1

The Call to Adventure

The first pitch an entrepreneur presents to a VC sets the tone of the future partnership. Such contacts are first and foremost light and subtle—however, they offer a good opportunity to watch out for those nearly imperceptible tell-tale signs. Both sides then size each other up and assess whether they want to continue with the engagement. Figure 1.1 sketches the interplay.

The Rules of the Game

Venture capital is the process of professional investment alongside management in young, rapidly growing companies, typically in early stages of company development, in return for equity securities in the start-up. The mandate of venture capitalists (called VCs; the abbreviation works for both the field and the people who practice in it) is to generate high rates of return over long periods of time, offering institutional investors and high-net-worth individuals high returns and strong diversification benefits from very low correlations with other asset classes. The major negatives of investing in VC are long time frames, lack of liquidity, higher risks (with the expectation of higher rewards), and high management fees. For start-up companies, venture capital is an important source of equity, but more important, venture capital fund managers play a significant role via active participation—providing related expertise to fuel the development of young and growing firms as well as funds for them to draw on. There is growing evidence that vibrant venture capital markets spur innovation and economic growth.

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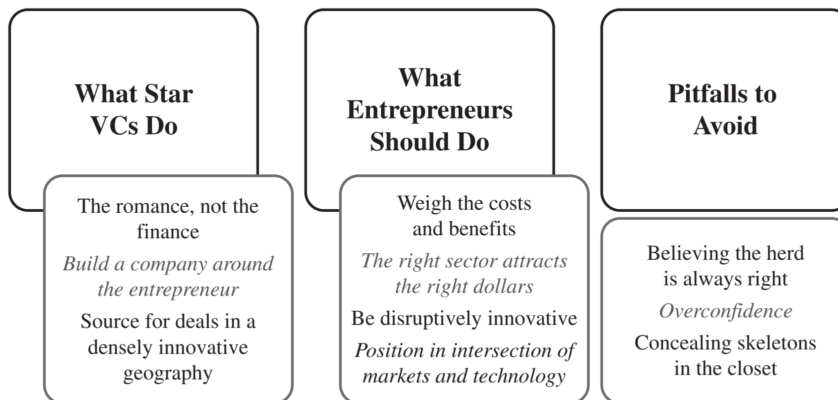

Figure 1.1 The Choice: To VC or Not VC?

Bridging the Gap

Many start-up firms require substantial capital, and their founders generally lack sufficient funds to go it alone. And today's start-ups—with their significant intangible assets and uncertain prospects—are unlikely to receive bank loans or other debt financing, and they typically struggle to attract normal equity financing. Venture capital aims to fill this gap in the supply of finance.

Venture capital is commonly seen as a subset of private equity: focused on equity or equity-linked investments in privately held, high-growth companies in their seed, start-up, and early expansion phases of development. Table 1.1 presents an overview of the field.

Who Is a Venture Capitalist?

The popular image of a venture capitalist is that of a wealthy financier who funds start-up companies. If an entrepreneur who develops a change-the-world invention needs capital and can't get it from a bank or from friends, fools, and family members, venture capitalists stand ready to step in and save the day.

In practice, a venture capitalist may look at several hundred investment opportunities before making a choice, investing in only a few selected companies with favorable investment opportunities. Far from simply looking for homes for money, venture capitalists foster growth in companies through their involvement in the management,

Table 1.1 Institutional Venture Capital at a Glance

Principle		Example
Definition[1]	Institutional venture capital comes from professionally managed funds that have $25 million to $1 billion to invest in emerging growth companies.	Intel Capital China Technology Fund II is a US$500 million fund that aims to invest in wireless broadband, media, telecommunications, and green technology in Xinhua.
		The Kleiner Perkins Caufield & Byers (KPCB) iFund™ is a US$100 million investment initiative that aims to fund innovators who are creating evolutionary applications atop the iPhone/iPod platform.
Ideal client	High-growth companies that are capable of reaching at least $25 million in sales.	E-bay: Subsequent to its IPO in September 1998, the company posted net revenue of US$12.9 million in the third quarter of 1998[2]
		Amazon: The company reported net revenue of US$27.9 million in the second quarter 1997, immediately after its IPO which raised US$54 million[3]
Best use	Varied—from financing product development to expansion of a proven and profitable product or service.	Expansion: Bessemer Venture Partners, DCM, Emergence Capital Partners, and Softbank Capital jointly contributed US$20 million to Goodmail Systems' third round of funding. The purpose of this fund is to expand Goodmail's client base to include banks, as well as retailers currently restricting themselves to paper mail despite the proliferation of e-mail.[4]
		Development: U.S. Venture Partners, Benchmark Capital

(*continued*)

Table 1.1 Continued

Principle		Example
		and several other prominent angels together raised US$6.5 million for Nanosolar. The fund was used to develop its technology in providing affordable solar panels and establish key supplier, manufacturer, and distribution partnership.[5]
Cost and funds typically available	Expensive. Institutional venture capitalists demand significant equity in a business. The earlier the investment stage, the more equity is required to convince an institutional venture capitalist to invest. The range of funds typically available is US$500,000 to US$10 million.	Sequoia Capital was among YouTube's first funders, providing US$11.5 million in two rounds. It wound up owning approximately 30 percent of YouTube before it was sold to Google for US$1.65 billion in stock.[6]
Ease of acquisition	Difficult. Institutional venture capitalists are choosy. Compounding the degree of difficulty is the fact that institutional venture capital is an appropriate source of funding for a limited number of companies.	KPCB led a US$75 million investment in Silver Spring Networks which is a leading provider of Smart Grid Technology. This unique technology facilitates efficiency in electric consumption, thereby reducing carbon emissions. Apart from that, it enables consumers to monitor their consumption levels.[7] As observed, ``green technology'' is a market with very bright prospects, and this global market trend is not a mere fad. In fact, there is pressing need for such technologies. Venture funds are particularly interested in such initiatives; Markets in the growth stage and with the potential to expand globally.

Supply	Depends on these factors:[8] - Tax rates on capital gains - Health of public equity markets - Government policy, including regulatory restrictions	``An institutional investor will allocate 2 percent to 3 percent of their institutional portfolio for investment in alternative assets such as private equity or venture capital as part of their overall asset allocation. Currently, over 50 percent of investments in venture capital/ private equity comes from institutional public and private pension funds, with the balance coming from endowments, foundations, insurance companies, banks, individuals, and other entities who seek to diversify their portfolio with this investment class.''[9]

strategic marketing, and planning of the firms they choose. They are entrepreneurs first and financiers second.

Both organizations and individuals can be venture capitalists. In the early days of venture capital investment, in the 1950s and 1960s, individual venture investors were the norm. While individual investment did not totally disappear over the next few decades, the modern venture firm emerged as the dominant vehicle for this type of investment. Then the cycle began to turn again, and individuals became a potent and increasingly larger part of the early-stage start-up venture life cycle.

More commonly known as ''angel investors,'' individual VCs are especially inclined to mentor a company and provide needed capital and expertise to help it develop. Angel investors may either be high-net-worth individuals with management expertise or retired businessmen and businesswomen who seek the opportunity for firsthand business development.

Venture Capital as an Asset Class

Venture capital investing has grown from a small investment pool in the 1960s and early 1970s to a mainstream asset class that is a viable

and significant part of the institutional and corporate investment portfolio.

Professionally managed venture capital firms generally are private partnerships or closely held corporations funded by private and public pension funds, endowment funds, foundations, corporations, wealthy individuals, foreign investors, and the venture capitalists themselves. As a general rule, venture capital firms engage in the following practices:

- Investing for the long term, taking higher risks with the expectation of higher rewards
- Purchasing equity securities
- Adding value to the company through active participation

Venture capitalists mitigate the risk of venture investing by developing a portfolio of young companies in a single venture fund. Many times, they will co-invest with other professional venture capital firms. Pierre Hennes of Upstream Ventures adds that the job of a VC is to reduce risk over time, keeping in mind the capital risk. ''In the beginning, all risks are high. Building a company is heavily dependent on team in building revenue, markets, and products. A good team reduces the management risk. There is a technology risk. With a beta or a proof-of-concept, product risk is minimized. There is also market risk in that the market may not pick up product and also financial risk in that the venture may not be well-funded.''

Recently, some investors have been referring to venture investing and buyout investing as ''private equity investing.'' This term can be confusing because some in the investment industry use *private equity* to refer only to buyout fund investing. Strictly speaking, *private equity* refers to an asset class made up of investments that are not publicly traded. Venture capital is a broad subcategory of private equity that refers to equity investments typically made in young and emerging companies for the launch, early development, or expansion of a business.

Fund Partnership VC firms typically manage multiple funds formed over intervals of several years. Funds are illiquid, but as companies in the portfolio go public or are sold, the investors realize their returns. Funds typically consist of limited partnerships invested in a number of companies. VC firms generally regard the following breakdown of

returns as normal: a third of the investments they make will be complete losses, another third will be the ''living dead,'' and the remaining third will generate returns on the original investment substantial enough to make it all worthwhile. The big winners yield 10 times the original investment, or more.[10]

Investment Philosophy Venture capitalists mitigate the risk of venture investing by developing a portfolio of young companies in a single venture fund. Many times, they will co-invest with other professional venture capital firms. In addition, many venture partnerships will manage multiple funds simultaneously. For decades, venture capitalists have nurtured the growth of high-technology and entrepreneurial communities worldwide, resulting in significant job creation, economic growth, and international competitiveness. Digital Equipment Corporation, Baidu, Focus Media, Apple, Federal Express, Compaq, Sun Microsystems, Intel, Microsoft, and Genentech are just a few famous examples of companies that received venture capital early in their development.

Types of Venture Capital Firms

Most mainstream VC firms invest their capital through funds organized as limited partnerships (LPs) in which the venture capital firm serves as the general partner (GP). Venture firms may also be affiliates or subsidiaries of a commercial bank, investment bank, or insurance company and make investments on behalf of external investors or the parent firm's clients. Some firms may be subsidiaries of nonfinancial industrial corporations making investments on behalf of their parent. These latter firms are typically called ''direct investors'' or ''corporate venture investors.'' Many corporate venture investors are motivated by strategic reasons when injecting capital into investments. Corporate venture capital is often employed as a means to screen the surroundings for novel technologies that either form a threat or fit with the parent's primary business. Microsoft IP Ventures is an example of a corporate venture investor that licenses its technology to companies so as to cultivate innovation and accelerate product development. Other organizations may include government-affiliated investment programs that help start-up companies through programs organized at a variety of levels, from national to local.

Organizational Forms In the United States, the tax code has allowed the formation of either Limited Liability Partnerships (LLPs) or Limited Liability Companies (LLCs) as alternative forms of organization. However, the limited partnership is still the predominant organizational form. Preference for the LP structure may be due to the ''flow-through'' taxation position in most jurisdictions and limited liability of investors. The advantages and disadvantages of each involve liability, taxation issues, and management responsibility.

Fund Structuring Most venture capital firms organize their partnership as a *pooled fund*; that is, a group consisting of the general partner and the investors or limited partners. These pooled funds are typically organized as fixed-life partnerships, usually having a life of 10 years. Each fund is capitalized by commitments of capital from the limited partners. Once the partnership has reached its target size, it is closed to further investment from new investors or even existing investors. This is to create a fixed capital pool from which investments can be made. Venture Capital funds are highly illiquid. For example, 95 percent of venture funds are not liquidated for more than 10 years, and half last more than 15 years.

Fund Management Like a mutual fund company, a VC firm may have more than one fund in existence. It may raise another fund a few years after closing the first one so it can continue to invest in companies and to provide more opportunities for existing and new investors. It is not uncommon to see a successful firm raise six or seven funds consecutively over the span of a decade or so. Each fund is managed separately and has its own investors or limited partners and its own general partner. These funds may employ an investment strategy similar to that of other funds in the firm. However, a firm can launch a variety of funds with different areas of focus and different levels of diversification. The decision depends on the strategy and focus of the venture firm itself.

Management Fees As an investment manager, the general partner will typically charge a management fee to cover the costs of managing the committed capital. The management fee will usually be paid

quarterly for the life of the fund, but it may be tapered or curtailed in the later stages of a fund's life. A ballpark figure that general partners usually charge for management fees is around one to two percent of the fund's net profit. This is most often negotiated with investors upon formation of the fund and stated in the terms and conditions of the investment.

Carried Interest ''Carried interest'' is the term used to denote the profit split of proceeds to the general partner. This is the general partner's fee for carrying the management responsibility plus all the liability, and for providing the needed expertise to manage the investment successfully.

Generalist or Specialist? Venture capitalists may be generalist or specialist investors depending on their strategy. Generalists invest in various industry sectors, or various geographic locations, or several stages of a company's life. On the other hand, specialists prefer to focus on one or two industry sectors, or may seek to invest in only a limited geographic area. The degree of diversification of investments also differs. Some venture funds are broadly diversified; they invest in companies in industry sectors as diverse as semiconductors, software, retailing, and restaurants. Meanwhile, other firms choose to invest in only one technology—Silicon Valley, for example, attracts many such specialist investors that invest in high-growth technology-based start-ups.

Stage of Investment

Not all venture capitalists invest in start-ups. While venture firms will invest in companies that are in their initial start-up modes, venture capitalists will also invest in companies at various stages of the business life cycle. A venture capitalist may invest before a real product or company exists (so-called *seed investing*), or it may provide capital to start up a company in its first or second stages of development (known as *early-stage investing*). Also, the venture capitalist may provide needed financing to help a company grow beyond a critical mass to become more successful (*expansion-stage financing*). Some funds focus on later-stage investing by providing financing to help the company grow large enough to attract public financing

through an initial public offering (IPO). A notable case of a venture-backed stock offering is Baidu.com. It was named ''Best Exit of the Year'' in the China Venture Capital Ranking 2005, based on the success of its listing on NASDAQ. It was listed on August 5, 2005 with an offer price of US$25. It subsequently opened at US$66 and closed at US$122.54 per share. Alternatively, the venture capitalist may help the company attract a merger or acquisition with another company by providing liquidity and exit for the company's founders. At the other end of the spectrum, some venture funds specialize in the acquisition, turnaround, or recapitalization of public and private companies that represent favorable investment opportunities.[11] Table 1.2 traces the VC history of Focus Media, showing the impact of venture capital at various stages of its growth.

When Is VC Inappropriate?

Venture capital can be the answer to an entrepreneur's problems, but it is not always the ideal choice. The following sections spotlight some of the problems:

Too Early Stage Without real customers, revenue, or product, anything on your business plan will be merely assumptions. VCs tend to favor deals that offer more market traction. To get a sense of the type of business plan and type of market traction that VCs are looking for, please refer to http://wayofthevc-vbp.easyurl.net. At the same site, I have also provided a simple tool to generate a business plan for your type of business.

Small Market The economics should make sense. If the company cannot generate more than US$20 million in revenues, it probably does not have the scalability that VCs look for. As Kate Harnish and Tom Lister, authors of *Finding Money: The Small Business Guide to Financing*, note, ''Venture funded companies are expected to be able to grow to US$30, US$50 or even US$100 million in five to seven years. This means that the industry has to be big enough to support such growth. But many venture proposals fail to adequately convince investors of the market potential while others naively project that they'll capture 10%, 20% and even 50% market share in a very short period. When the entrepreneur is projecting potential market share,

Table 1.2 Funding Focus Media

Stage	Start-Up	Early Growth		Late Growth
Year	2003, 2004	2005	2006	2007—Present
Milestones	Source for advertising space in areas yet to be occupied. Source for clients. Source for advertising materials.	Expand existing advertising channels (mobile handset, cinema, Internet).	Continual expansion in advertising channels. Broaden coverage in as many cities as possible.	Growing market share, albeit not as fast as before. Financial performance in revenue and delivering consistent value to shareholders.
Financing structure and development stages	First received seed capital from Softbank China Venture Capital. However, Focus Media ('Focus') was operating at a net loss and urgently needed more capital. In December 2003, CDH Fund injected US$12 million. Revenue started growing in 2004, attracting investors such as Goldman Sachs Group Inc., venture-capital fund 3i Group and United China Investment Ltd., which together, provided US$30 million.	July 13: Announced IPO at NASDAQ. Issued 10,100,000 American Depositary Shares (ADSs), at US$17 per ADS.[12] October 16: Acquired 100 percent of equity stake in Framedia for US$39.6 million in cash and US$55.4 million in the form of new Focus Media common stock.[13]	January 27: Follow-on offering of 6,787,829 ADSs at $43.5 per ADS.[14] February 28: Acquired rival Target Media for US$7 million in new Focus common stock.[15] March 21: Acquired Dotad, a leading mobile handset advertising service provider in China.[16] June 16: Follow-on offering of 6,700,000 ADRs, at US$54.00 each.[17] August 31: Purchased 70 percent of the equity interest in ACL, which	2007: Two follow-on offerings (1) 6,655,700 ADRs, at US$79.50 per ADS. (2) 13,720,873 ADSs at US$64.75 per ADS. 2007: Acquired Allyes Information Technology Company Limited, the largest Internet advertising service company in China.[19] 2008: acquired CGEN Technology, a leading operator of an in-store digital advertising network.[20]

(continued)

Table 1.2 Continued

Stage	Start-Up	Early Growth		Late Growth
Year	2003, 2004	2005	2006	2007—Present
			leases screen time prior to the start of every movie.[18]	2008: Announce plans to repurchase up to US$100 million worth of its issued and outstanding ADRs over the next 12 months.[21]
Analysis of financing stages	Most start-ups will face this initial problem; capital intensive yet revenues do not reflect high returns. Typically loss-making.	At this stage, revenue growth is not considered a milestone yet as Focus was trying to gain a foothold in the industry. Following a very successful IPO, Focus Media could embark on expanding operations. Given how rivals can easily copy its business model, Focus had to expand its service offerings swiftly to outdo them. In addition, Focus engaged in long-term exclusive deals which forbade entry of rivals.	Expansion speed is key at this stage. Apart from increasing advertising channels, Focus had to cast its net wider to include tier two cities in China in order to maintain a lead. Therefore, in 2006, there were multiple offerings to raise funds quickly. Each capital injection gave Focus the capacity to upgrade the battle fought.	In 2007, Focus is still strong on expanding operations. But come 2008, where signs of credit turmoil surfaced, growth slowed down. Share price inevitably plunged, leading to a decision to repurchase its ADRs, which signals that current prices are undervalued. Considering that Focus is now unparalleled in scale of network, it believes that it can still compete effectively in this challenging time.

be mindful that Apple's personal computer market share is less than 9%, despite Apple's marketing prowess.''[22]

Businesses with the potential for long-term returns are more captivating. Contrary to the popular belief that VCs are more interested in quick returns, they usually are not dependent on short-term income (that is, three to six months); they tend to adopt a longer-term view, usually in the horizon of two to five years. ''VCs never pressurise you for quick profits if you are able to explain when you aim to get profits and the details of how you are working toward it,'' says Quentin Staes-Polet, founder of Kreeda Games India.[23] Hence, companies with the best prospects to create the largest long-term increase in shareholder value will stand out.

No Barriers to Entry If the venture requires speedy execution to have any chance of success, VC may not come online fast enough. The VC fundraising process requires a minimum of six months, and if the venture is a pure execution play, where anyone who moves right now can get in, someone else will probably do so. Venture capitalists prefer to support companies with stronger fences: proprietary products or services that allow them to enjoy a desirable ''unfair'' competitive advantage by virtue of the exclusivity of their products. Patents, trademarks, copyrights, exclusive distributorships, or other special rights may protect a company's unique position in the market. Sometimes, a nonprotected product or service with an exceptional head start on potential competition can fit these criteria, as well. The point is that the company must have some significant advantage over existing or potential competitors so it can achieve and maintain a dominant position in its industry.[24]

What Star VCs Do: Winning Techniques

Tim Draper, founder of DFJ, highlights that the most common mistake VCs make is not investing when they see passion. The best VCs apply three winning techniques:

- Follow the romance, not the finance.
- Build a company around the entrepreneur.
- Source for deals in a densely innovative geography.

WINNING TECHNIQUE #1: Follow the Romance, Not the Finance

VCs love to build great businesses. The ultimate joy of a VC is in helping and seeing entrepreneurs realize their dreams. Most of our interviewees share that their passion was in seeing companies grow. Andy Tang, managing partner of DFJ Dragon, says it is a privilege to be in the VC industry, adding that he feels privileged because he enjoys taking part in the entrepreneur's dream. At any given time, he has seven dreams, as every portfolio CEO he is helping has a dream. A VC who doesn't feel privileged, he adds, ''cannot endure the long journey of company formation with a CEO. In Silicon Valley especially, the passion of the entrepreneur is much greater than that of any other region. Passion is a powerful device—if you start a business purely based on passion, the impact is unimaginable.'' VCs look for entrepreneurs who love what they do and who are very good at doing it.

Bing Gordon, partner at Kleiner Perkins Caufield & Byers, who has been on the board of Amazon since 2003, agrees. ''I love mentoring highly motivated people, but I also like being accountable for results. VCs get to mentor, but also have line responsibility for investment outcomes. It is the best of both worlds. My biological clock was also ticking. At this stage of my life, the opportunity to work side by side with a nucleus of brilliant people was irresistible.''

WINNING TECHNIQUE #2: Build a Company Around the Entrepreneur

Soo Boon Koh, managing partner of iGlobe Ventures, explains, ''The venture capitalist is a mentor to the CEO of the portfolio company. This is analogous to a coach training an athlete. A VC is most effective when working with a coachable CEO. The challenge of a VC is take the vision of an entrepreneur team and to work with this team to build a global sustainable business.'' The journey to build a successful business is not straightforward. It will see up times and down times. The key is the passion, dedication, and perseverance of the team, and some stroke of good luck.

Returning to the kitchen, imagine a chef assigned the task of cooking dinner. There are two ways the task could be organized. The host might ask the chef to look through the cupboards for ingredients and utensils and cook a meal. Here, the chef has to imagine possible menus based on the given ingredients and utensils, select

one, and then prepare the meal. It starts with given ingredients and utensils, and focuses on preparing one of many possible desirable meals with them. Most venture capitalists adopt this approach—from the pool of companies that they see, they choose the best deals and invest, following which they assist the companies—with the wide range of outcomes discussed earlier.

Alternatively, the host might pick out a menu in advance and present it to the chef. All the chef needs to do is to list the ingredients and utensils needed, shop for any that aren't already on hand, and then cook the meal. It starts with a given menu and focuses on selecting between effective ways to prepare the meal. In the venture capital landscape, the best VCs choose their chefs—that is, they choose markets, choose the business model for it, and then assemble the team with a clear exit strategy in mind.

After first-round funding of US$10 million by Warburg Pincus, RDA Micro (led by CEO Vincent Tai) was on its way to grow into a leading global player in the IC design market. Particularly noteworthy was that Vincent Tai was scouted by Warburg Pincus before he'd generated a dollar of income or hired the first team member. Warburg Pincus saw the market opening: a vacuum in China's IC design market. It was not a difficult decision to occupy that vacuum. After deciding on the market, Warburg Pincus then found the CEO—Vincent Tai. It then assembled the team to complement him. Such was the confidence in Vincent and the market opportunity that Warburg Pincus took the lead in the investment.

Soo Boon Koh takes time to coach the teams in her portfolio companies. ''Team stability is of greatest importance. Changes and new challenges need to be absorbed as soon as possible. The VC intervenes quickly in the case of conflicts among portfolio team members and uses informal contacts to sense team morale and satisfaction.''

WINNING TECHNIQUE #3: Source for Deals in a Densely Innovative Geography

Innovation is not a unified phenomenon: some forms of innovation disrupt, destroy, and make obsolete established competence; others refine and improve it, and are incremental in their effects. Different kinds of innovation require different kinds of organizational environment and different managerial skills.[25]

Revolutionary innovation, applied to existing markets and customers, disrupts the industrial status quo and renders established technical and production competence obsolete. This mode of innovation is dominated by ''technology push'' and often follows on the heels of architectural innovation. Vacuum tubes, mechanical calculators, and the Disk Operating System (DOS) are examples of established technologies that have been overthrown through a revolutionary design.

Differences in the cross-border mobility of factors of innovation often determine the formation of disruptive companies. For example, Shanghai-based Focus Media, founded by ad veteran Jason Jiang in 2003, operates LCD screens displaying ads in elevator lobbies of office towers and upscale apartment blocks. In July 2005, the firm raised about US$120 million with a NASDAQ listing, turning Jiang into one of the richest men in China when he was in his early 30s.[26] Focus Media has established itself as an advertising powerhouse by recognizing that innovation generates profits. The company conveys clients' messages by way of 200,000 flat panel TVs. It also operates an advertising network for the Chinese mobile telecommunications market and recently acquired China's largest Internet advertising agency. Clients include Coca-Cola (KO), Yum! Brands (YUM), and Procter & Gamble (PG).[27]

What Focus Media accomplished was not via ground-breaking technology but an innovative business model. Among the innovations by Jiang are ones introduced to bring down the costs. Focus Media employees pedal their bikes to buildings to manually change flash memory cards containing ad videos, thus ensuring a very low-cost ad delivery that advertisers find appetizing. Focus Media's success stems largely from the fact that people don't mind staring at LCD screens to while away their time in the elevator.[28]

Scientific discoveries travel across national borders much more easily than context-specific know-how and marketing practices. Focus Media was the application of a scientific technology (LCD screen) in the context and local marketing practice of Asia (mass growth of commercial buildings in Asia). In these instances, the original developers capture a low share of the value of innovations vis-à-vis the agents who have applied the development locally. The growth of this ''untraded'' services sector has sparked excitement on the latent opportunities, which have at least partially offset the more intensive trading of goods.

Finding Innovation Innovation in a geography can be difficult to measure directly, but a number of measures can serve as proxies for it:

1. *Patents*. While copyright only protects the expression of an idea, patents protect the idea itself, with a set of exclusive rights granted by a state to an inventor or assignee for a limited period of time in exchange for a disclosure of an invention. Although patent offices in Asia are generally reliable, many Asian technology firms actually file their patents in the United States due to the territorial nature of patents. (Many Asian firms want to enter the U.S. market, hence they end up filing their first patents in the U.S. Patent Office.)

2. *Ownership*. VCs will shift out of places where there is a decline in sense of ownership, to places where the idea of ownership with active leadership is thriving.

3. *Scientific publications*. The best way to find out if something has been accepted by the scientific community is through peer-reviewed publications. John Doerr, a partner at Kleiner Perkins, worked at this exhaustively, subscribing to thousands of dollars' worth of technical publications, all of which he dutifully read.[29] Outside of the peer review system, it becomes difficult to assess whether scientific discoveries are really up to accepted standards. These are not perfect measures—for example, Hwang Woo-suk's cloning paper, which *Science* published in 2004, sparked a growing controversy over the rigor of peer-reviewed journals like *Science*, *Nature*, and a host of lesser-known peer-reviewed publications. Nonetheless, such publications do reduce the chance of reporting something that has not been accepted as fact.

4. *Migration of scientists*. There is an increasing trend in the reverse migration of Asians trained in U.S. universities, particularly back to China and India. China's state media reported in January 2008 that China is setting up science research and development centers to convince the 200,000 Chinese studying abroad to return home. This is a manifestation of the *bandwagon effect* (where people have the tendency to do something because many people around them do the same thing); more important, it reflects an increasing awareness by overseas scholars and researchers of the opportunities in Asia.

5. *Cutting-edge design hubs*. Design and service innovation have become buzzwords and core themes in innovation. Designers of Web sites and consumer electronics are the global economy's translators of experimental technologies, ranging from software code to

earth-friendly plastics, into goods and services. Cities and corporations are paying attention to design as a gambit to attract the world's top innovators. The New York Museum of Modern Art, in a bid to help corporations unearth fresh development talent, assembled 200 projects by international designers and exhibited these designs to CEOs. The show includes displays on nanotechnology, data visualization (interactive graphs of statistics such as Web site traffic), and low-cost computers for developing nations. The designs are also showcased on platforms such as the World Economic Forum in Davos.

East versus West Overcoming the bandwagon effect is essential to top returns for a VC. Top VCs take calculated risks to venture into unexplored frontiers before their contemporaries. Bobby Chao, founding managing director of DFJ Dragon, says,

> The VCs entered China and made the best returns on their investments when China was not all that solid and open for foreign investors. The VCs entered Google and Baidu when all the odds did not suggest that they made the right decisions. The definition of VC is to venture out ahead of the mainstream investors. While everyone went to Boston and New York, the ones who went to Silicon Valley ventured well. While everyone went to Silicon Valley, the ones who went to Shanghai and Beijing ventured well. While everyone is going to Beijing and Shanghai, the ones who are going to Chengdu, Xi'an, and Inner Mongolia will venture well. It doesn't mean that there is no gold left for New York, Silicon Valley, Shanghai, Beijing, and other places in the world. There are plenty of opportunities for late-stage investments, buyouts, and M&As. In my opinion, the contrast is more like the real VC creates the pie and enlarges it while the other kind of investors mostly rearrange the size of slices of the pie.

Chao's colleague Andy Tang (another managing director at DFJ Dragon) recalls that in January 2005 he was a principal at Infineon, the corporate venture arm of a German semiconductor firm, when the parent company decided to sell its venture portfolio to Cipio Partners. Tang decided to move to China because as a hardware investor, he saw a lot of CEOs coming back to China, and he thought that if customers were moving there, he needed to follow them.

VCs who explore new frontiers have to be realistic and patient. Andy Tang believes that the Silicon Valley model cannot be wholly replicated. ''I am not sure whether China (or any parts of Asia) can replicate the SV model. SV is unique (in terms of its academic culture). It has not been replicated anywhere else. Israel, which has come the closest, still has some way to go. I think the culture is impossible to replicate. The level of innovation and disruptive flow is unparalleled. China has shown some early signs of success. China is successful in other ways. Chinese entrepreneurs have come up with interesting business models and technology which is unique to China and can possibly be extended past China.'' A lot of ideas in SV are replicated in China. SV copies China too, but the balance of exchange is not equal. China is not as fast as SV and there is still a long way to go in terms of the levels of tech and entrepreneurial spirit.

However, in a downturn, there is a real opportunity for VCs in the emerging geographies (such as China) to step into the limelight like their Western counterparts. Entrepreneurs will be less ambitious about looking for VCs in Sand Hill Road (the center of venture capital in Silicon Valley) and start looking for local money. It is likely to open the door for local venture capital. For example, Chinese RMB-denominated funds are likely to get superior pricing and a real boost to their profile. Robert Zhou, managing director of Northern Light, explains that China, as an emerging market, is different from the mature venture capital hotbeds. The VCs in China invest not only in the traditional VC-invested industries such as technology but also in traditional industries such as consumer products, retail, and professional services. Thus, on one hand, the average return on investment will be more modest than the typical VC return on investment. But on the other hand, the investment landscape is more stable. Consequently, VCs will not experience a major slowdown in China due to economic fluctuation

What Entrepreneurs Should Do: Commandments to Follow

Wise entrepreneurs abide by the following principles:

- Weigh the costs and benefits of venture capital.
- Remember that the right sector attracts the dollars.

- Be disruptively innovative.
- Position yourself in an intersection of markets and technology.
- Employ weapons of influence.

COMMANDMENT #1: Weigh the Costs and Benefits of Venture Capital

Finding the right VC can seed the ultimate success of the enterprise.[30] Companies that are funded by more experienced VC firms are more likely to succeed.[31] Top-quartile VC firms are better in identifying high-quality companies and entrepreneurs—these top-quartile VCs could actually add more value to the companies—by helping new ventures make customer contacts, fill key management positions, or set business strategy.

However, 99 percent of start-ups do not require venture capital. Similarly, VCs are very selective in the type of businesses that they look for—large market prospects, scalability, and capital efficiency. As a rule of thumb, a business should offer the prospect of significant turnover growth within five years before it is of interest to a venture capital firm.[32] Not all businesses are suitable for VCs. Some successful businesses may not fit this definition although they are profitable and generate healthy cash flows. ''Many small companies are lifestyle businesses whose main purpose is to provide a good standard of living and job satisfaction for their owners. These businesses are not generally suitable for venture capital investment, as they are unlikely to provide high financial returns for investors.''[33] VCs invest in companies with a threshold valuation because of the fund size they manage. They would rather focus both their expertise and funds on a few large portfolio companies than on many small companies.

Companies with a significant research and development component often seek venture capital funds, especially for sectors such as semiconductors, biotech, and data-communication equipment. In the United States, there were disproportionately more venture deals in heavy R&D industries like semiconductors and biotech than other sectors.[34] The only exceptional sector with low initial capital expenditure drawing VC funds is the software industry, which has seen more VC deals than any industry to date. In the fourth quarter of 2008 in the United States, there were 194 reported software deals, 109 biotech deals, 36 semiconductor deals, and only 4 retail deals.[35] Figure 1.2 traces this history.

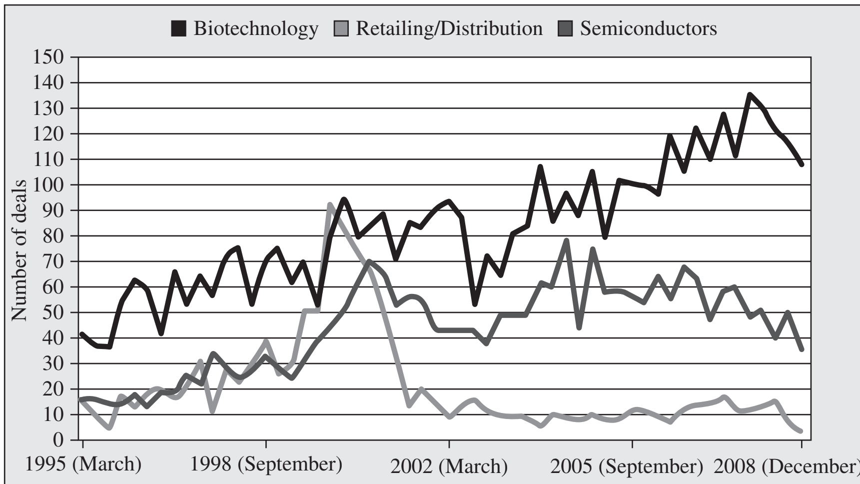

Figure 1.2 VC Deals in Various Fields

A start-up entrepreneur should also stop to think whether the current venture is a large opportunity requiring significant working capital. Reva Electric Car Company, for example, received US$20 million funding in late 2006 from Global Environment Fund (GEF) and Draper Fisher Jurvetson (DFJ). Reva had sought venture investment to increase its working capital for immediate expansion of production to enter international markets; it needed to expand the production capacity of its plant in Bangalore from 6,000 vehicles a year to 30,000, to enhance its global presence. At the time of writing, 1,800 Reva cars were on the road, and 600 of them were in the United Kingdom. Other than venture capital, Reva considered options such as debt financing, factoring, and organic growth bootstrapping. This choice boils down time horizons: an entrepreneur who chooses to grow big fast (thereby capitalizing on a narrow window of opportunity) rather than pursue long-term, organic growth needs capital on a scale only a VC is likely to supply.

It is often very difficult for a start-up with negative cash flows to obtain funds from bank loans as the prerequisite track record simply isn't there. As one wise VC told me, ''Banks look at the past

records of a company, venture capitalists assess the future potential.'' Entrepreneurs often try to borrow from families and friends, who are apt to ask less searching questions but are unable to supply funds in the quantities needed, and they can also opt to bootstrap, starting small and tapping the increasing cash flows to finance the operations. This is common in the service industry but impractical for businesses that require large capital investments, especially in the technology industry.

Despite its obvious advantages, however, it is also essential to weigh the cost of venture capital. One significant cost is dilution of founder stock. The average founder who seeks funding from a VC owns less than 10 percent of the business upon exit. Fred Wilson of Union Square Venture comments that founders who go all the way through the process of building a lasting and sustainable profitable business (as opposed to an early exit) will generally suffer the most dilution. In his experience, it will generally take three to four rounds of equity capital to finance the business, and 20–25 percent of the company to recruit and retain a management team. That will typically leave the founder or the founding team with 10–20 percent of the business when all is said and done. The final equity split will typically be 20–25 percent for the management team, 20 percent for the founders, and 55–60 percent for the investors (ranging from the original angel all the way to late-stage VC). Founders who opt for a ''quick flip'' or any form of early exit (to me, *early* means any time before the company becomes sustainable and profitable) can see much less dilution. For example, Joshua Schachter owned more than 50 percent of Delicious when Yahoo bought it. The four founders of FeedBurner owned more than 25 percent of the company when it was sold to Google. Those exits are generally for less money so the trade-off is more ownership times less total value, but sometimes the early sale is advantageous—especially if the entrepreneur has the next project in mind. This explains why early exits continue to be part of the venture capital landscape.[36]

It's worth bearing in mind that the founder might not always retain any practical control of the company. A partnership with a VC is analogous to a marriage. In the event of a divorce, the founder may not always get to keep the company—custody of children is not guaranteed to one spouse or the other in a divorce.

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CASE STUDY: ''The dream wasn't supposed to end like this.''

One entrepreneur we interviewed founded an engineering solution company in Boston Harbor. Three years later, she had to seek financing for the launch of a new product, and with limited options, she returned to her original VCs. The firm offered a loan secured with the rights to two patents, her most valuable assets. Rather than close the company, the entrepreneur took the money despite the onerous conditions. Her control of the struggling engineering solution firm was quickly ebbing. With sales dead in the water, the VC—which owned 75 percent of the company's shares—ousted the entrepreneur and, in early 1995, made its newly hired vice president for sales and marketing the CEO. Today, the company is little more than a shell. And the entrepreneur has turned warrior, suing her former partner for breach of fiduciary duty. In court papers, the VC countered that it replaced the CEO only after she had ``four years to prove herself and failed to sell a single system.''[37]

COMMANDMENT #2: Remember That the Right Sector Attracts the Dollars

Most believe that VCs invest in good people and ideas.[38] The reality is that VCs invest in good industries—industries that are more competitively forgiving than the market as a whole. In the 1980s, more than 20 percent of venture capital in the United States went into energy industries. In 1999, at the height of the dot-com boom, about 60 percent of venture capital disbursements in the United States went to information-technology industries, especially communications, networking, software, and information services. About 10 percent went to life sciences and medical companies, while the rest was spread over the other industries. In 2008, the industry saw a much higher proportion going to renewable energy despite a global recession, with US$2.8 billion of investments made globally in the third quarter of 2008, according to the PricewaterhouseCoopers Money Tree Survey. This is a familiar winning technique among our star investors. Peter Lim, one of Singapore's leading angel

investors, looks at prospective sectors and invests heavily where he sees long-term growth potential. His most successful investments include Wilmar, an agribusiness group that is today among the largest listed companies by market capitalization on the Singapore Exchange. He advises, ''You may not have a lot of money, but you have a lot of time.'' Sumir Chadha, managing director of Sequoia Capital India, adds that entrepreneurs need to ask themselves if they are in a capital-efficient sector with a ''significantly large market opportunity.''

While high-technology investment makes up most of the venture investing in the United States, and the venture industry gets a lot of attention for its high-technology investments, venture capitalists also invest in other niches, such as retail company investment, ''socially responsible'' start-up endeavors, or fields such as construction, industrial products, and business services. One such company was Sahajanand Laser Technology Limited, one of the largest manufacturers of laser systems for diamond industry in India. It received Rs. 40 million (approximately US$8 million) in late 2007 from Gujarat Venture Finance Limited (GVFL), a fund started by Gujarat Industrial and Investment Corporation (GIIC) at the initiative of the World Bank. ''Picking up innovative technology companies early and nurturing them to leadership is GVFL's forte.'' With India emerging as ''the global destination for diamond cutting and adding value to small and very small diamond 'roughs,' Sahajanand has the potential to become a definite winner with GVFL's effective nurturing and constant support,'' says Vishnu Varshney, CEO of GVFL Ltd.[39] The common denominator in these types of venture investing is that the venture capitalist is typically not a passive investor but someone who takes an active and vested interest in guiding, leading, and growing the company (and thereby increasing the probability of a successful exit). These VCs seek to add value through their sectoral experience.

COMMANDMENT #3: Be Disruptively Innovative

Breakthrough innovations tend to be disproportionately developed and brought to market by individuals or new firms (even though the ideas behind the breakthroughs originate in larger firms or universities that do not exploit them because of their bureaucratic structures). Research suggests that entrepreneurial action occurs

with firms whose organizational structures are not bureaucratic and rigid. The potential for stimulating breakthroughs is greatest among individuals who have prior experience in relevant technologies and insight about fresh roles for existing inventions and technologies, and who have the energy and means to act on their insight. For these reasons, smaller, younger firms produce substantially more innovations per employee than larger, more established ones. Look at your business model: if you have underlying core technology that can change the market complexion, you will be more attractive to VCs than of you're starting a me-too company.

Clayton Christenson, a renowned professor at Harvard Business School and founder of Innosight Ventures, argues that VCs look for disruptive innovation, not sustainable innovation. A VC employs several litmus tests to assess disruptive business. If a technology enables the larger population of less skilled and less wealthy people to do something that historically they could not do or that only specialists could do, it fits the mold of a disruptive business. This is especially so if the business model appears unattractive to the established players, and clearly isn't a sustaining technology to anyone else. For these businesses, the right strategy is unknowable in advance and disruptive ventures should realize that they should put in place a strategy to learn, rather than a strategy to implement.

Tim Draper of Draper Fisher Jurvetson adds, ''VC makes money because large companies don't have all the answers. In fact, most large companies are risk averse, which allows small companies to jump in and try new things. I also believe that the entrepreneurs and the teams they build have more energy and put more effort into their jobs than employees of big companies. So more value is created there.''

COMMANDMENT #4: Position Yourself in an Intersection of Markets and Technology

What are star venture capitalists and angel investors looking for? The collision of a technology and a market. Ron Conway, a legendary investor in some of Silicon Valley's most successful companies, including Google, looks for convergence of two apparently separate markets. For example, new online video is the convergence between wireless mobile devices and Internet video. Live content being posted by a mobile phone to Internet can serve

extremely relevant ads, which in turn allows the content provider to monetize traffic.

Another convergence of two markets is bioinformatics. The massive knowledge base of genetic information needed major computational tools to decipher the underlying meaning. An exciting field of bioinformatics is thus born at this intersection. The science of genomics is intricately intertwined with robotic applications. Cell biology now relies heavily on imaging techniques, and biologists cannot live a day without their innumerable laser-based applications. Attractive themes can also boil down to structural change.[40] Possible changes suggested by DFJ Gotham Ventures include the decline of the firm and the rise of one-to-one commerce, the merging of cyberspace and real space, cloud computing, and the generational shift. The *generational shift* is defined as the difference between people who dated before they had their first computer and those who had their first computer before they started dating. Thatcher Bell, a partner at DFJ Gotham, thinks we still have a long way to go in terms of making the Web easy to use. For instance, Bell compares Google's current interface to the C: prompt days of the PC before Windows. According to Bell, this is a really good way for a search engine to get input from a human and for Google to make money. It is not the best way for a human to interact with a computer. He argues that more intuitive Web and search interfaces, like SearchMe, are needed.

In all such cases, sparks of innovation took place when the participating disciplines were ripe with their respective developments. Intersections thus do not represent forced marriages between disciplines but are natural outcomes when they come of age.

COMMANDMENT #5: Employ Weapons of Influence

VCs are typically busy executives, yet much of what they do for a living is sit through presentations—lots of them. The following weapons of influence could tip the scales in the entrepreneurs' favor.[41]

- Social Proof: ''We're meeting DFJ next week, and we previously raised US$44M from Sequoia and others.'' People tend to be followers. Use testimonials, the more similar to the people you are trying to persuade the better. Likewise, draw upon people who are seen as having expertise or authority.

- Authority: ''Ron Conway is an angel for us.'' ''Our CFO has also worked in [a major VC firm].'' ''I was introduced to your partner by [someone the prospective VC knows and respects].'' Build legitimacy and seem like an expert on the topic at hand. This can mean past experience, credentials, or perceived knowledge. Try to establish this early in the persuasion process to keep people listening to you. People will tend to obey authority figures, even when asked to do something they would normally resist.
- Scarcity: ''There's only room for one investor in this round.'' People want more of what they can get less of. Show why your product or service is unique and scarce and people will want it.
- Desirability: ''We had a great time pitching to you.'' Get people to like you and you are more likely to persuade them successfully. People are easily persuaded by other people they like—and they tend to like people who like them.

Pitfalls to Avoid

The road to acquiring venture capital support is not always smooth. Watch out for the following common pitfalls:

- Believing the herd is always right
- Overconfidence
- Concealing skeletons in the closet

PITFALL #1: Believing the Herd Is Always Right

The common gripe among entrepreneurs is that if one big-name VC firm funds a particular sector, the others follow. VCs either all fund something or none of them will. Therefore, an entrepreneur who has an idea that's too new and too different will face a serious struggle for funding.

There is a certain truth in that. According to Eric Tao, vice president of Keytone Ventures and formerly an associate at KPCB China, bubbles do tend to swell in certain sectors. For example, as of 2008, the Internet and mobile space in China includes no companies that are undervalued. However, there are verticals such as solar and retail chains, wireless communications, and wireless

applications where ventures are currently doing well and still exhibit potential growth.

PITFALL #2: Overconfidence

As an entrepreneur, it is important to exhibit confidence in your company. However, overconfidence has downside repercussions. Note that three attitudes, anti-authority (''Don't tell me''), invulnerability (''It won't happen to me''), and macho (''I can do it''), were identified by the U.S. Federal Aviation Administration as hazardous to pilot decision making.[42] These same attitudes also affect an entrepreneur's chances of success. Overly optimistic projections may ruin an entrepreneur's credibility. Investors rely on credible financial projections, not expectations. Unless your assumptions on future earnings are backed up by credible sources, do not bring them up. It's better to present realistic figures that can be achieved by the business.

PITFALL #3: Concealing Skeletons in the Closet

All investors understand that businesses have problems. Attempting to avoid mentioning them will be futile. As Rick Segal, member of the BlackBerry Partners Fund, explains, ''We're going to find out. We do background checks and real/paid reference reviews. We will know about jail time, know about bankruptcy, know you got fired despite the 'pursue other options' nonsense, so fess up.''[43] This may sound intimidating but it reflects reality. As an entrepreneur, never try to provide incomplete financial information. Entrepreneurs ought to present both past and projected financial data, including balance sheets and income and cash flow statements to VCs. Relevant historical financial data will help give meaning and context, and will lend credibility to future projections. Be honest and clear about how you will manage each problem and solve it in the future. Owning up to past and existing problems is better than hiding them—just present a solution your investors will understand.[44] The key here is to communicate well.

Post-investment, entrepreneurs need to spend conservatively and control overhead. Make sure venture partners stay informed of progress—or glitches. Think early on about bringing in professional managers, or recognize that the venture firm may do that for you.

When seeking new sources of capital, it is important to alert venture partners early if the company requires more financing, and prepare to see your ownership stake cut. To minimize dilution, seek stock options or a performance-based compensation plan.

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