Neither is 99 percent of the population shut out of opportunities that are still afforded to those who live in this greatest of nations. That is a propagandist distortion of statistics to the grossest extreme for purely nefarious reasons. The political paradigm put forth by the inciters behind the Occupy movement calls for sublimating the individual for the good of the collective; surrendering the inherent greed of private property rights for the altruistic enrichment of the community; and achieving a fair and equitable outcome for society by redistributing the ill-gotten gains of the successful in order to supplement the lifestyle choices of the under-achievers. Really?

The demonization of the economically successful is not at all about fairness and equality. It's about political power and economic control; the seizure of political power by those who cannot possibly gain it through reasoned public discourse and the theft of wealth that they desire but are unwilling to obtain through traditional, legitimate means. It is not fair. It is not democratic. It is unethical and it is totally antithetical to what it means to be an American.

America was built on the premise that if you have a dream, set your goals, and work hard to achieve it, you can accomplish anything. How did we become the global vortex for demonizing success? How does transforming our commercial and financial centers into landfills of consumer excess serve to bring about constructive resolution of the gulf between the have-lots and the have-nots? Whining pithy slogans based upon entitlement expectations and offering no comprehensive solutions are not synonymous with civil disobedience. We must confront the fact that the American people have allowed a few sociopathic narcissists to steal their dreams along with their money. And we must refuse to accept the hysterical, illogical, and unfounded rhetoric that it is "unfair" and "evil" for an individual to use her own vision, analysis, courage, and due diligence and to invest her own money to underwrite someone else's dream of starting a private business, creating jobs and contributing to the economic health and social well-being of the community.

What Is Venture Capital Investing?

Venture capital investing is a lot like the old baseball adage: You win some, you lose some, and some get rained out. There is no secret formula or guaranteed path to success, especially in the field of venture capital investing. Many venture capitalists have lost their entire investment when the once-brilliant ideas they funded foundered in the competitive marketplace or got torpedoed by even greater innovations.

Sand Hill Road, the legendary 3.5-mile stretch of concrete that runs east from I-280 to El Camino Real in Menlo Park, California, is the financial epicenter of Silicon Valley. It is littered with the fading memories of companies and grand ideas you've never even heard of. It is also home to many early investors in businesses who went on to become household names; calculated risks made many of them quite comfortable.

The returns on the initial investment are just the tangible rewards for being a venture capitalist. Many who live and work along this short stretch of road, which skirts the north side of Stanford University, are driven by more than money. Reid Hoffman is a perfect example; the 45-year-old partner at Greylock Partners has been in on the initiation of over 80 startups including such game-changers as PayPal and LinkedIn. He sits on the board of directors for Kiva.org and is known as the consummate connector in Silicon Valley. He genuinely cares about people and making the world a better place. As LinkedIn CEO Jeff Weiner says of Hoffman, "His true north is making a positive, lasting impact on the world in a very profound way."

Hoffman is a self-identified liberal who still drives the 2002 Acura he purchased with his share of the PayPal buyout. He probably understands the angst underscoring the Occupy complaint, but it would be an incredible stretch of credibility to paint Reid Hoffman with the scarlet "1 percent" label.

How does one become a venture capitalist? For many, like Bill Joy, it was a natural progression. Born in 1954, Bill grew up in the northern Detroit suburb of Farmington Hills, Michigan. He obtained a bachelor's degree in electrical engineering from the University of Michigan and by 1979 had completed a master's degree in computer science from the University of California, Berkeley. He also holds an honorary PhD in engineering from the University of Michigan. As a graduate student at Berkeley, Joy designed and wrote Berkeley UNIX, the first open source operating system with built-in transmission control protocols for the Internet protocol (TCP/IP), which is the basic communication backbone of the Internet. He founded Sun Microsystems in 1982 and was a key designer involved with a number of Sun technologies, including the Solaris operating system, the SPARC microprocessor architecture and several of its implementations, and the Java programming language. As an inventor, Bill is named on more than 40 patents. In February 1999, his many industry contributions were recognized in a *Fortune* magazine cover story that called him the "Edison of the Internet."

His accomplishments, the product of his keen intellect and inquisitive nature, resulted in substantial financial rewards. This prompted him to pursue interests in other areas, and in 2005 Bill Joy joined Kleiner Perkins Caufield & Byers, one of the first Sand Hill Road VC firms and the company that had provided the startup capital for Sun in 1982. Joy helped develop KPCB's strategy of funding game-changing technologies that broadly address the twin problems of climate change and sustainability. His ventures included investments in wind, solar, and thermoelectric power generation; low-cost electrical energy storage; renewable fuels and green chemicals from nonfuel sources; low-embodied-energy materials; and energy-efficient electronics. He now serves as a Partner Emeritus at the firm.

My VC journey is different from Bill Joy's and Reid Hoffman's, but I believe we share some traits in common: a strong work ethic, a willingness to invest, the strong desire to make the world a better place, and an innate ability to take a setback as a learning experience and press onward. I was 16 years old when I experienced my first business failure. It was a summertime sole proprietorship called Paul Bunyan Tree Service. Due to my lack of experience in risk assessment and due diligence, I lost all my hard-earned gains paying for damages caused by a tree coming through a client's roof. It was an expensive lesson, but business fascinated me, and I was determined to learn from my mistakes.

I earned a bachelor's degree in economics from the University of Redlands and went on to receive an MBA from the Southern Methodist University Graduate School of Business and a master's degree in international business from the American Graduate School. After finishing my university studies, I was hired by The Bank of California, where I monitored privately-held companies, and subsequently worked with a pioneering emerging markets investment manager, London-based GT Capital Management. I then self-financed a start-up called TCG, a telecom consulting engineering practice, which I sold to Pricewaterhouse-Cooper's consulting practice.

This helped set the course of my life, and later I landed a job as head of Venture Capital Investments with Wells Fargo Bank, where I serendipitously developed one of the first U.S. fund of funds with Anthony Moore, one of my current partners at Gerken Capital Associates (GCA). Some of the best ideas are born by complete accident. Sometimes the best path is the one you take alone. For example, while with Wells Fargo, I had been presented with opportunities to invest in a number of "risky," early stage companies, including Sun Microsystems and Microsoft. My investment acumen aside, the organizational guidelines that governed investments of the group at that time would not even permit me to present these opportunities to the group's Investment Committee. The unintended consequence was the creation of one of the first U.S. venture capital "fund of funds."

I did a stint at Montgomery Securities Venture Capital and was subsequently hired to become a co-GP with Prutech, the venture capital investment subsidiary of Prudential Securities, founded by another one of my current GCA partners, Hugh McClung. As one of the largest U.S. venture capital funds, Prutech was responsible for completing 50 IT and biotech sector early-stage and expansion-stage investments, and was one of the first VC funds to pioneer corporate partnering as a co-investment strategy. Eventually, I was asked to head up Prudential Securities Technology Investment Banking Division.

I left Prudential in the late 1980s, thinking I was ready for an early retirement. After a much needed vacation in South Africa, one of my favorite destinations, the entrepreneurial bug bit once again. I founded GCA in 1989 as an alternative asset fund management firm, with particular focus on alternative assets and emerging markets. Version 1.0 of our business was to act as a seeder to "next generation" alternative asset fund managers, backing more than two dozen teams. GCA morphed circa 2000 into its present v. 2.0 business—managing and advising alternative assets (private equity, venture capital, and hedge funds), and merger and acquisitions advising. I think what differentiates our approach toward investing is that we take a very active and hands-on approach toward managing assets and, as a privately owned boutique, have the flexibility to move on investment opportunities very quickly. We are not reluctant to do the heavy lifting associated with being the lead investor. We are chameleons by nature and have adapted our investment thesis and approach to the prevailing investment climates. By way of example, our latest vintage VC fund's investment strategy is to focus on start-up and/or early-stage companies and "deal fatigued" expansion-stage companies, where our value-add is more advantageous than our investment capital.

An Overview of the Venture Capital Industry

Like Bill Joy, most venture capitalists come into the industry from another field in which they have experienced success or which holds a great deal of interest for them. There is a high tech legend that Bill Joy and futurist Ray Kurzweil were having drinks in a hotel bar one night and got into a rather protracted discussion about GNR technologies—genetics, nanotechnology, and robotics—and the possibilities of reaching a point in the future where the human race becomes one with machine. This is a favorite and recurring theme in Kurzweil's writings, but it so disturbed Joy that he developed a fund to invest in GNR for the sole reason of monitoring the progress of the sector's development. Reid Hoffman started SocialNet.com as a way for students on the Stanford campus to connect with others who shared their interests. He was about seven years ahead of the social media phenomenon, but the interest has definitely influenced his investment strategies. It led to him doing everything right when he rolled out LinkedIn several years later.

VCs don't typically use a lot of their own money. That is usually an activity reserved for what is known as an angel investor and typically involves investments of $1 million or less. Venture capitalists form a firm and start a fund, which is often designated for a specific industry sector. The fund will attract money from pension funds, endowments, foundations, and high-net-worth individuals (HNWs) and family offices who are interested in either investing in that particular sector or just looking for the higher than normal return that is the attraction and the pitfall of venture capital investing. When all goes as planned, the VC finds an entrepreneur with the next big idea, invests the fund's money for an equity position, mentors the entrepreneur's management team to the point where the new company is showing success, and then exits the investment through either an initial public offering (IPO) on the stock market or a sale of the company through a merger and acquisition by another firm. The return on the growth of the VC's equity position is then returned to the fund and paid out to the fund's investors on a prorated basis. According to statistics of the National Venture Capital Association (NVCA), 40 percent of all ventures fail to ever show a positive return, while another 40 percent may eventually break even. Everybody is chasing that elusive 20 percent that is the next LinkedIn, Google, or Facebook. Those success stories are what keep the lights on in the office buildings along Sand Hill Road and elsewhere across the country.

Venture capital activity has a significant impact on the U.S. and global economies. Venture capital is a catalyst for job creation, innovation, technology advancement, international competitiveness, and increased tax revenues. According to the 2011 Venture Impact study, produced by IHS Global

Insight, originally venture-backed companies accounted for 11.87 million jobs and over $3.1 trillion in revenue in the United States (based on 2010 data). Those totals compare to 21 percent of GDP and 11 percent of private sector employment.

So, how is the VC industry doing these days? For the fourth quarter of 2012, the NVCA issued a press release with the headline: VENTURE-BACKED EXITS ENJOYED HIGHER AVERAGE VALUES ON LOWER TOTAL VOLUMES IN 2012.

According to the release, $1.4 billion was raised from eight IPOs during the fourth quarter of 2012. This was a decline in volume from the preceding quarter, but a 23 percent increase in dollars raised. For the full year, 2012 saw 49 IPOs raise a total of $21.5 billion, driven largely by the Facebook offering. This was the strongest annual period for IPOs, by dollar value, since 2000. M&A deals were down 11 percent from 2011, with 120 disclosed value deals returning $21.5 billion for full year 2012.

As detailed in other Little Books, indexing and thoughtful asset allocation are probably a solid choice for many investors' core holdings. But for those seeking exceptional gains on a long-term investment horizon, alternative investments like private equity (including venture capital) can offer an uncorrelated—and often highly lucrative—complement to an otherwise staid investment plan.

Just like other markets, venture capital experiences periodic investment cycles. Coming off the historic dot-com boom and the Great Recession that followed, venture capital has recently taken some hits but is poised for a new run. "The lesson of the late 1990s is that venture capital can be powerful at times," said Greg Turk, director of investments for the $37 billion Teachers' Retirement System of the State of Illinois. The system is increasing its allocation to venture capital to diversify its portfolio. "If you don't have it, you might miss out if venture capital returns outperform again."

Not Your Grandfather's Venture Capital

"Hold on a second," you say. "Building tangible economic value sounds great, but aren't private equity and venture capital investments only available to highly sophisticated, ultra-wealthy individuals or institutional investors?" The answer is yes . . . and no. Historically, your grandfather's venture capital tended to be a closed club to which average investors felt they could not apply. But market competition is causing venture capital to evolve in exciting new ways, which I'll tell you about in the chapters to come.

What This Little Book Is and What It Isn't

The book is not intended as a textbook on how to raise VC or as a guide to becoming the next Google. I provide an insider's view of how VC works and how to best define VC, tying its fascinating history to its transcendent present. I offer additional background into who VC investors are, what their investment strategies are, their VC performance, and the sectors they invested in, as well as the difference geography can make. We explore the multiplier impact of VC investing, both in dollar terms and social impact. We examine the prevailing investment climate, revealing startling data on new start-up growth and challenges. Then we take a look at both the private and listed venture capital investment options available to you so that you too have the ability to become a 1 percenter!

This *Little Book* outlines a practical field guide to the VC investment process—everything from setting investment criteria to monetizing VC investments.

You will find a handy Appendix with a glossary of terms and links to a due diligence checklist and additional resources pertinent to VC investing. With this information you can properly assess the risk-reward relationship of venture capital investing. I believe you will find the insights offered pleasantly surprising.

Chapter One

An Historic Overview of Venture Capitalism

Those who cannot remember the past are condemned to repeat it.

—George Santayana

WHY IS AN HISTORICAL overview of VC important? Because history does in fact repeat itself, and a study of history allows us to frame an understanding of the present and the future. The players and the investment climate change, but the entrepreneur's innate instinct to risk capital for a return is no different today from what it was when John D. Rockefeller became America's first billionaire in 1900. When Andrew